

Whenever your mother ask you to go to the nearby grocery store to buy items of daily use like match box, candle stick, soap cake, coffee, spices etc. you need not pay for these items immediately. When you buy these items, the store owner immediately opens the page of note book on which your father's name is written. He records the value of items purchased. At the end of the month, your father goes to him. He again opens the same page tells the total amount to be paid and records when your father makes the payment .In a similar manner, he keep the records of other customers also. Whenever he gets the commodities from suppliers he records the same and also records the payment he makes to them. Similarly, every business small or big, sole propriertor or a firm keeps the record of the business transactions. Have you ever thought why do they keep record of business transactions? If they do not keep the record how will they know how much, when and to whom they have to make payments or from whom, how much and when they have to receive payments or what they have earned after a particular period and so on. Recording of transactions by a business man in proper books and in a systematic manner is known as accounting. In this lesson you will learn about this in detail.

OBJECTIVES

After studying this lesson you will be able to :

- explain the meaning of book-keeping and accounting
- explain the advantages & limitations of accounting;
- state the functions and objectives of financial accounting;
- explain various accounting terms.
- understand the accounting concepts, conventions, accounting standards and GAAP (Generally Accepted Accounting Principles)

1.1 BOOK KEEPING AND ACCOUNTING

A business undertakes number of transactions. Can you estimate the number of transactions a business undertakes? It depends upon the size of a business entity. Every day business transactions may be around hundreds or thousands. Can a businessman remember all these transactions in every respect? Not at all. So it becomes necessary to record

these business transactions in detail and systematic manner. Recording of business transactions in a systematic manner in the books of accounts is called book-keeping. Book-keeping is concerned with recording of financial data. This may be defined as

“The art of keeping a permanent record of business transactions is book-keeping”.

From books of accounts important details such as total sales, total purchases, total cash receipts and total payments, etc. may be ascertained. As you know the main objective of business is to earn profits. In order to ascertain the profit earned during the period, mere recording of business transactions is not enough. Accounting involves not only book keeping but also many other activities. In 1941, the American Institute of Certified Public Accountants (AICPA) defined accounting as

“The art of recording, classifying, summarizing, analyzing and interpreting the business transactions systematically and communicating business results to interested users in accounting”.

Accounting is defined as a system of recording of business transactions that create economic information about business enterprises to facilitate decision making. The function of accounting is to provide quantitative information, primarily financial in nature, about economic entities, that is intended to be useful in making economic decisions.

The American Accounting Association defined accounting as:

“It is the process of identifying, measuring, recording and communicating the required information relating to the economic events of an organization to the interested users of such information.”

In order to appreciate the nature of accounting it is necessary to understand the following relevant aspects of the definition of accounting:

- **Economic events :** It is the occurring of the consequence to a business organization which consists of transactions that are measurable in monetary terms. Purchase of machinery, installing and keeping it ready for manufacturing is an economic event which consists of a number of financial transactions. These transactions are (a) buying the machine, (b) transporting the same, (c) preparing the site for its installation and (d) incurring expenditure on installing the same.
- **Identification, Measurement, Recording and Communication :** Identifying implies determining what transactions are to be recorded i.e. items of financial transactions are to be recorded for example goods purchased for cashier on credit will be recorded. Items of non –financial character such as a changes in managerial policies, etc. are not recorded in the books of accounts.

Measurement means quantification of business conception into financial terms by using monetary unit. If an event cannot be quantified in monetary terms it is not considered fit for recording in the books of the firm. That way important items like appointment, signing of contracts, etc. are not shown in the books of accounts.

Recording having identified and measured the economic events in financial terms, these are recorded in the books of accounts in monetary terms date wise. The recording of the business transactions is done in such a manner that the necessary financial information is summarized according to well established accounting practices.

Communication : The economic events are identified, measured and recorded in such a manner that the necessary relevant information is generate and communicated in a certain from to the management and other internal and external users of information. The financial information is regularly communicated through accounting reports.

- **Organisation :** refers to a business enterprise whether for profit or not for profit motive.
- **Interest users of information :** Many users need financial information to make important decisions. These users can be investors, creditors, labour unions, trade associations, etc.

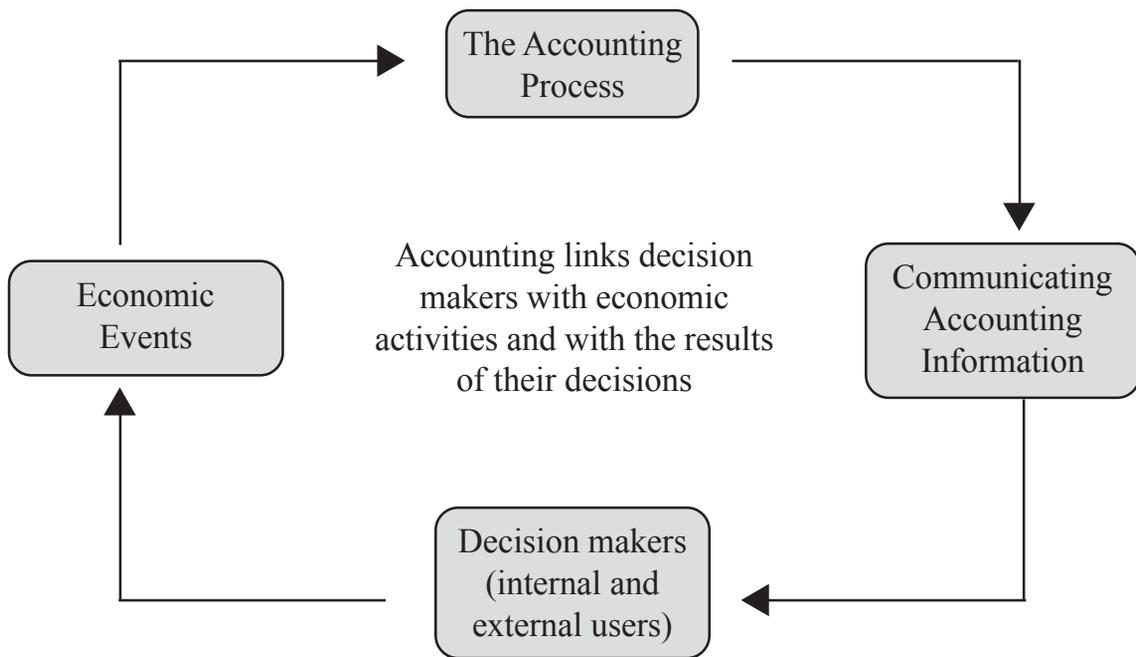
Evolution of Accounting

As per Indian mythology Chitra Gupta is responsible for maintaining accounting in God's Court.

A book on Arthashashtra written by Kautilya who was a minister in Chandra Gupta's kingdom twenty three centuries ago mentions about the accounting practices in India. It describes how accounting records have to be maintained. In china and in Egypt accounting was used for maintaining revenue records of the government treasury.

A book on Arithmetica Geometrica. Proportion at Proportionality (Review of Arithmetic and Geometric proportion) by an Italian Luca Pacioli is considered as the first authentic book on double entry book keeping. In his book he used the present day popular terms of accounting Debit (Dr.) and Credit (Cr). He also discussed the details of memorandum, journal, ledger and specialised accounting procedures. He also state that, "all entries have to be double entries, i.e. if you make one creditor you must make some debtor.)

Aounting can be summaraized as



Accounting Process

Difference between Book-keeping and Accounting : Book-keeping and Accounting can be differentiated on the basis of nature, objective, function, basis, level of knowledge, etc.

Difference between Book keeping and Accounting

Basis of Difference	Book-keeping	Accounting
Objective	It is to maintain systematic records of financial transactions.	It aims at ascertaining business income and financial position by maintaining records of business transactions.
Functions	It is to recorded business transactions. So its scope is limited.	It is the recording, classifying, interpreting business transactions and communicating the results thus its is scope is quite wide.
Basis	Vouchers and other supporting documents are necessary as evidence to record the business transactions.	Book-keeping works as the basis for accounting information.

Level of Knowledge	It is enough to have elementary knowledge of accounting to do book-keeping.	For accounting, advanced and in depth knowledge and understanding is required.
Relation	Book-keeping is the first step to accounting.	Accounting begins where book-keeping ends.

1.2 BRANCHES AND OBJECTIVES OF ACCOUNTING

1.2.1 BRANCHES OF ACCOUNTING

The changing requirements of the business over the centuries have given rise to specialised branches of accounting and these are:

Financial Accounting

It is concerned with recording the transactions of financial character, summarizing and interpreting them and communicating the results to the users. It ascertains profit earned or loss incurred during a period (usually one year as accounting year) and the financial position as on the date when the accounting period ends. It can provide financial information required by the management and other parties. The word accounting and financial accounting are used interchangeably. At present we are concerned with financial accounting only.

Cost Accounting

It analyses 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

It is concerned with generating of information relating to funds, cost and profits etc. This enables the management in decision making. Basically, it is meant to assist the management in taking rational policy decisions and to evaluate the impact of its decisions and actions and the performance of various departments.

Tax Accounting

This branch of accounting has grown in response to the difficult tax laws such as relating to income tax, GST etc. An accountant is required to be fully aware of various tax legislations.

Social Accounting

This branch of accounting is also known as social reporting or social responsibility accounting. It discloses the social benefits created and the costs incurred by the enterprise. Social benefits include such facilities as medical, housing, education, canteen, provident

fund and so on while the social costs may include such matters as exploitation of employees, industrial interest, environment pollution, unreasonable terminations, social evils resulting from setting up industries etc.

1.2.2 Objectives and Functions of Financial Accounting

The main objectives of financial accounting are as under:

Finding out Various Balances

Systematic recording of business transactions provides vital information about various balances like cash balance, bank balance, etc.

Providing Knowledge of transactions

Systematic maintenance of books provides the detail of every transactions.

Ascertaining Net Profit or Loss

Summarisation in form of Profit and Loss Account provides business income over a period of time.

Depicting Financial Position

Balance sheet is prepared to depict financial position of business means what the business owns and what it owes to others.

Information to All Interested Users

After analysis and interpretation, business performance and position are communicated to the interested users.

Fulfilling Legal Obligations

Vital accounting information helps in fulfilling legal obligations e.g. GST, income tax etc.

1.2.3 Functions of Accounting

The function of accounting is to provide quantitative information primarily financial in nature about economic entities, which is intended to be useful in making economic decisions. Financial accounting performs the following major functions:

Maintaining Systematic Records

Business transactions are properly recorded, classified under appropriate accounts and summarized into financial statements.

Communicating the Financial results

It is used to communicate financial information in respect of net profit (or loss), assets, liabilities etc. to the interested parties.

Meeting Legal Requirements

The provisions of various Laws such as Companies Act, 2013 Income Tax and GST Acts, require the submission of various statements i.e. Annual accounts, Income Tax returns, Returns for GST etc.

Fixing responsibility

It helps in computing of profits of different departments of an enterprise. This facilitates the fixing of the responsibility of departmental heads.

Decision Making

It provides the users the relevant data to enable them make appropriate decisions in respect of investment in the capital of the business enterprise or to supply goods on credit or lend money etc.

1.2.4 Advantages of Accounting

1. **Financial Information about Business:** Financial performance during the accounting period, i.e., profit or loss and also the financial position at the end of the accounting period is known through accounting.
2. **Assistance of Management:** The management makes business plans, takes decision and exercise control on affairs on the basis of accounting information.
3. **Replace Memory:** A systematic and timely recording of transactions obviates the necessity to remember the transactions. The accounting record provides this necessary information.
4. **Facilitates Comparative Study:** A systematic record enables a businessman to compare one year's results with those of other years and locate significant factors leading to the change, if any.
5. **Facilitates Settlement of tax Liabilities:** A systematic accounting record immensely helps settlement of income tax and GST liabilities since it is a good evidence of the correctness of transactions.
6. **Facilitates Loans:** Loan is granted by banks and financial institutions on the basis of growth potential which is supported by the performance. Accounting makes available the information with respect to performance.
7. **Evidence in Court:** Systematic record of transactions is often accepted by the courts as good evidence.
8. **Facilitates Sale of Business:** If someone desires to sell his business, the accounts maintained by him will enabled to ascertainment of the proper purchase price.
9. **Assistance in the Event of Insolvency:** Insolvency proceedings involve explaining many transactions that have taken place in the past. Systematic accounting records assist a great deal in such a situation.

10. Helpful Partnership Accounts: At the time of admission of a partner, retirement or death of a partner and dissolution of a firm, accounting records are of vital importance and use. It is so because such records provides the basis to reach a settlement.

1.2.5 Limitations of Accounting

1. **Accounting information is expressed in terms of Money:** Non-monetary events or transactions are completely omitted.
2. **Fixed assets are recorded in the accounting records at the original cost :** Actual amount spent on the assets like building, machinery, plus all incidental charges is recorded. In this way the effect of rise in prices is not taken into consideration. As a result the Balance Sheet does not represent the true financial position of the business.
3. **Accounting information is sometimes based on estimates :** Estimates are often inaccurate. For example, it is not possible to predict the actual life of an asset for the purpose of depreciation.
4. **Accounting information cannot be used as the only test of managerial performance of the basis of mere profits :** Profit for a period of one year can readily be manipulated by ommitting certain expenses such as advertisement, research and development etc i.e. window dressing is possible.
5. **Accounting information is not neutral or unbiased:** Accountants ascertain income as excess of revenue over expenses. But they consider selected revenue and expenses for calculating profit of the concern. They also do not include cost of such items as water, noise or air pollution i.e. social cost, they may also use different methods of valuation of stock or depreciations.

1.3 Accounting as an Information System and its Users.

In 1970, the Accounting Principles Board of The American Institute of certified Public Accountants (AICPA) emphasized that the function of accounting is to provide quantitative information, primarily financial in nature, about economic entities, that is intended to be useful in making economic decisions. Accounting is often called the “**Language of Business**”. It is the common language used to communicate financial information to individuals, organisations, government agencies about various aspects of business such as financial position, operating results (i.e. Profit or Loss) and cash flows. **Users**, both inside and outside the business, have to make decisions concerning the allocation of limited economic resources. In order to ensure that resources are allocated in an efficient and effective manner, **users require financial information** for the purpose of making decisions. Accounting provides information that is useful in making business and economic decisions. It is the primary means of communicating financial information to owners, lenders, managers. Government and its regulatory agencies and others who

have interest in an enterprise. It helps the users in taking better decisions by providing relevant, reliable and timely information on the financial and operational position of an enterprise.

It is observed that almost all business enterprises maintain detailed accounting records. Even the most intelligent manager with a sharp memory would find it difficult to remember the daily transactions simply by observing them. So he/she must rely upon the accounting process which begins with the recording of business transactions and ends up with the preparation of summarized financial statements. Thus, Accounting as an information system is necessitated by great complexity of modern business organisations.

Accounting as a source of Information

“Accounting is a service activity. Its function is to provide qualitative information, primarily financial in nature, about economic entities that is intended to be useful in making economic decisions.”

As an information system, accounting collects data and communicates economic information about the organisation to a number of users whose decisions and actions are related to its performance. Accounting begins with the identification of transactions of financial nature and ends with the preparation of financial statements (i.e., Income Statement and Balance Sheet). Each step in the process of accounting generates information. Generation of information is not an end in itself, it is a way to facilitate the dissemination of information among users of accounting information. Accounting information is used for predicting, comparing and evaluating the earning power and financial position of a business enterprise. Therefore, dissemination of information is an essential function of accounting.

1.3.1 Users of Accounting Information

Users of Accounting Information may be categorised into Internal Users and External Users.

Internal Users

- i. Owners :** Owners contribute capital in the business and thus, are exposed maximum risk. Naturally, they are interested in knowing the profit earned or loss suffered by the business besides the safety of their capital. The financial statements give the information about profit or loss and financial position of the business.
- ii. Management :** The management makes extensive use of accounting information to arrive at informed decisions such as determination of selling price, cost controls and reduction, investment into new projects etc.
- iii. Employees and Workers :** Employees and workers are entitled to bonus at the year end, which is linked to the profit earned by an enterprise. Therefore, the employees and workers are interested in financial statements. Besides, the financial

statements also reflect whether the enterprise has deposited its dues into the provident fund and employees state insurance accounts, etc., or not.

External Users

- i. Banks and Financial Institutions :** Banks and Financial Institutions are essential part of any business as they provide loans to the businesses. Naturally, they watch the performance of the business to know whether it is making progress. As projected to ensure the safety and recovery of the loan advanced. They assess it by analyzing the accounting information.
- ii. Investors and Potential Investors :** Investment involves risk and also the investors do not have direct control over the business affairs. Therefore, they rely on the accounting information available to them and seek answers to the questions such as what is the earning capacity of the enterprise and how safe is their investment?
- iii. Creditors :** Creditors are those parties who supply goods or services on credit. Before granting credit, creditors satisfy themselves about the credit worthiness of the business. The financial statements help them immensely in making such an assessment.
- iv. Government and Its Authorities:** The government makes use of financial statements to compile national income accounts and other informations. The informations so available to it enables them to take policy decision. Government levies varied taxes such as GST Tax and Service Tax and Income Tax. These government authorities assess the correct tax dues from an analysis of financial statements.
- v. Researchers :** Researchers use accounting information in their research work.
- vi. Consumers :** Consumers require accounting information for establishing good accounting control so that cost of production may be reduced with the resultant reduction of the prices of products they buy. Sometimes, prices of some products are fixed by the government, so it needs accounting information to fix fair prices so that consumers and producers are not exploited.
- vii. Public :** They want to see the business running since it makes a substantial contribution to the economy in many ways, *e.g.*, employment of people, patronage to suppliers, etc. Thus financial accounting provides useful financial information to various user groups for decision-making.

1.3.2 Qualitative Characteristics of Accounting Information

Two fundamental characteristics of financial statement are their truth and fairness. An auditor of the enterprise has to make a statement in his report whether, in his opinion, the financial statement give a true and fair view. It means that the Balance Sheet should give the true and fair view of the state of affairs and the Profit and Loss Account should give the true and correct profit or loss for the period. Besides the above fundamental

characteristics, there are other qualitative characteristics (attributes) that make the information content of the financial statements meaningful to its users. There are:

1. Reliability :
2. Relevance :
3. Understandability and
4. Comparability.

Let us discuss these characteristics in detail :

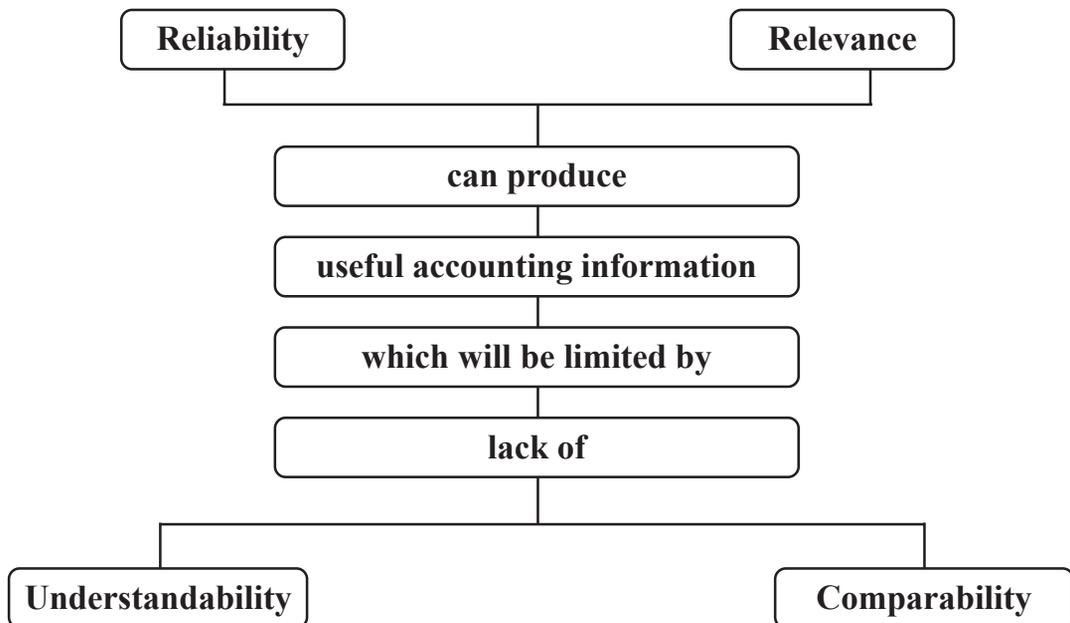
1. **Reliability** : Accounting information must be reliable. the foremost factors that make it reliable are that
 - i. It should be verifiable. It means, transactions should be evidenced by documents. For example, purchases, sales be evidenced by sales bill, etc.
 - ii. It should be free from personal bias. It means, where personal judgement is to be exercised, it should be independent and free from bias.

Reliability of the accounting information depends on:

- i. *Neutrality*: Neutrality means that the accounting information made available does not suffer from bias.
 - ii. *Prudence*: The accounting information prepared on the principle of prudence (conservatism) means that the accounting information is prepared by providing all prospective losses while leaving all prospective profits.
 - iii. *Completeness*: The accounting information to be meaningful, should be complete in all respects as incomplete information may lead to wrong interpretation.
 - iv. *Substance Over Form*: The accounting information to be meaningful, should be governed by the substance of the information and not by its legal form alone.
2. **Relevance**: The accounting information, besides disclosing statutorily required disclosures, should disclose other information, after judging its relevance to the decision-making need of its users. For example, interest on borrowings is disclosed without stating the rate of interest. Users, therefore, cannot link interest cost to different types of borrowed funds. In the process, they fail to appreciate the rationality of financing decisions. Generally, only the statutory (legal) required information is disclosed. The information disclosure requirements are set after a public debate reflecting the views of cross-sections of users. But, what is relevant information in a particular circumstance cannot be generalised and specified. The management of the enterprise is in the best position to decide the contents of the information. It may be noted that relevance of the information is always guided by the principle of materiality.

3. **Understandability:** Understandability means that the information provided through the financial statements be presented in a manner that the users are able to understand it in the manner it should be. However, if an information is considered relevant for the users' decision-making it must be disclosed even if the information is complex and not readily understandable by common users. The information disclosure requirement of law must be fulfilled however complex such information may be.
4. **Comparability:** Comparability means that the users should be able to compare the accounting information of an enterprise of the period either with that of other periods, known as intra-firm comparison or with the accounting information of other enterprises, known as inter-firm comparison. It is, therefore, necessary to follow standardised accounting policies consistently to the extent possible.

Accounting information to be useful should have all the above characteristics. The accounting information produced in the light of Reliability and Relevance Qualitative Characteristics can be useful but its usefulness shall be limited if it lacks understandability and comparability. We may explain this with the help of a diagram:



1. 4 Accounting Terms

Transaction

It is an event which involves exchange of some value between or more entities. It can be purchase of stationery, receipt of money, payment to a supplier, incurring expenses, etc. It can be a cash transaction or a credit transaction.

Purchases

This term is used for goods to be dealt-in i.e. goods are purchased for resale or for producing the finished products which are meant for sale. Goods purchased may be Cash Purchases or Credit Purchases. Thus, Purchase of goods is the sum of cash purchases and credit purchases.

Sundry Creditors

Creditors are persons who have to be paid by an enterprise an amount for providing goods and services on credit.

Sales

Sales are total revenues from goods or services provided to customers. Sales may be in cash or credit.

Sundry Debtors

Persons who have to pay for goods sold or services rendered or in respect of contractual obligations. It is also termed as debtor, trade debtor, and accounts receivable.

Revenue (Sales)

Sales revenue is the amount by selling products or providing services to customers. Other items of revenue common to many businesses are: Commission, Interest, Dividends, Royalties, and Rent received, etc.

Expenses

Costs incurred by a business in the process of earning revenue are called expenses. In general, expenses are measured by the cost of assets consumed or services used during the accounting period. The common items of expenses are: Depreciation, Rent, Wages, Salaries, Interest, Cost of heating, Light and water and Telephone, etc.

Income

The difference between revenue and expense is called income. For example, goods costing Rs.25000 are sold for Rs.35000, the cost of goods sold, i.e. Rs.25000 is expense, the sales of goods, i.e. Rs. 35000 is revenue and the difference, i.e. Rs 10000 is income. In other words, we can state that

$$\text{Income} = \text{Revenue} - \text{Expense}$$

Gain

Usually this term is used for profit of an irregular nature, for example, capital gain.

Profit

It is the excess of revenue of a business over its costs. It may be gross profit and net profit. Gross profit is the difference between sales revenue or the proceeds of goods sold

and/or services provided over its direct cost of the goods sold. Net profit is the profit made after allowing for all types of expenses. There may be a net loss if the expenses exceed the revenue.

Expenditure

Spending money or incurring a liability for some benefit, service or property received is called expenditure. Payment of rent, salary, purchase of goods, purchase of machinery, etc. are some examples of expenditure. If the benefit of expenditure is exhausted within a year, it is treated as revenue expenditure. In case the benefit of expenditure lasts for more than one year, it is treated as an asset and also known as capital expenditure. Expenditure is usually the amount spent for the purchase of assets. It increases the profit earning capacity of the business. Expense, on the other hand, is an amount to earn revenue. Expenditure is considered as capital expenditure unless it is qualified with words like revenue expenditure on rent, salaries etc., while expense is always considered as a revenue expense because it is always incurred to earn revenue.

Drawings

It is the amount of money or the value of goods which the proprietor takes away from business for his/her household or private use.

Capital

It is the amount invested in an enterprise by its owners e.g. paid up share capital in a corporate enterprise. It also refers to the interest of owners in the assets of an enterprise. It is the claim against the assets of the business. Any amount contributed by the owner towards the business unit is a liability for the business enterprise. This liability is also termed as capital which may be brought in the form of cash or assets by the owner.

Assets

These are tangible objects or intangible rights owned by the enterprise and carrying probable future benefits. Tangible items are those which can be touched and their physical presence can be noted/felt e.g. furniture, machine etc. Intangible rights are those rights which one possesses but cannot see e.g. patent rights, copyrights, goodwill etc. Assets are purchased for business use and for sale. They raise the profit earning capacity of the business enterprise.

Assets are broadly categorized as current assets and non-current assets/fixed assets. **Current assets** are those assets which are held for a short period generally one year's time. The balance of such items goes on fluctuating i.e. it keeps on changing throughout the year. The balance of cash in hand may change so many times in a day. Various current assets are cash in hand/at bank, debtors, bills receivable, stock, pre-paid expenses.

Non-current assets : Those assets are acquired for long term use in the business. Such assets raise the profit earning capacity of the business enterprise. Expenditure on

such assets is non-recurring and of capital nature. Expenses incurred on acquiring these assets are added to the value of the assets.

Liability

It is the financial obligation of an enterprise other than owner's funds.

Liabilities : Liabilities mean the amount which the business owes to outsiders, that is, except the proprietors. In the words of **Finny and Miller**, "*Liabilities are debts, they are amounts owed to creditors.*" Thus, the claims of those who are not owners are called **Liabilities**. this can be expressed as:

$$\text{Liabilities} = \text{Assets} - \text{Capital}$$

In business, transactions are recorded taking business to be an entity distinct from its owners. Thus, capital invested by the proprietors is a liability but an internal liability. On the other hand, *external liability* is a liability that is payable to outsiders, i.e., other than the proprietors.

External liability arises because of credit transactions or loans raised. Examples of external liabilities are creditors, bank overdraft, bills payable, outstanding liabilities.

Liabilities can be classified into the following :

- i. *Long-Term Liabilities* : These are those liabilities which are payable after a long-term, (generally more than year). Examples of Long-Term Liabilities are long-term loans, debentures, etc.
- ii. *Short-Term/Current Liabilities* : These are liabilities which are payable in the near future (generally within a year). Examples of Current Liabilities are creditors, bank overdraft, bills payable, short-term loans, etc.

Account : Account is a summarised record of relevant transactions at one place relating to a particular head. It records not only the amount of transactions but also their effect and direction.

Stock or Inventory : Stock is the tangible property held by an enterprise for the purpose of sale in the ordinary course of business or for the purpose of using it in the production of goods meant for sale or services to be rendered. Stock may be *opening stock or closing stock*. In case of manufacturing concern, Closing Stock comprises raw materials, Work-in-Progress (i.e., semi-finished goods) and finished goods in hand on the closing date. Similarly, Opening Stock (beginning inventory) is the amount of stock at the beginning of the accounting period.

Goods : They refer to items forming part of the Stock-in-Trade of an enterprise, which are purchased or manufactured with a purpose of selling. In other words, they refer to the products in which an enterprise is dealing. For an enterprise dealing in home appliances such as T.V.,fridge, A.C., etc.,these are goods. Similarly, for a stationer, stationery is goods, whereas for others, it is an item of expense (not purchases). An enterprise may

purchase assets for use in furtherance of business or stationery for use in the business, but they are not purchases of 'goods' but fixed assets and expense respectively.

Receivables : The term 'Receivables' includes the outstanding amount due from others. Sometimes, a debtor may accept a Bill of Exchange, which is payable after a certain period. Such a bill is known as **Bill Receivable**. Sometimes, a debtor promises to pay the specific amount in writing after a specified period. Such a promise is known as a **Promissory Note** and is recorded as *note receivable*. The term - accounts receivable includes trade debtors as well as bills receivable and promissory notes receivable. The term receivable includes all the amounts due from others.

Payables : The term 'Payables' include the amounts due to other. Accounts Payable includes trade creditors as well as bills payable and promissory notes payable. The term payable includes all the amounts due to others.

Bill Receivable : Bill Receivable means a Bill of Exchange accepted by a debtor the amount of which will be receivable on the specified date.

Bill Payable : Bill Payable means a Bill of Exchange, the amount of which will be payable on the specified date.

Event : Any transactions in an organisation can be called as an event. Transactions in an organisation have documentary evidence and will create a change in revenue, expense, assets, liabilities and capital.

Cost : It is the amount of expenditure incurred on or is attributed to a specified article; product or activity.

Voucher : It is proof of a business transaction. Cash Memo, Bill/Invoice, Credit/Debit notes etc, are examples of voucher.

Discount : Some customers are allowed reduction in the price of goods by the business. It is called a Discount.

Trade Discount : It is the reduction allowed by the sellers to the buyers at the time of sale on the list price of goods. Trade discount is allowed on buik purchase. Normally, trade discount is deducted from the list price and only the balance is accounted. Therefore, trade discount will not be shown in the books of accounts.

Cash Discount : It is the deduction allowed by the creditor to the debtor on the amount due by the latter. This concession is given only to those who settle their accounts within a stipulative period. Therefore, cash discount encourage prompt settlement of accounts. For the debtor who pays the amount, it is an income. For creditor, cash discounts is an expense.

1.5. Accounting Concepts

In order to maintain uniformity and consistency in preparing and maintaining books of accounts, certain rules or principles have been evolved. These rules/principles are classified as concepts and conventions. These are foundations of preparing and maintaining accounting records. In this lesson we will learn about various accounting concepts, their meaning and significance.

1.5.1 Meaning of Accounting Concept

Let us take an example. In India there is a basic rule to be followed by everyone that one should walk or drive on the left hand side of the road. It helps in the smooth flow of traffic. Similarly, there are certain rules that an accountant should follow while recording business transactions and preparing accounts. These may be termed as accounting concepts. Thus, it can be said that:

Accounting concepts refer to the basic assumptions, rules and principles which work as the basis for recording of business transactions and preparing accounts.

The main objective is to maintain uniformity and consistency in accounting records. These concepts constitute the very basis of accounting. All the concepts have been developed over the years from experience and thus, they are universally accepted rules. Following are the various accounting concepts that have been discussed in the following sections:

- Business entity concept
- Money measurement concept
- Going concern concept
- Accounting period concept
- Accounting cost concept
- Duality aspect concept
- Realisation concept
- Accrual concept
- Matching concept

1.5.2 Business Entity Concept

This concept assumes that, for accounting purpose, the business enterprise and its owners are two separate independent entities. Thus, the business and personal transactions of its owner are separate. For example, when the owner invests money in the business, it is recorded as liability of the business to the owner. Similarly, when the owner takes away from the business cash/goods for his/her personal use, it is not treated as business expense. Thus the accounting records are made in the books of accounts from the point of view of the business unit and not the person owing the business. This concept is the very basis of accounting.

Let us take an example. Suppose Mr. Sahoo started business investing ₹100000. He purchased goods for ₹40000, Furniture for ₹20000 and plant and machinery of ₹30000, ₹10000 remains in hand. These are the assets of business and not of the owner. According to the business entity concept ₹100000 will be treated by business as capital i.e. a liability of business towards the owner of the business.

Now suppose, he takes away ₹5000 cash or goods worth ₹5000 for his domestic purpose. This withdrawal of cash/goods by the owner from the business in his private expense and not an expense of the business. It is termed as Drawings. Thus, the business entity concept states that business and the owner are two separate/distinct persons. Accordingly, any expense incurred by owner for himself or his family from business will be considered as expenses and it will be shown as drawings.

Significance

The following points highlight the significance of business entity concept:

- This concept helps in ascertaining the profit of the business as only the business expenses and revenues are recorded and all the private and personal expenses are ignored.
- This concept restrains accountants from recording of owner's private/personal transaction.
- It also facilitates the recording and reporting of business transactions from the business point of view.
- It is the very basis of accounting concepts, conventions and principles.

1.5.3 Money Measurement Concept

This concept assumes that all business transactions must be in terms of money, that is in the currency of a country. In our country such transactions are in terms of rupees.

Thus, as per the money measurement concept transactions which can be expressed in terms of money are recorded in the books of accounts. For example, sale of goods

worth ₹ 200000, purchase of raw materials ₹ 100000, Rent paid ₹ 1000 etc. are expressed in terms of money, and so these are recorded in the books of accounts. But the transactions which cannot be expressed in monetary terms are not recorded in the books of accounts. For example, sincerity, loyalty, honesty of employees are not recorded in books of accounts because these cannot be measured in terms of money although they do affect the profits and losses of the business concern.

Another aspect of this concept is that the records of the transactions are to be kept not in the physical units but in the monetary unit. For example, at the end of the year 2023, an organisation may have a factory on a piece of land measuring 10 acres, office building containing 50 rooms, 50 personal computers, 50 office chairs and table, 100 kg of raw materials etc. These are expressed in different units. But for accounting purposes land may be say ₹ 12 crore, office building of Rs. 10 crore, computers Rs. 10 lakhs, office chairs and tables ₹ 2 lakhs, raw material ₹ 30 lakhs. Thus the total assets of the organisation are valued at ₹ 22 crore and ₹ 42 lakhs. Therefore, the transactions which can be expressed in terms of money is recorded in the accounts books, that too in terms of money and not in terms of the quantity.

Significance

The following points highlight the significance of money measurement concept: This concept guides accountants about what to record and what not to record.

- It helps in recording business transactions uniformly.
- If all the business transactions are expressed in monetary terms, it will be easy to understand the accounts prepared by the business enterprise.
- It facilitates comparison of business performance of two different periods of the same firm or of the two different firms for the same period.

1.5.4 Going Concern Concept

This concept states that a business firm will continue to carry on its activities for an indefinite period of time. Simply stated, it means that every business entity has continuity of life. Thus it will not be dissolved in the near future. This is an important assumption of accounting, as it provides a basis for showing the value of assets in the balance sheet; For example, a company purchases a plant and machinery of ₹100000 and its life span is 10 years. According to this concept every year some amount will be shown as expenses and the balance amount as an asset. Thus, if an amount is spent on an item which will be used in business for many years, it will not be proper to charge the amount from the revenues of the year in which the item is acquired. Only a part of the value is shown as expense in the year of purchase and the remaining balance is shown as an asset.

Significance

The following points highlight the significance of going concern concept:

- This concept facilitates preparation of financial statements
- On the basis of this concept, depreciation is charged on the fixed assets.
- It is of great help to the investors, because, it assures them that they will continue to get income on their investments.
- In the absence of this concept, the cost of a fixed asset will be treated as an expense in the year of its purchase.
- A business is judged for its capacity to earn profits in future.

1.5.5 Accounting Period Concept

All the transactions are recorded in the books of accounts on the assumption that profits on these transactions are to be ascertained for a specified period. This is known as accounting period concept. Thus, this concept requires that a balance sheet and profit and loss account should be prepared at regular intervals. This is necessary for different purposes like, calculation of profit, ascertaining financial position, tax computation etc.

Further, this concept assumes that, indefinite life of business is divided into parts. These parts are known as Accounting Period. It may be of one year, six months, three months, one month, etc. But usually one year is taken as one accounting Period which may be a calendar year or a financial year.

Year that begins from 1st of January and ends on 31st of December, is known as Calendar Year. The year that begins from 1st of April and ends on 31st of March of the following year, is known as financial year.

As per accounting period concept, all the transactions are recorded in the books of accounts for a specified period of time. Hence, goods purchased and sold during the period, rent salaries etc. Paid for the period are accounted for against that period only.

Significance

- It helps in predicting the future prospects of the business.
- It helps in calculating tax on business income calculated for a particular time period.
- It also helps banks, financial institutions, creditors, etc. to assess and analyse the performance of business for a particular period.
- It also helps the business firms to distribute their income at regular intervals as dividends.

1.5.6 Accounting Cost Concept

Accounting cost concept states that all assets are recorded in the books of accounts at their purchase price, which includes cost of acquisition, transportation and installation and not at its market price. It means that fixed assets like building, plant and machinery, furniture etc are recorded in the books of accounts at a price paid for them. For example, a machine was purchased by XYZ Limited for Rs. 500000, for manufacturing shoes. An amount of Rs. 1000 were spent on transporting the machine to the factory site. In addition, Rs. 2000 were spent on its installation. The total amount at which the machine will be recorded in the books of accounts would be the sum of all these items i.e. Rs. 503000. This cost is also known as historical cost. Suppose the market price of the same is now Rs. 90000 it will not be shown at this value. Further, it may be clarified that cost means original or acquisition cost only for new assets and for the used ones, cost means original cost less depreciation. The cost concept is also known as historical cost concept. The effect of cost concept is that if the business entity does not pay anything for acquiring the asset this item would not appear in the books of accounts. Thus, goodwill appears in the accounts only if the entity has purchased this intangible asset for a price.

Significance

- This concept requires an asset to be shown at the price at which it has been acquired, which can be verified from the supporting documents.
- It helps in calculating depreciation on fixed assets.
- The effect of cost concept is that if the business entity does not pay anything for an asset, this item will not be shown in the books of accounts.

1.5.7 Dual Aspect Concept

Dual aspect is the foundation or basic principle of accounting. It provides the very basis of recording business transactions in the books of accounts. This concept assumes that every transaction has a dual effect, i.e. It affects two accounts in their respective opposite sides. Therefore, the transaction should be recorded at two places. It means, both the aspects of the transaction must be recorded in the books of accounts. For example, goods purchased for cash has two aspects which are (i) Giving of cash (ii) Receiving of goods. These two aspects are to be recorded.

Thus the duality concept is commonly expressed in terms of fundamental accounting equation:

$$\text{Asset} = \text{Liabilities} + \text{Capital}$$

This above accounting equation states that the assets of a business are always equal to the claims of owner/owners and the outsiders. This claim is also termed as capital or owners equity and that of outsiders, as liabilities or creditor's equity.

The knowledge of dual aspect helps in identifying the two aspects of a transaction which helps in applying the rules of recording the transactions in books of accounts. The implication of dual aspect concept is that every transaction has an equal impact on assets and liabilities in such a way that total assets are always equal to total liabilities.

Let us analyse some more business transactions in terms of their dual aspect:

1. Capital brought in by the owner of the business

The two aspects in this transaction are:

- (i) Receipt of cash
- (ii) Increase in Capital (owners equity)

2. Purchase of machinery by cheque

The two aspects in the transaction are

- (i) Reduction in Bank Balance
- (ii) Owning of Machinery

Significance

- This concept helps accountant in detecting error.
- It encourages the accountant to post each entry in opposite sides of two affected accounts.

1.5.8 Realisation Concept

This concept states that revenue from any business transaction should be included in the accounting records only when it is realised. The term realisation means creation of legal right to receive money. Selling goods is realisation, receiving order is not. In other words, it can be said that:

Revenue is said to have been realised when cash has been received or right to receive cash on the sale of goods or services or both have been created.

Let us study the following examples:

- i) N.P. Jeweller received an order to supply gold ornaments worth ₹5,00,000. They supplied ornaments worth ₹20000 up to the year ending 31st December 2023 and rest of the ornaments were supplied in January 2024.
- ii) Bansal sold goods for ₹1,00,000 for cash in 2023 and the goods have been delivered during the same year.

- iii) Akshay sold goods on credit for ₹ 50,000 during the year ending 31st December 2023. The goods have been delivered in 2023 but the payment was received in March 2024.

Now let us analyse the above examples to ascertain the correction amount of revenue realised for the year ending 31st December 2023.

- i) The revenue for the year 2023 for N.P. Jeweller is 200000. Mere getting an order is not considered as revenue until the goods have been delivered.
- ii) The revenue is for Bansal for year 2013 is ₹ 100000 as the goods have been delivered in the year 2023. Cash has also been received in the same year.
- iii) Akshay's revenue for the year 2023 is Rs. 50000, because the goods have been delivered to the customer in the year 2023. Revenue became due in the year 2023 itself. In the above examples, revenue is realised when the goods are delivered to the customers.

The concept of realisation states that revenue is realised at the time when goods or services are actually delivered.

In short, the realisation occurs when the goods and services have been sold either for cash or on credit. It also refers to inflow of assets in the form of receivables.

Significance

- It helps in making the accounting information more objective.
- It provides that the transactions should be recorded only when goods are delivered to the buyer.

1.5.9 Accrual Concept

The meaning of accrual is something that becomes due especially an amount of money that is yet to be paid or received at the end of the accounting period. It means that revenues are recognised when they become receivable. Though cash is received or not received and the expenses are recognised when they become payable though cash is paid or not paid. Both transactions will be recorded in the accounting period to which they relate. Therefore, the accrual concept makes a distinction between the accrual receipt of cash and the right to receive cash as regards revenue and actual payment of cash and obligation to pay cash as regards expenses.

The accrual concept under accounting assumes that revenue is realised at the time of sale of goods or services irrespective of the fact when the cash is received. For example, a firm sells goods for ₹ 55000 on 25th March 2023 and the payment is not received until 10th April 2023, the amount is due and payable to the firm on the date of sale i.e. 25th March 2023. It must be included in the revenue for the year ending 31st March 2023. Similarly,

expenses are recognised at the time services are made. For example, if the firm received goods costing ₹ 20000 on 29th March 2023 but the payment is made on 2nd April 2023 the accrual concept requires that expenses must be recorded for the year ending 31st March 2023 although no payment has been made until 31st March 2023 though the service has been received and person to whom the payment should have been made is shown as creditor.

In brief, accrual concept requires that revenue is recognised when realised and expenses are recognised when they become due and payable without regard to the time of cash receipt or cash payment.

Significance

- It helps in knowing actual expenses and actual income during a particular time period.
- It helps in calculating the net profit of the business.

1.5.10 Matching Concept

In matching concept states that the revenue and the expenses incurred to earn the revenues must belong to the same accounting period. So once the revenue is realised, the next step is to allocate it to the relevant accounting period. This can be done with the help of accrual concept.

Let us study the following transactions of a business during the month of December, 2023.

1. Sale : cash ₹2000 and credit ₹1000
2. Salaries Paid ₹ 350
3. Commission Paid ₹150
4. Interest Received ₹50
5. Rent received ₹140, out of which ₹40 received for the year 2024
6. Carriage Paid ₹20
7. Postage ₹30
8. Rent paid ₹200, out of which ₹50 belong to the year 2021
9. Goods purchased in the year for cash ₹1500 and on credit ₹ 500
10. Depreciation on machine ₹ 200

Let us record the above transactions under the heading of Expenses and Revenue.

<i>Expenses</i>		<i>Amount</i> ₹	<i>Revenue</i>		<i>Amount</i> ₹
1. Salaries		350	1. Sales		
2. Commission		150	Cash	2000	
3. Carriage		20	Credit	<u>1000</u>	3000
4. Postage		30	2. Interest received		50
5. Rent paid	200		3. Rent received	140	
Less for 2021	<u>-50</u>	150	Less for 2024	<u>(40)</u>	100
6. Goods purchase					
Cash	1500				
Credit	<u>500</u>	2000			
7. Depreciation on machine		200			
Total		2900	Total		3150

In the above example expenses have been matched with revenue i.e.(Revenue ₹3150 Expenses ₹2900) This comparison has resulted in profit of ₹250. If the revenue is more than the expenses, it is called profit. If the expenses are more than revenue it is called a loss. This is what exactly has been done by applying the matching concept.

Therefore, the matching concept implies that all revenues earned during an accounting year, whether received/not received during that year and all cost incurred, whether paid/not paid during the year should be taken into account while ascertaining profit or loss for that year.

Significance

- It guides how the expenses should be matched with revenue for determining exact profit or loss for a particular year.
- It is very helpful for the inventors/shareholders to know the exact amount of profit or loss of the business.

1.6 Accounting Conventions

You have studied the accounting concepts like business entity, money measurement, going concern, accounting period, cost, duality, realisation, accrual and matching. These concepts of assumptions or principles are working rules for all accounting activities.

You may visit some business units doing a particular kind of business. Enquire them and find out how unsold goods are being valued. You will find that they follow the same method of valuation of unsold stock of goods. If you ask them, why do they value the unsold goods at cost price, whichever is lower, even though the market price is higher than the cost price, the businessman may answer that it is the convention, tradition or practice or custom of the business, that business is following year after year. In accounting, there are many conventions or practices which are used while recording the transactions in the books of accounts. Apart from these, the Institute of Chartered Accountants of India (ICAI), which is the main regulatory body for standardisation of accounting policies in the country has issued a number of accounting standards from time to time bring consistency in the accounting practices. We shall study about accounting conventions and standards in detail in this lesson.

1.6.1 Meaning of Accounting Conventions

An accounting convention refers to common practices which are universally followed in recording and presenting accounting information of the business entity. They are followed like customs, traditions, etc. in a society. Accounting conventions are evolved through regular and consistent practice over the years to facilitate uniform recording in the books of accounts. Accounting Conventions help in comparing accounting data of different business units or of the same unit for different periods. These have been developed over the years. The most important conventions which have been used for a long period are:

- Convention of consistency.
- Convention of full disclosure.
- Convention of materiality.
- Convention of conservatism.

1.6.2 Convention of Consistency

The Convention of consistency means that same accounting principles should be used for preparing financial statements year after year. A meaningful conclusion can be drawn from financial statements of the same enterprise when there is a comparison between them over a period of time. But this can be possible only when accounting policies and practices followed by the enterprise are uniform and consistent over a period of time. If different accounting procedures and practices are used for preparing financial statement of different years, then the result will not be comparable.

Generally a businessman follows the undermentioned general practices or methods year after year.

While charging depreciation on fixed assets or valuing unsold stock, once a particular method is used it should be followed year so that the financial statements can be analysed and compared provided that the depreciation on fixed assets is charged or unsold stock is valued by using particular method year after year. This can be further clarified as in case of charging depreciation on fixed assets accountant can decide to adopt any one of the methods of depreciation such as diminishing value method or straight line method.

Similarly, in case of valuation of closing stock it can be valued at actual cost price or market price or whichever is less. However precious metals like gold, diamond, Minerals are generally valued at market price only.

Types of consistency

There are three types of consistency namely:

- I. Vertical consistency (Same organisation) :** It is to be found within the group of interrelated financial statements of an organisation on the same date. It occurs when fixed assets have been shown at cost price and in the interrelated income statement depreciation has also been charged on the historical cost of the assets
- II. Horizontal consistency (Time basis):** This consistency is to be found between financial statements of one entity from period to period. Thus, it helps in comparing performance of the business between two years i.e. current year with past year
- III. Dimensional consistency (Two organisations in the same trade):** This consistency is to be found in the statements of two different business entities of the same period. This type of consistency assists in making comparison of the performance of one business entity with the other business entity in the same trade and on the same date.

Therefore, as per the convention the same accounting methods should be adopted every year in preparing financial statements. But it does not mean that a particular method of accounting once adopted can never be changed. Whenever a change in method is necessary, it should be disclosed by way of footnotes in the financial statements of that year.

- It facilitates comparative analysis of the financial statements.
- It ensures uniformity in charging depreciation on fixed assets and valuation of closing stock.

1.6.3 Convention of Full Disclosure

Convention of full disclosure requires that all material and relevant facts concerning financial statements should be fully disclosed. Full disclosure means that there should be full, fair and adequate disclosure of accounting information. Adequate means sufficient set of information to be disclosed. **Fair** indicates an equitable treatment of users. **Full** refers to complete detailed presentation of information. Thus, the convention of full disclosure suggests that every financial statement should fully disclose all relevant

information. Let us relate it to the business. The business provides financial information to all interested parties like investors, lenders, creditors, shareholders etc. The shareholders would like to know profitability of the firm while the creditors would like to know the solvency of the business. In the same way, other parties would be interested in the financial information according to their requirements. This is possible if financial statements disclose all relevant information in full, fair and adequate manner.

Let us take an example. As per accounts, net sales are ₹1,50,000, it is important for the interested parties to know the amount of gross sales which may be ₹2,00,000 and the sales return ₹50,000. The disclosure of 25% sale returns may help them to find out the actual sales position. Therefore, whatever details are available, that must be honestly provided. Additional information should also be given in the financial statements. For example, in a balance sheet the basis of valuation of assets, such as investments, inventories, land and building etc. should be clearly stated. Similarly, any change in the method of depreciation or in making provision for bad debts or creating any reserve must also be shown clearly in the transactions of a business and any change in accounting policies, methods and procedures are fully recorded and presented in accounting.

Significance

- It helps in meaningful comparison of financial statements of the different business units.
- This can also help in the comparison of financial statements of different years of the same business unit.
- This convention is of great help to investor and shareholder for making investment decisions.
- The convention of full disclosure presents reliable information.

1.6.4 Convention of Materiality

The convention of materiality states that, to make financial statements meaningful, only material facts i.e., important and relevant information should be supplied to the users of accounting information. The question that arises here is what is a material fact. The materiality of a fact depends on its nature and the amount involved. Material fact means the information of which will influence the decision of its user.

For example, a businessman is dealing in electronic goods. He purchases T.V., Refrigerator, Washing Machine, Computer etc. for his business. In buying these items he uses larger part of his capital. These items are significant items; thus, these should be recorded in the books of accounts in detail. At the same time to maintain day to day office work he purchases pen, pencil, match box, scented stick, etc. For this he will use very small amount of his capital. But to maintain the details of every pen, pencil, match box or other small items is not considered of much significance. These items are insignificant items and hence they should be recorded separately. Thus, the items that are significantly important

in recording the details are termed as material facts or significant items. The items that are of less significance are immaterial facts or insignificant items.

Thus according to this convention, important and significant items should be recorded in their respective heads and all immaterial or insignificant transactions should be clubbed under a different accounting head.

Significance

- It helps in minimising the errors of calculation.
- It helps in making financial statements more meaningful.
- It saves time and resources.

1.6.5 Convention of Conservatism

This convention is based on the principle that “**Anticipate no profit, but provide for all possible losses**”. It provides guidance for recording transactions in the books of accounts. It is based on the policy of playing safe in regard to showing profit. The main objective of this convention is to show minimum profit. Profit should not be overstated. If profit shows more than actual, it may lead to distribution of dividend out of capital. This is not a fair policy and it will lead to the reduction in the capital of the enterprise.

Thus, this convention clearly states that profit should not be recorded until it is realised. But if the business anticipates any loss in the near future, provision should be made in the books of accounts for the same. For example, valuing closing stock at cost or market price whichever is lower, creating provision of doubtful debts, discount on debtors, writing off intangible assets like goodwill, patent, etc. The convention of conservatism is a very useful tool in situation of uncertainty and doubts.

Significance

- It helps in ascertaining actual profit.
- It is useful in the situation of uncertainties and doubts.
- It helps in maintaining the capital of the enterprise.

1.7 Generally Accepted Accounting Principles (GAAP) and Accounting Standards

In order to maintain uniformity and consistency in accounting records throughout the world, certain rules and principles have been developed which are generally accepted by the accounting profession. These rules/principles are called by different names such as principles, concepts, conventions, postulates, assumptions. These rules/principles are judged on their general acceptability rather than universal acceptability. Hence, they are popularly called Generally Accepted Accounting Principles (GAAP). The term “generally accepted” means that these principles must have support, that generally comes from the

professional accounting bodies. Thus, Generally Accepted Accounting Principles (GAAP) refer to the rules or guidelines adopted for recording and reporting of business transactions of financial statements. These principles have evolved over a long period of time on the basis of past experiences, usages or customs, etc. These principles are also referred as concepts and conventions, which have already been discussed.

Accounting standards : Concept and Objectives

The term standard denotes a discipline, which provides both guidelines and yardsticks for evaluation. As guidelines, accounting standards provide uniform practices and common techniques of accounting. As general rule, accounting standards are applicable to all corporate enterprises. They are made operative from a date specified in the standards. The Institute of Chartered Accountants of India (ICAI) constituted the Accounting Standards Board (ASB) in April 1977 for developing accounting standards. However, the International Accounting Standards Committee (IASC) was set up in 1973, with its headquarter in London (U.K.).

The Accounting Standards Board is entrusted with the responsibility of formulating standards on significant accounting matters keeping in view the international developments, and legal requirements in India.

The main function of the ASB is to identify areas in which uniformity in standards is required and to develop draft standards after discussions with representatives of the Government, public sector undertakings, industries and other agencies.

In the initial years, the standards are of recommendatory in nature. Once an awareness is created about the benefits and relevance of accounting standards, steps are taken to make the accounting standards mandatory for all companies. In case of non compliance, the companies are required to disclose the reasons for deviations and its financial effects:

Till date, the IASC has brought out 40 accounting standards, However, the ICAI has so far issued 29 accounting standards. These are :

- AS-1** Disclosure of accounting policies (January 1979). This standard deals with the disclosure of significant accounting policies in the financial statements.
- AS-2** Valuation of Inventories (June 1981). This standard deals with the principles of valuing inventories for the financial statements.
- AS-3 (Revised)** Cash flow statement (June 1981, Revised in March 1997). This standard deals with the financial statement which summarises for a given period the sources and applications of an enterprise.
- AS-4** Contingencies and events occurring after the Balance Sheet date (November 1982, Revised in April, 1995) This standard deals with the treatment of contingencies and events occurring after the balance sheet date.
- AS-5** Net profit or loss for the period, prior period (period before the date of balance sheet) items and changes in accounting policies (November 1982, Revised in

february 1997). This standard deals with the treatment in financial statement of prior period and extraordinary items and changes in accounting policies.

- AS-6** Depreciation Accounting (November 1982). This standard applies to all depreciable assets. But this standard does not apply to assets in the category of forests, plantations and similar natural resources and wasting assets.
- AS-7** Accounting for construction contracts (December 1983, revised in April 2003). This standard deals with accounting for construction contracts in the financial statements of contractors.
- AS-8** Accounting for Research and Development (January 1985). This standard deals with the treatment of costs of research and development in financial tatements.
- AS-9** Revenue Recognition (November 1985). This standard deals with the bases for recognition of revenue in the statement of profit and loss of an enterprise.
- AS-10** Accounting for fixed assets (November 1991). This standard deals with recognition of fixed assets grouped into various categories, such as land, building, plant and machinery, vehicles, furniture and gifts, goodwill, patents, trading and designs.
- AS-11** Accounting for the effects of change in foreign exchange Rates. (August 1991 and Revised in 1993). This standard deals with the issues relating accounting for effect of change in foreign exchange rates.
- AS-12** Accounting for Government grants (April 1994). This standard deals with the accounting for government grants.
- AS-13** Accounting for investments (September 1994). This standard deals with accounting aspect concerning investments in the financial statements. These include classification, determination of cost for initial recognition, disposal and re-classification of investment.
- AS-14** Accounting for amalgamation (October 1994). This standard deals with accounting treatment of any resultant goodwill or reserves in amalgamation of companies.
- AS-15** Accounting for retirement Benefits in the financial statement of employes (January 1995). This standard deals with accounting for retirement benefits in the financial statements of employers.
- AS-16** Borrowing Costs (April 2000). This standard deals with the uses involved relating to capitalization of interest on borrowings for purchase of fixed assets.
- AS-17** Segment reporting (October 2000). This standard applies to companies which have an annual turnover of 50 crores or more. These companies have to present segment wise financial statements and consolidated financial statements.

- AS-18** Related party disclosures (October 2000 received 1st July 2003). This standard requires certain disclosure which must be made for transactions between the enterprise and related agreements.
- AS-19** Leases (January 2001). This standard deals with the accounting treatment of transactions related to lease agreements.
- AS-20** Earning per share (April 2001). This standard deals with the presentation and computation of earning per share (EPS).
- AS-21** Consolidated financial statements (April 2001). This standard deals with the preparation of consolidated financial statements with an intention to provide information about activities of a group.
- AS-22** Accounting for taxes on Income (April 2001). This standard deals with determination of the account of tax expenses for the related revenue.
- AS-23** Accounting for investments in Associates in consolidated financial statement (July 2001). This standard deals with the principles and procedures to be followed for recognising, in the consolidated financial statement.
- AS-24** Discontinued operations (February 2002). This standard deals with the principles of discontinuing operations of an enterprise with the activities which are continuing.
- AS-25** Interim financial reporting (February 2002). This standard deals with the minimum content of interim financial report.
- AS-26** Intangible Assets (February 2002). This standard prescribed the accounting treatment for intangible assets which are not covered by any other specific accounting standard.
- AS-27** Financial reporting of interest for joint venture (February 2002). This standard sets principles and procedures for accounting for interest in joint venture.
- AS-28** Impairment of Assets (2004). This standard prescribed procedures to ensure that an asset is carried at no more than its carrying amount and procedures as to when to recognise an asset as impaired.
- AS-29** Provision for contingent liabilities and contingent assets(2004). This standard deals with measurement and recognition criteria in three areas, namely provisions, contingent liabilities and contingent assets.

All the above standards issued by the Accounting Standards Board are recommended for use by companies listed on a recognized stock exchange and other large commercial, industrial and business enterprises in the public and private sectors.

What you have learnt

- Accounting is the art of recording, classifying and summarizing in terms of money transactions and events of a financial nature and interpreting the results thereof. It is the process of collecting, recording, summarizing and communicating financial information. It is an information system which generates information for decision making by interested parties.
- Recording of business transactions in a systematic manner in the books of accounts is called book keeping.
- Accounting consists of economic events which are identified, measured, recorded and communicated.
- Branches of accounting: Financial accounting, cost accounting and management accounting are some of the branches of accounting.
- Accounting in modern times is treated as an information system which has transaction accounting process, decision useful financial information as the necessary ingredients.

The accountant with his specialized knowledge extensive training and experience helps the management and plays an important role in the society.

- Important accounting terms are: Business entity, purchases, sales, debtors, creditors, etc.,
- Accounting concepts refer to the basic assumptions which serve the basis of recording actual business transactions.
- The important accounting concepts are business entity, money measurement, going concern, accounting period, cost concept, duality aspect concept, realization concept, accrual concept and matching concept.
- Business entity concept assumes that for accounting purposes, the business enterprise and its owners are two separate entities.
- Money measurement concept assumes that all business transactions must be recorded in the books of accounts in terms of money.
- Going concern concept states that a business firm will continue to carry on activities for an indefinite period of time.
- Accounting period concept states that all the business transactions are recorded in the books of accounts on the assumption that profits of transactions is to be ascertained for a specified period of time.
- Accounting cost concept states that all assets are recorded in the books of accounts at their cost price.
- Dual aspect concept states that every transaction has a dual effect.

- Realisation concept states that revenue from any business transaction should be included in the accounting records only when it is realized.
- Matching concept states that the revenue and the expenses incurred to earn the revenue must belong to the same accounting period.
- Accounting conventions are common practices which are followed in recording and presenting accounting information of business.
- Convention of consistency states that the same accounting methods should be adopted every year in preparing financial statements.
- Convention of disclosure states that all material and relevant facts relating to financial statements should be fully disclosed.
- Convention of materiality states that, to make financial statements more meaningful only significant information should be shown in the financial statements.
- Convention of conservatism states that, profit should not be recorded until it is realized. But if business anticipates any loss in near future provision should be made in the books of account.
- Generally accepted accounting principles refer to the rules or guidelines adopted for recording and reporting of business transactions in order to bring uniformity in the preparation and presentation of financial statements.

Terminal Exercise

Section - A

1. What is accounting ? What are its objective and limitations ?
2. Distinguish between book-keeping and accounting ?
3. Explain the different branches of accounting ?
4. Explain the objectives and function of financial accounting ?
5. Explain the advantages and limitations of accounting ?
6. Explain the role of an accountant in the society ?
7. Explain accounting as a system of information. Enlist the parties that are interested in the accounting information ?
8. What do you mean by accounting standards ? Enumerate the accounting standard issued by the ASB from time to time ?
9. What do your accounting convention ? Explain various accounting conventions ?
10. Explain the convention of materiality ?

Section - B

1. State the meaning of the term “assets” with examples ?
2. Explain meaning and significance of going concern concept ?
3. What do you mean by business entity concept ?
4. State meaning and significance of money measurement concept ?
5. Explain the convention of consistency with examples ?
6. Explain the convention of conservatism with example ?
7. Explain the convention of consistency with examples ?
8. Explain the accounting convention of full disclosure with examples ?

Section - C

1. Book Keeping
2. Accounting
3. Social Accounting
4. Expenses
5. Capital
6. Assets
7. Meaning of Accounting concept
8. Meaning of Accounting conventions
9. Convention of materiality
10. Accounting standards

ACCOUNTING FOR BUSINESS TRANSACTIONS

You visit the shop of a person known to you and observe the activities he/she is doing. He/she is selling goods for cash and on credit, collecting payments, making payments to suppliers, instructing the worker to deliver the goods in time, making payments for telephone, carriage, etc. These are all business activities, but cash is not involved in all of them at the time of making transactions. Activities which are in cash terms are called business transactions. You will also find that for every transaction, he/she makes use of a document like bills, cash memos, receipts, etc. These are termed as vouchers. In this lesson, you will learn about business transactions, accounting vouchers, accounting equation and the basic mechanism of accounting.

OBJECTIVES

After studying this lesson, you will be able to:

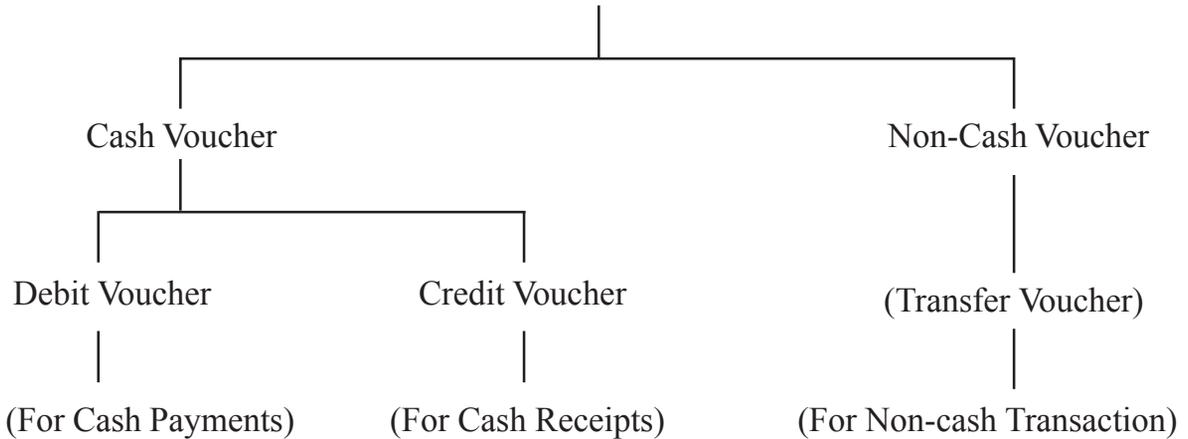
- explain the meaning of source documents and accounting vouchers;
- explain the meaning of accounting equation;
- explain the effect of business transactions on the accounting equation;
- explain the rules and bases of accounting, double entry mechanism.
- explain the meaning of journal, format, process of journalizing
- explain the meaning and importance of ledger, posting and balancing.

2.1 Source Documents and Accounting Vouchers

Accounting process begins with the origin of business transactions and it is followed by analysis of such transactions. A business transaction is a transaction, which involves exchange of value between two parties. Every transaction involves Give and Take aspect. The debit represents take aspect and credit represents the give aspect in a transaction. For example, when a computer is purchased for office use for cash, then the delivery of computer represents take aspect and payment of cash represents give aspect. Thus, business transactions are exchange of goods or services between two parties and effects of these transactions are recorded in two accounts. All business transactions are based on documentary evidence. A document which provides evidence of the transaction is called

the Source Document or a voucher. It is the primary evidence in support of a business transaction. A source document is the first record prepared for a business transaction and is the basis for entries in the books of accounts. Accounting voucher may be classified as follows :

Types of Accounting Voucher



2.2 Accounting Equation and Effects of Transactions on it

The recording of business transactions in the books of account is based on a fundamental equation called Accounting Equation. Whatever business possesses in the form of assets is financed by proprietor or by outsiders. This equation expresses the equality of assets on the one side and equity on the other side i.e., the claims of outsider [liabilities] and owners or proprietors funds on the other side. In mathematical form,

$$\text{Assets} = \text{Equity}$$

$$\text{Equity} = \text{Liabilities} + \text{Capital}$$

As an asset is introduced in the business, a corresponding liability also emerges.

Effect of business transactions on accounting equation

These transactions increase or decrease the assets, liabilities, or capital. Every business has some assets. For example, Sunil started business with cash 3,00,000 as Capital. In this transaction, asset in the form of cash is created for the business. Hence,

Cash (Asset)		Capital (Equity)
₹ 3,00,000	=	₹ 3,00,000

Sunil purchased Machinery for ₹40,000 and Furniture for ₹20,000. Thus, the position of the assets and capital is as :

Cash	+	Machinery	+	Furniture	=	Capital
2,40,000	+	40,000	+	20,000	=	3,00,00

The above transaction shows that

Assets = Capital
Or
Capital = Assets

Increase or decrease in capital will result in the correspondig increase or decrease in assets, For example Sunil withdraw cash for personal use ₹5,000. Thus, the position of the assets and capital is as under :

Cash	+	Machinery	+	Furniture	=	Capital
2,40,000	+	40,000	+	20,000	=	3,00,000
[-5,000]	+	0	+	0	=	[-5,000]
2,35,000	+	40,000	+	20,000	=	2,95,000

Business enterprises borrows money in the form of loan from outsiders to carry on its activities. In other words, every business concern owes money from outsiders. Money borrowed from outsiders is called as liability. For example, ₹1,50,000 were borrowed from Shipra. Thus, the position of the assets and capital will be as under

Cash	+	Machinery	+	Furniture	=	Liabilities	+	Capital
2,35,000	+	40,000	+	20,000	=	0	+	2,95,000
+1,50,000	+	0	+	0	=	1,50,000	+	0
3,85,000	+	40,000	+	20,000	=	1,50,000	+	2,95,000

The fact that business receives funds from proprietors and creditors and retains all of them in the form of assets, can be presented in the terms of an accounting equation as under

Assets = Liabilities + Capital or $A = L + C$

OR

$$\text{Liabilities} = \text{Assets} - \text{Capital} \quad \text{or} \quad L = A - C$$

OR

$$\text{Capital} = \text{Assets} - \text{Liabilities} \quad \text{or} \quad C = A - L$$

Expenses and Revenue also affect the accounting equation. Their effect is always on the capital.

A business concern has to meet some expenses in its normal course of operations such as payment of salary, rent, insurance premium, postage, wages, repairs etc. Payment of these expenses reduces the cash. These expenses reduce the net income of the business. All the income is the income of proprietor, which is added in the capital account, so all these expenses are deducted from the capital. Similarly, business concern receives some revenues during normal course of operations, such as rent received, commission received, etc. Revenue is added to the cash balance as it is received in terms of cash. Revenue increases the net income of the business and hence, it is added to the capital. Now, the accounting equation is represented by

Assets	=	Liabilities	+	Capital
+ Revenue [Cash]	=		+	Revenue
- Expenses [Cash]	=		-	Expenses

Accounting equation is thus, affected by every business transaction. Any increase or decrease in assets, liabilities, and capital can be identified by preparing accounting equation. It shows that every business transaction satisfies the dual aspect concept of accounting. It also serves as the basis for preparing the Balance Sheet.

Effect of Transactions on the Account Equation

You have learnt that assets, liabilities and capital are the three basic elements of every business transaction, and their relationship is expressed in the form of accounting equation which always remains equal. At any point of time, there can be a change in the individual asset, liability or capital, but the two sides of the accounting equation always remain equal. Let us verify this fact by taking up some transactions and see how these transactions affect the accounting equation :

- Namita started business with cash ₹3,50,000 introduced as capital. Thus the equation is as :

Assets	=	Liabilities	+	Capital
3,50,000	=	0	+	3,50,000

This transaction shows that ₹3,50,000 have been introduced by Namita in terms of cash, which is the capital for the business concern. Hence on one hand, the asset [cash] has been created to the extent of ₹3,50,000

2. She purchased goods for cash ₹90,000.

Thus the accounting equation is as :

	Assets			=	Liabilities	+	Capital
	Cash	+	Goods				
Old Equation	3,50,00			=	0	+	3,50,000
Effect of Transaction	-90,000	+	90,000	=	0	+	0
New equation	2,60,00	+	90,000	=	0	+	3,50,000

Goods purchased in an asset and cash paid is also an asset. Hence in this transaction, there is an increase in one asset [Goods] and decrease in the other asset [cash]. There is no change in capital and liabilities. i.e. other side of the accounting equation.

3. She purchased goods from Mohit for 60,000 on credit

Thus the equation is as :

	Assets			=	Liabilities	+	Capital
	Cash	+	Goods				
Old Equation	2,60,00	+	90,000	=	0	+	3,50,000
Effect of Transaction	0	+	60,000	=	60,000	+	0
New equation	2,60,00	+	1,50,000	=	60,000	+	3,50,000

In this transaction goods have been purchased on credit from Mohit, hence there is an increase in the assets [goods] by ₹60,000 and also an increase in the liabilities by ₹60,000 as the business concern now owes money to Mohit.

4. She sold goods to Anish for ₹40,000 (Cost ₹25,000) and received Cash ₹10,000 and balance after one month. Thus the accounting equation is as :

	Assets				=	Liabilities	+	Capital	
	Cash	+	Goods	+	Debtors				
Old Equation	2,60,00	+	1,50,000	+	0	=	60,000	+	3,50,000
Effect of									

Transaction	10,000	+	[-25,000]	+	30,000	=	0	+	15,000
New equation	2,70,00	+	1,25,000	=	30,000	=	60,000	+	3,65,00

In this transaction goods have been sold on credit and some on cash to Anish, so there is a decrease in the assets [goods] by ₹25,000, and increase in the assets (Anish) by ₹30,000 and [Cash] by ₹10,000. In this process the proprietor has gained an amount of ₹15,000 which is added to his capital.

5. She paid salaries to employees for ₹60,000

Thus the equation is as :

	Assets			=	Liabilities + Capital	
	Cash	+	Goods	+	Debtors	
Old Equation	2,70,00	+	1,25,000	+	30,000	= 60,000 + 3,65,000
Effect of						
Transaction	[-16,000]	+	0	+	0	= 0 + [-16,000]
New equation	2,54,000	+	1,25,000	+	30,000	= 60,000 + 3,49,000

In this transaction, salaries paid to employees are expenses for the business concern. Salaries are paid in terms of cash, hence cash as an asset is reduced by ₹16,000 and as all expenses reduce the capital, so capital is also reduced by ₹16,000.

From the above transactions, it is obvious that how every transaction has its effect on the accounting equation without disturbing the equality of the two sides of the equation.

Illustration 1

Prepare accounting equation from the following Transactions :

- | | |
|--|----------|
| 1. Hemant started business with cash | 3,00,000 |
| 2. Purchased goods for cash | 80,000 |
| 3. Sold goods [costing 30,000] for | 45,000 |
| 4. Purchased goods from Monika | 70,000 |
| 5. Salary paid | 7,000 |
| 6. Commission received | 5,000 |
| 7. Paid Cash to Monika in full settlement | 69,000 |
| 8. Goods sold to Rahul {Costing ₹20,000} for | 25,000 |

Solution

Sl. No.	Transaction	Assets			= Total	Equity		Total	
		Cash	Goods	Debtors		Liabilities	Capital		
1.	Started business with cash	3,00,00	+	0	+	0	+	3,00,000	3,00,000
2.	Purchased goods for cash New Equation	-80,000	+	80,000	+	0	+	0	3,00,000
3.	Sold goods for cash New Equation	45,000	+	-30,000	+	0	+	15,000	3,15,000
4.	Purchased goods from Monika New Equation	0	+	70,000	+	0	+	70,000	3,85,000
5.	Salary paid New Equation	-7,000	+	0	+	0	+	-7,000	3,78,000
6.	Commission received New Equation	5,000	+	0	+	0	+	5,000	3,83,000
7.	Paid Cash to Monika in full settlement New Equation	-69,000	+	0	+	0	+	-70,000	3,14,000
8.	Goods sold to Rahul New Equation	0	+	-20,000	+	25,000	+	0	3,19,000
		1,94,000	+	1,00,000	+	25,000	+	0	3,19,000

Illustration 2

Prepare accounting equation from the following Transactions :

	₹
1. Nutan started business with cash	4,00,000
2. Purchased goods for Rohit	60,000
3. Sold goods [costing ₹25,000] for cash	22,000
4. Purchased goods for cash	50,000
5. Salary outstanding	3,000
6. Rent received	6,000
7. Paid Cash to Rohit on account	35,000
8. Goods sold to Bharti {Costing ₹30,000} for	40,000

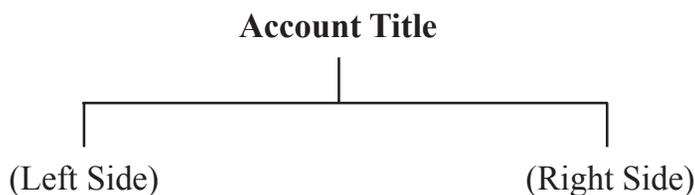
(Answer in Next Page)

2.3 RULES OF ACCOUNTING

Using Debit and Credit

In Double Entry accounting both the aspects of the transaction are recorded. Every transaction has two aspects and according to this system, both the aspects are recorded. If the business acquires something, it must have been acquired by giving something. While recording each transaction, the total amount debited must be equal to the total amount credited. The terms 'Debit' and 'Credit' indicate whether the transaction is to be recorded on the left hand side or right hand side of the account. In this simplest form, an account looks like the English Language Letter 'T'. Because of its shape, this simple form of account is called T-account (refer figure 4.5). Have you observed that the 'T' format has a left side and a right side for recording increases and decreases in the item? This helps in ascertaining the ultimate position of each item at the end of an accounting period. For example, if it is an account of a supplier all goods/materials supplied shall appear on the right (Credit) side of the Supplier's account and all payments made on the left (debit) side.

In a 'T' account, the left side is called debit (usually abbreviated as Dr.) and the right side is known as credit (as usually abbreviated Cr.).



Solution

Sl. No.	Transaction	Assets			= Total	Equity		Total	
		Cash	Goods	Debtors		Liabilities	Capital		
1.	Started business with cash	4,00,00	+	0	+	0	+	4,00,000	4,00,000
2.	Purchased goods for cash New Equation	0	+	60,000	+	0	+	0	4,60,000
3.	Sold goods for cash New Equation	22,000	+	[-25,000]	+	0	+	[-3,000]	4,57,000
4.	Purchased goods from Monika New Equation	[-50,000]	+	50,000	+	0	+	0	4,57,000
5.	Salary paid New Equation	0	+	0	+	0	+	[-3,000]	4,57,000
6.	Commission received New Equation	6,000	+	0	+	0	+	6,000	4,63,000
7.	Paid Cash to Monika in full settlement New Equation	[-35,000]	+	0	+	0	+	0	4,28,000
8.	Goods sold to Rahul New Equation	0	+	[-30,000]	+	40,000	+	10,000	4,38,000

Rules of Accounting

All accounts are divided into five categories for the purpose of recording of the business transactions :

- (i) Assets, (ii) Liability, (iii) Capital,
 (iv) Expenses / Losses, and (v) Revenue/Gains.

Two Fundamental Rules are followed to record the changes in these accounts :

- For recording changes in Assets / Expenses / Losses

“Increase in Asset is debited, and decrease in Asset is credited”
 “Increase in Expenses/Losses is debited, and decrease in Expenses/Losses is credited.”

- For recording changes in Liabilities and Capital / Revenue / Gains

“Increase in Liabilities is credited and decrease in Liabilities is debited.”
 “Increase in Capital is credited and decrease in Capital is debited.”
 “Increase in revenue/gains is credited and decrease in revenue/gain is debited”.

The rules applicable to the five kinds of accounts are summarised in the following chart:

Rules of Accounting

Assets	Liabilities
(Increase) +	(Decrease) -
Debit	Credit
Capital	Expenses/Losses
(Decrease) -	(Increase) +
Debit	Credit
Revenue/Gains	Expenses/Losses
(Decrease) -	(Decrease) -
Debit	Credit

I. Analysis of Rule Applied to Assets Accounts

Rohan Purchased Furniture for 80,000.

Analysis of Transaction : In this transaction, the affected accounts are Cash account and Furniture account. Cash account is an assets account and has decreased. As per rule if asset decreases the affected account is credited, so cash account credited. Furniture is also an asset and it has increased. As per rule asset if increases the affected account is debited thus, furniture account is debited.

Cash		Furniture	
	Decrease 80,000 [-] Credit	Increase 80,000 [+] Debit	

II. Analysis of Rule Applied to Liabilities Accounts

Purchase Machinery for 60,000 on credit from M/s Indian Machinery Mart.

Analysis of Transaction : In this transaction, the two accounts affected are machinery and M/s Indian Machinery Mart. Machinery is an asset, an asset has increased, therefore machinery account is debited. M/s Indian Machinery Mart is the creditor on account of supply of machinery and constitutes, the liability for the buying firm which has increased. Rule is that no increase of liability the concerned account is credited and vice-versa. Thus, M/s Indian Machinery Mart A/c is credited.

M/s Indian Machinery Mart (Liability)		Machinery (Asset)	
	Increase 60,000 [+] Credit	Increase 60,000 [+] Debit	

III. Analysis of Rule Applied to Capital Account :

Cash of 50,000 introduced in business as Capital by Rakeh.

Analysis of Transaction : In this transaction, the two accounts affected are Cash account and Rakesh [Capital account]. Cash is an asset and Rakesh invested capital. Rule for Capital is that if it increase the account is credited and vice-versa. So, here capital account is credited.

Capital (Rakesh) Account		Cash (Asset)	
	Increase	Increase	
	50,000	50,000	
	[+] Credit	[+] Debit	

IV. Analysis of Rule Applied to Expenses/Losses Accounts :

Paid 60,000 to the employees as Salary.

Analysis of Transaction : In this transaction, the two accounts affected are salary account and Cash account. Salary account is an expense and has increased. Cash is an asset and decreased. Rule regarding expenses/losses is that if it increases the account is debited.

Salary Account [Expenses]		Cash (Assets)	
Increase			Decrease
6,000			6,000
[+] Debit			Credit [-]

V. Analysis of Rules Applied to Revenue/Profit Accounts :

Received interes for the month 4,000.

Analysis of Transaction : In this transaction, the two accounts affected are Interest and Cash. Interest is an item of Income and Cash an item of asset. Rule regarding Recenue/ profit is, increase in revenue is credited. Cash is an asset and rule for assets is increase in assets is debited.

Interest Account (Revenue)		Cash (Assets)	
	Increase	Increase	
	4,000	4,000	
	[+] Credit	[+] Debit	

Illustration 3

From the following transactions, state the titles of the accounts to be affected, types of the accounts and the account to be debited and the account to be credited :

	₹
1. Ankur started business with cash	6,00,000
2. Purchased goods for cash	80,000
3. Paid salaries	10,000
4. Sold goods to Rohit on Credit	60,000
5. Office machine purchased for cash	12,000
6. He took loan from Bank	30,000
7. He received commission	4,000
8. Postage paid	500
9. Paid rent	6,000
10. Received cash from Rohit	60,000

Solution

Trans- action No.	Names of accounts		Type of accounts		Type of accounts	
	(1)	(2)	(1)	(2)	(1)	(2)
1	Cash	Capital	Asset	Capital	Cash (Increase)	Capital (Increase)
2	Purchases	Cash	Expense	Asset	Purchase (")	Cash (decrease)
3	Salaries	Cash	Expense	Asset	Salaries (")	Cash (decrease)
4	Rohit	Sales	Asset Debtor	Revenue	Rohit (")	Sales (Increase)
5	Office machine	Cash	Asset	Asset	Office (") machine	Cash (decrease)
6	Cash	Bank loan	Asset	Liability	Cash (Increase)	Bank loan (Increase)
7	Cash	Commis- sion	Asset	Revenue	Cash (Increase)	Commission (Increase)
8	Postage	Cash	Expense	Asset	Printing and Stationery (Increase)	Cash (decrease)
9	Rent	Cash	Expense	Asset	Rent (Increase)	Cash (decrease)
10	Cash	Rohit	Asset	Asset	Cash (Increase)	Rohit (decrease)

2.4 Basis of Accounting

Using Debit and Credit

As we are aware that one of the most significant functions of accounting is to make us know true and fair amount of profit earned by the business entity in a particular period. This Profit or income figure can be ascertained by following

- (i) Cash Basis of accounting
- (ii) Accrual Basis of accounting
- (iii) Hybrid Basis of accounting

I. Cash Basis of accounting

This is a system in which accounting entries are recorded only when cash is received or paid. Revenue is recognized only on receipt of cash. Similarly, expenses are recorded as incurred when they are paid. The difference between the total revenues and total expenses represents profit or loss of an enterprise for a particular accounting period. Outstanding and prepaid expenses and income received in advance or accrued incomes are not considered.

Advantages

Following are the advantages of adopting cash basis of accounting:

- It is very simple as no adjustment entries are required.
- It appears more objective as very few estimates and personal judgments are required.
- It is more suitable to those entities which have most of the transactions on cash basis.

Disadvantages

Following are the disadvantages of adopting cash basis of accounting:

- It does not give a true and fair view of profit and loss and the financial position of the business unit as it ignores outstanding and prepaid expenses.
- It does not follow the matching concept of accounting.

Illustration 4

During the financial year 2023-24, Mela Ram had cash sales of ₹5,80,000 and credit sales of ₹2,65,000. His expenses for the year were ₹4,60,000 out of which ₹60,000 are

still to be paid. Find out Mela Ram's Income for the year 2023-24 following the cash basis of accounting.

Solution :

	Amount (₹)
Revenue (in terms of Cash Inflows)	580000
Less : Expenses (Outflow of cash) (i.e. 460000-60000)	400000
Net Income	<u>180000</u>

Note : Credit Sales and Outstanding Expenses are not be considered under cash basis of accounting.

II. Accrual Basis of accounting

Revenue and expense are taken into consideration for the purpose of income determination on the basis of accounting period to which they relate. The accrual basis makes a distinction between actual receipts of cash and the right to receive cash for revenues and the actual payment of cash and the legal obligation to pay expenses. It means the income accrued in the current year becomes the income of the current year whether the cash for that item is received in the current year or it was received in the previous year or it will be received in the next year. The same is true of expense items. Expense item is recorded if it becomes payable in the current year whether it is paid in the current year or it was paid in the previous year or it will be paid in the next year. For example, credit sales are included in the total sales of the period irrespective of the fact when cash on account is received. Similarly, in case the firm has taken benefit of a certain service, but has not paid within that period, the expense will relate to the period in which the service has been utilized and not the period in which the payment for it is made.

Outstanding Expenses are those expenses which have become due during the accounting period but which have yet not been paid off. Prepaid Expenses are those expenses which have been paid in advance. Accrued Income means income which has been earned by the business during the accounting period but has not yet become due for payment and therefore has not yet been received. Income received in advance means income which has been received by the business before being earned. Costs incurred during a particular period should be set out against the revenue of the period to ascertain profit or loss.

Following are the advantages :

- It is based on all business transactions of the year and discloses correct profit or loss.
- This method is used in all types of of business units.
- It is more scientific and rational in application.

Following are the disadvantages

- It is not simple one and requires the use of estimates and personal judgement
- It fails disclose actual cash flow.

Illustration 5

Taking the data given in the Illustration 4, find out the net income of Mela Ram as per accrual basis of accounting.

Solution

	Amount (₹)
Total Sales :	
Cash Sales (580000) + Credit Sales (265000)	845000
Less : Total Expenses for the year 2023-24	460000
Net Income	385000

Note : Outstanding Expenses of ₹60,000 relate to this accounting year and hence are to be charged to the revenues of current year. Similarly, credit sales of ₹2,65,000 are considered for this year as the transaction took place during this current year.

Difference between accrual basis of accounting and cash basis of accounting

<i>Basis of Difference</i>	<i>Accrual Basis of accounting</i>	<i>Cash Basis of accounting</i>
1. Prepaid, Outstanding and received in advance items	There may be outstanding expense, prepaid expenses, accrued income and income received in advance in the Balance sheet.	There is no outstanding expense, prepaid expenses, accrued income and income received in advance in the Balance Sheet
2. Effect on income of prepaid expense and accrued income	Income statement will show relatively higher income if there are items of prepaid expenses and accrued income.	Income statement will show relatively lower income if there are items of prepaid expenses and accrued income
3. Effect of outstanding expenses and unearned income	Income statement will show a lower income if there are items of outstanding expenses and unearned income	Income statement will show a higher income if there are items of outstanding expenses and unearned income
4. Legal Position	Companies Act 1956 recognizes this basis of accounting	Companies Act 1956 does not recognize this basis of accounting.

5. Option regarding valuation of inventories and method of depreciation	The business unit has the option to value the inventories at cost or market, whichever is less of depreciation.	No such option is available in regard to inventory valuation and method of depreciation.
6. Reliable	It is a reliable basis of accounting as it records all cash as well credit transactions. It ascertains true profit or loss.	It is not a reliable basis of accounting as only cash transactions are recorded. It fails to ascertain true profit or loss.
7. Users	A business unit with a profit motive ascertains its profit or loss as per accrual basis.	Professional people, small ventures of temporary nature, some Not-for-Profit Organizations ascertain their profit or loss as per cash basis.

III. Hybrid Basis of Accounting

Both cash basis of accounting and accrual basis of accounting have their own advantages and limitations. Cash Basis of Accounting can be used only in units which deal exclusively in cash and are very small in size. These days the number of transactions undertaken by an enterprise are very large and are for cash as well as on credit. Hence, an accounting system which is the combination of both cash as well as accrual basis is in use. This system is called hybrid basis of accounting. It has advantages of both the systems and is able to eliminate disadvantages of the both the system.

2.5 Double Entry Mechanism

Double Entry Mechanism entails recording of transactions keeping in mind the debit and credit aspect of the transaction. To record every transaction, one account is debited and the other is credited. This is based on the principle 'every debit has a credit'. The Double entry Book-Keeping seeks to record every transaction in money or money's worth in its dual aspect. The advantages of double entry mechanism are :

- **Systemic Record :** It records, classifies, and synthesizes the business transaction in a systematic manner. It provides reliable information for sound decision making. It meets the needs of users of accounting information.
- **Complete Record :** It maintains complete record of a business transaction. It records both the aspects of the transaction with narration.

- **Accurate records :** By preparing a Summarised Statement of Account the arithmetic accuracy of the records can be checked.
- **Operational Results :** By preparing Income Statement (Profit and Loss Account) the business can know profit or loss due to its operations during an accounting period.
- **Financial Position :** By preparing Position Statement (Balance Sheet) the business can know what it owns and what it owes to others. What are its assets and what are its Liabilities and Capital.
- **Possibility of Fraud :** Possibility of Frauds is minimized as complete information is recorded under this system.

2.6 Journal

Journal is a book of accounts in which all day to day business transactions are recorded in a chronological order i.e. in the order of occurrence. Transactions when recorded in Journal are known as entries. It is the book in which transactions are recorded for the first time. Journal is also known as ‘Book of Original Record’ or ‘Book of Primary Entry’.

Business transactions of financial nature are classified into various categories of accounts such as assets, liabilities, capital, revenue and expenses. These are debited or credited according to the rules of debit and credit, applicable to the specific accounts. Every business transaction affects two accounts. Applying the principle of double entry, one account is debited and the other account is credited. Every transaction can be recorded in Journal. The process of recording transactions in the Journal is known as ‘Journalising’.

Format of Journal

Every page of Journal has the following format. It is a columnar book. Each column is given a name written on its top. Format of journal is given below :

<i>Date</i>	<i>Particulars</i>	<i>Ledger Folio</i>	<i>Dr. Amount (Rs.)</i>	<i>Cr. Amount (Rs.)</i>
<i>(1)</i>	<i>(2)</i>	<i>(3)</i>	<i>(4)</i>	<i>(5)</i>

1. **Date :** In this column, we record the date of the transactions with its month and accounting year. We write year only once at the top and need not repeat it with every date.

2. **Particulars :** The accounts affected by the transaction i.e the accounts which have to be debited or credited are recorded in this column. In the first line, account which is to be debited is written and then the short form of Debit i.e. Dr is written against that name in the extreme right of the same column. In the second line after leaving some space from the left of the entry in the first line, the account which has to be credited is written starting with preposition 'To'. Then in the third line, narration for that entry which explains the transaction, the affected accounts of which are entered, is written within brackets. Narration should be short, complete and clear. After every journal entry, horizontal line is drawn in the particulars column to separate one entry from the other.
3. **Ledger Folio :** The transaction entered in a Journal is posted to the various related accounts in the 'ledger'. In ledger-folio column we enter the page number where the account pertaining to the entry is opened and posting from the Journal is made.
4. **Dr. Amount :** In this column, the amount to be debited is written against the same line in which the debited account is written.
5. **Cr.Amount :** In this column, the amount to be credited, is written against the same line in which the credited account is written.

2.7 Process of Journalising

Following steps are taken for the preparation of a journal :

- Identify the accounts : In every accounting transaction, the affected accounts are to be identified.
 - Recognise the type of accounts: The second step is to determine the type of the affected accounts i.e whether it is of expense, income, asset, capital or liability in nature.
 - Apply the Rules of Debit and Credit: Last step is to apply the rules of debit and credit to the affected accounts.
- (a) Assets and Expenses Accounts are debited if there is an increase and credited if there is decrease.
 - (b) Liability, Capital and Revenue Accounts are debited if there is decrease and credited if there is increase.

Illustration 6

Analyse in Tabular form and Enter the following transactions in the Journal of Tarun

		₹
2023		
January 1	Tarun started business with cash	1,00,000
January 2	Goods purchased for cash	20,000

January 4	Machinery Purchased from Vibhu	30,000
January 6	Rent paid in cash	10,000
January 8	Goods purchased on credit from Anil	25,000
January 10	Goods sold for cash	40,000
January 15	Goods sold on credit to Gurmeet	30,000
January 18	Salaries paid.	12,000
January 20	Cash withdrawn for personal use	5,000

Solution

As explained above, before making the journal entries, it is very essential to determine the kind of accounts to be debited or credited. This is shown in the Table :

Tabular Analysis of Business Transactions

<i>Date</i>	<i>Transaction</i>	<i>Affected Accounts</i>	<i>Kind of Accounts</i>	<i>Increase or Decrease in Accounts</i>	<i>Debited Accounts Dr.</i>	<i>Credited Accounts Cr.</i>
2023 Jan.1	Cash received from the owner Tarun	Cash Capital	Asset Capital	Increase Increase	Cash A/c	Capital A/c
Jan.2	Goods purchases for cash	Goods Cash	Asset Asset	Increase Decrease	Purchases A/c	Cash A/c
Jan.4	Machinery purchased on Credit from Vibhu	Machinery Vibhu	Asset Liability	Increase Increase	Machinery A/c	Vibhu A/c
Jan.6	Rent paid in cash	Rent Cash	Expense Asset	Increase Decrease	Rent A/c	Cash A/c
Jan.8	Goods on purchased Credit from Anil	Purchases Anil (creditor)	Asset Liability	Increase Decrease	Purchases A/c	Anil A/c
Jan.10	Goods sold for cash Cash	Cash sales	Asset Revenue	Increase Increase	Cash A/c	Sales A/c
Jan.15	Credit sales to Gurmeet	Gurmeet (Debtor) Sales	Asset Revenue	Increase Increase	Gurmeet	Sales A/c

Jan.18	Salaries paid in cash	Salaries Cash	Expense Asset	Increase Decrease	Salaries A/c	Cash A/c
Jan.20	Cash withdrawn for personal use	Drawings Cash	Capital Asset	Decrease Decrease	Drawings A/c	Cash A/c

On the basis of the above table, following entries can be made in the Journal.

Journal of Tarun

<i>Date</i>	<i>Particulars</i>	<i>L.F.</i>	<i>Dr. Amount ₹</i>	<i>Cr. Amount ₹</i>
2023 Jan. 1	Cash A/c Dr. To Tarun Capital A/c (Capital brought in by Tarun)		1,00,000	1,00,000
Jan. 2	Purchases A/c Dr. To Cash A/c (Goods purchased for Cash)		20,000	20,000
Jan. 4	Machinery A/c Dr. To Vibhu's A/c (Machinery purchased from Vibhu on credit)		30,000	30,000
Jan. 6	Rent A/c Dr. To Cash A/c (Rent paid)		10,000	10,000
Jan. 8	Purchases A/c Dr. To Anil's A/c (Good purchased on credit)		25,000	25,000
Jan. 10	Cash A/c Dr. To Sales A/c (Good sold for Cash)		40,000	40,000

Jan. 15	Gurmeet's A/c To Sales A/c (Good sold on credit to Gurmeet)	Dr.	30,000	30,000
Jan. 18	Salaries A/c To Cash A/c (Salaries paid)	Dr.	12,000	12,000
Jan. 20	Drawings A/c To Cash A/c (Cash withdrawn by the owner for personal use)	Dr.	5,000	5,000

2.8 Simple Compound and Adjusting Entries

A simple journal entry contains only one debit and one credit. But if an entry contains more than one debit or credit or both, that entry is known as a compound journal entry.

A compound journal entry is a combination of two or more simple journal entries which occur in the same day and one aspect i.e. either the debit or credit account is common.

A compound journal entry can be made in the following three ways:

- (i) By debiting one account and crediting more than one account
- (ii) By debiting more than one account and crediting one account

By debiting more than one account and also crediting more than one account.

Adjusting Journal entries are made for adjustments of outstanding expenses such as rent outstanding, prepaid expenses such as insurance premium paid in advance, accrued income such as rent (income) has become due but not received and income received in advance such as commission has been received though not yet due.

Following are the items for which adjustment is required :

1. Outstanding Expenses
2. Prepaid Expenses
3. Accrued Income
4. Income Received in Advance
5. Depreciation
6. Interest on Capital
7. Drawings

Illustration 7

Enter the following transactions in the books of Supriya, the owner of the business :
2023

- Jan. 8 Purchased goods worth 5,000 from Sarita on credit.
Jan. 12 Neha Purchased goods worth 4,000 from Supriya on credit.
Jan. 18 Received a Cheque from Neha in full settlement of her account 3,850.
Discount allowed to her 150
Jan. 20 Payment made to Sarita 4,900. Discount allowed by him 100.
Jan. 24 Goods sold to Kavita for 15,000.
Trade discount @20% is allowed to her.
Jan. 29 Payment received from Kavita by Cheque.

Solution

The above transactions will be entered in the journal as follows :

Journal of Supriya

<i>Date</i>	<i>Particulars</i>	<i>L.F.</i>	<i>Dr. Amount ₹</i>	<i>Cr. Amount ₹</i>
2014				
Jan. 8	Purchases A/c Dr. To Sarita A/c (Capital brought in by Tarun)		5,000	5,000
Jan. 12	Neha's A/c Dr. To Sales A/c (Goods sold on credit to Neha)		4,000	4,000
Jan. 18	Bank A/c Dr. Discount A/c Dr. To Neha's A/c (Payment received from Neha and discount allowed)		3,850 150	4,000

Jan. 20	Sarita's A/c	Dr.	5,000	
	To Cash A/c			4,900
	To Discount A/c			100
	(Payment made and discount allowed by Sarita)			
Jan. 22	Purchases A/c	Dr.	10,000	
	To Cash A/c			10,000
	(Goods purchased for cash)			
Jan. 24	Kavita A/c	Dr.	12,000	
	To Sales A/c			12,000
	(Sold goods to Kavita on credit of ₹15000 less Trade Discount @20%)			
Jan. 29	Bank A/c	Dr.	12,000	
	To Kavita's A/c			12,000
	(Payment received from Kavita by Cheque)			

2.9 Classification of Journal

Journal is a book in which transactions are recorded in chronological order/date wise, therefore it will be practically difficult to record if the number of transactions is large. To take the benefit of division of labour, journal should be divided into number of specialized journals or subsidiary books.

Subsidiary books are the books of original entry as all transactions are first recorded in these books before they are recorded in respective accounts in ledger. These special journals are called subsidiary books because they are subsidiary to the principal or main book namely ledger. Subsidiary books do not provide final accounting information relating to the business but helps in the preparation of ledger accounts.

Advantages of Subsidiary Books

When the size of business grows, automatically the number of transactions will increase. Hence, it is very difficult to record all transactions in one journal. It is desirable to divide the journal in to various subsidiary books to record similar nature of transactions at one place.

Following are the advantages of subsidiary books :

Easy recording : Recording of transactions is simplified, in this system as transactions are not journalized except in the journal proper. Transactions can be recorded quickly and easily.

Time saving : No journal entries are recorded in subsidiary books, transactions are entered into their respective subsidiary books and then directly posted into the ledger which results in saving of time, and there is a substantial reduction of clerical work which results in saving of stationary and human resource cost.

Division of work : Sub division of the journal into subsidiary books will results in improved efficiency due to repetitive work, which leads to the specialization and perfection in recording as each staff is entrusted with only one activity of accounting work to undertake the same work repeatedly.

Availability of information : Easy reference becomes possible since each subsidiary book provides information relating to a particular aspect of the business only. Information relating to particular item is available at one place, eg: information related to credit purchases of goods is available in purchases book. Whenever any information is needed, the particular subsidiary book is directly referred to get such information.

Detection of errors : The existence of separate books helps in detection of errors quickly in case of disagreement of trial balance.

Business Transactions

Generally Business Transactions are classified into two types:

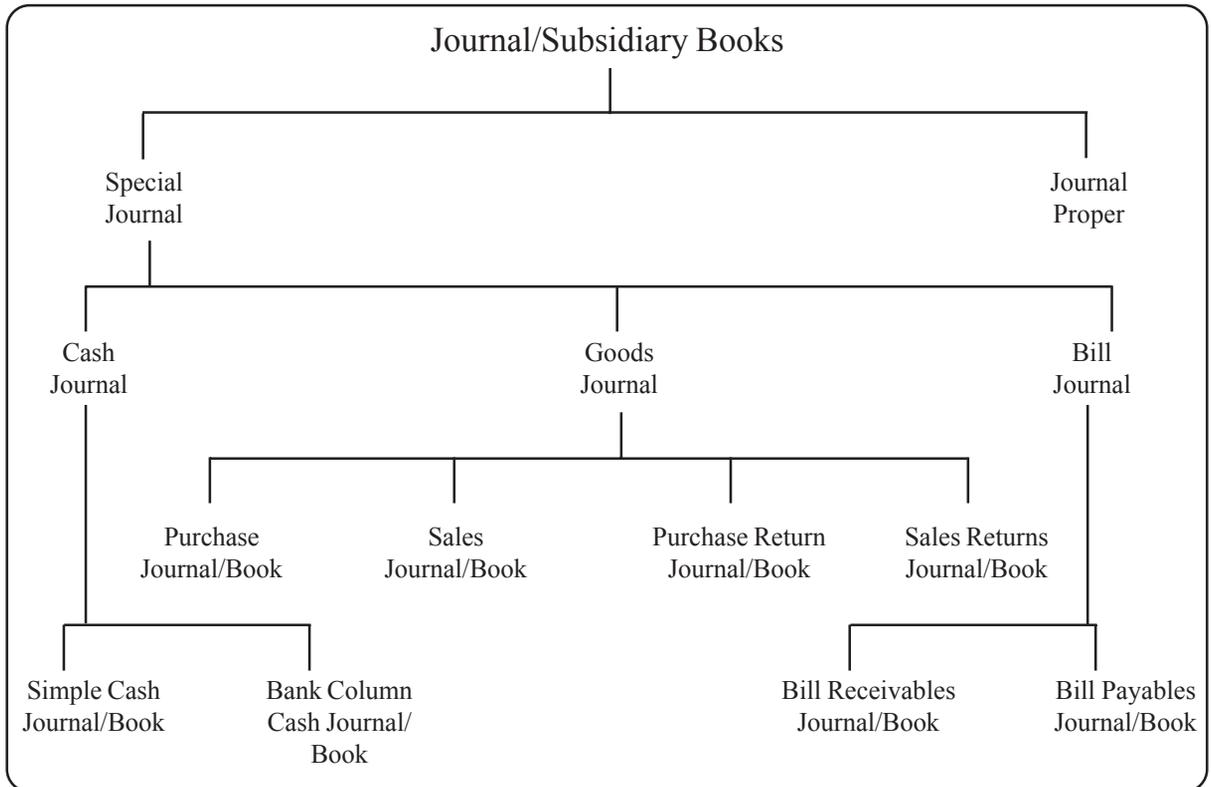
- A. Cash Transactions
- B. Credit Transactions

The above classification is briefly explained as under:

A. Cash Transactions : The Transaction in which receipt or payment of cash is involved, such transaction is called cash transaction. Cash transactions are recorded in particular subsidiary journal i.e., Cash Book.

B. Credit Transactions : Any transaction in which receipt or payment of cash is not involved, such transaction is called credit transaction. Credit transactions are recorded in the subsidiary books other than the cash book.

Classification of Journal can be explained with the help of the following chart :



Types of Journal / Subsidiary Books

Following are the different subsidiary books used in business:

1. Purchases book - To record credit purchases of goods.
2. Purchases returns book - To record all purchases returns i.e. all goods returned by the trader to his suppliers.
3. Sales book - To record all credit sales of goods.
4. Sales return book – To record all sales returns i.e. all goods returned by the customers to the trader.
5. Cash book - To record receipts and payments of cash including deposits and payments out of bank.
6. Bills receivable book –To record all the bills received from the customers
7. Bills payable book - To record all the bills accepted by the customers
8. Journal proper - To record all those transaction that cannot be recorded in any of the above books. Example: opening entries, closing entries, adjustment entries etc.

Purchases book

Purchases book is the book of original entry in which only credit purchase of goods are recorded. Cash purchases of goods and assets are recorded in cash book. Credit purchases related to assets is also not recorded in the purchases book. They are recorded in the journal proper. When goods are purchased on credit, the supplier of goods sends an invoice to trader along with the goods; this invoice is popularly known as “Purchase bill”. It is the primary source of document for recording transactions in Purchases book.

Format of Purchases Book

<i>Date</i>	<i>Particulars</i>	<i>Inward Invoice No.</i>	<i>L.F.No.</i>	<i>Details</i>	<i>Amount Rs.</i>

Explanation to Columns of Purchases book

1. **Date column:** The date of credit Purchases is entered in the date column.
2. **Particulars column:** This column is meant for recording the names of the suppliers of goods.
3. **Inward invoice number:** This column is meant for recording the serial number of each inward invoice. It is written to facilitate reference to the inward invoice.
4. **Ledger folio column:** This column is meant for recording the page number of the ledger where the account of the supplier is opened.
5. **Details column:** If more than one item is purchased and trade discount is given, then it is entered in the Details column.
6. **Amount column:** In the amount column the net amount of the invoice is entered.

Illustration 8

From the following transactions during the month of January 2023 prepare **purchases book**

January 1 purchased goods from Nithya Rs. 6,000

January 5 purchased goods from Anuhya Rs.4,000 (Trade discount Rs.200)

January 10 Goods purchased from Lathika Rs.10,000 (Trade discount 10%)

January 15 Varsha sold goods to us Rs.5,000

January 20 Purchased goods from Srinidhi for cash Rs.5,000

Solution**Purchases book**

<i>Date</i>	<i>Particulars</i>	<i>Inward Invoice No.</i>	<i>L.F.No.</i>	<i>Details</i>	<i>Amount Rs.</i>
2023					
Jan 1	Nithya				6,000
Jan 5	Anuhya			4,000	
	Less : Trade Discount			200	3,800
Jan 10	Lathika			10,000	
	Less : Trade Discout (10%)			1,000	9,000
Jan 15	Varsha				5,000
	Total				23,800

Note : The transaction dated January 20, 2023 is not recorded in Purchases Journal because; it is cash transaction of purchases.

Illustration 9

Prepare Purchases Book from the following transactions

2021		Rs.
Dec. 2	Purchased goods from Manoj	5,000
Dec. 6	Goods bought from Arun (Trade discount 10%)	10,000
Dec. 7	Bought 10 boxes of goods @Rs.600 each from Deva Raju	6,000
Dec. 10	Purchased office table from Rajender furniture	10,000
Dec. 20	Cash purchases	5,000

Solution**Purchases book**

<i>Date</i>	<i>Particulars</i>	<i>Inward Invoice No.</i>	<i>L.F.No.</i>	<i>Details</i>	<i>Amount Rs.</i>
2023					
Dec. 2	Manoj				5,000
Dec. 6	Arun			10,000	
	Less : Trade Discount			1,000	9,000
Dec. 10	Deva Raju				6,000
	Total				20,000

Note: The transactions dated Dec. 10 asset and purchase Dec. 20, 2021 are not recorded because they are cash transactions

Purchases returns book or return outward book

Purchases returns book is a book of original entry in which transactions related to the return of purchased goods are recorded, there may be several reasons for returning the goods to the supplier, and few of them are as under:

- Some of the goods are found defective in quality.
- Some goods are found damaged in transit.
- Some goods are not up to the sample shown at the time of placing order.
- Quantity of the goods supplied is more than ordered.
- When there is a breach of agreement between the seller and the purchaser.

Debit Note: When the trader returns the goods to the supplier, a statement which is called debit note is sent along with it. Debit note is a statement sent by the purchaser to the seller giving particulars of the goods returned and reasons for returning them. It indicates the supplier that his account has been debited with the amount of goods returned and serially numbered and dated.

It contains the following details:

- Name and address of the supplier
- The value of the goods returned
- The value of the goods purchased
- The reasons for the return of goods

Format of Purchases Returns Book

<i>Date</i>	<i>Particulars</i>	<i>Debit Note</i>	<i>L.F. No.</i>	<i>Amount Rs.</i>

Explanation to columns in the Purchases Returns Book

1. **Date column:** The date on which the goods are returned is recorded
2. **Particulars column:** Name and address to whom goods are returned is recorded
3. **Debit note column:** Debit note number is recorded

4. **L.F No. column:** Page number of the supplier account is recorded
5. **Amount column:** Net value of the goods returned is recorded

Illustration 10

Enter the following transactions in **Purchases Returns Book**

2020

Jan 5 Returned goods to Ramesh, Hyderabad Rs. 2,000

Jan 10 Returned goods to Soujanya Bangalore Rs. 1,000

Jan 15 Returned goods to Suresh Bombay Rs. 2,000

Jan 20 Returned goods to Raghu Vizag Rs.1,000

Solution

Purchases Returns Book

<i>Date</i>	<i>Particulars</i>	<i>Debit Note</i>	<i>L.F. No.</i>	<i>Amount Rs.</i>
2020				
Jan 5	Ramesh, Hyderabad	1		2, 000
Jan 10	Soujanya, Bangalore	2		1, 000
Jan 15	Suresh, Bombay	3		2, 000
Jan 20	Raghu, Vizag	4		1, 000
	Total :			6, 000

Sales Book

Sales Book is a book of original entry in which only credit sale of goods are recorded. Cash sales of goods are recorded in the cash book. Credit sales of other assets are also not recorded in the sales book, they are recorded in the journal proper.

Format of Sales Book

<i>Date</i>	<i>Particulars</i>	<i>Outward Invoice Number</i>	<i>L.F. No.</i>	<i>Details</i>	<i>Amount Rs.</i>

Explanations to Columns of Sales Book:

- 1. Date Column:** The date on which goods were sold on credit shall be recorded
- 2. Particulars Column:** In this column, name of the customers/person, to whom the goods were sold on credit is written along with all details and description of goods
- 3. Outward Invoice Number Column:** The serial number of Invoice (source document) showing the sales of goods shall be recorded in this column
- 4. L.F.No Column:** Page number of the ledger of the customer, on which the transaction is recorded, is shown in this column.
- 5. Details Column:** The individual total amount of various items, if sold to the same customer shall be recorded in this column. If any trade discount is allowed is also shown in this column.
- 6. Amount Column:** The net amount receivable from the customer shall be recorded. The total amount of this column shall be transferred to the credit side of the sales account.

Illustration 11

Prepare **Sales Book** from the following in the books of Balaji Rao
2021

Feb 1 Sold goods to Rajani Rs.10,000

Feb 5 Goods sold to Mahalaxmi Rs. 20,000

Feb 10 Sales to Balalaxmi Rs. 15,000

Feb 15 Sold goods to Dhanalaxmi Rs.5,000 on credit

Feb 20 Sales to Varalaxmi Rs. 5,000 (Trade discount Rs.100)

Solution

Sales Book

<i>Date</i>	<i>Particulars</i>	<i>Outward Invoice Number</i>	<i>L.F. No.</i>	<i>Details</i>	<i>Amount Rs.</i>
2021					
Feb 1	Rajani				10,000
Feb 5	Mahalaxmi				20,000
Feb 10	Balalaxmi				15,000
Feb 15	Dhanalaxmi				5,000
Feb 20	Varalaxmi			5,000	
	Less : Trade Discount			100	4,900
	Total				54,900

Illustration 12

Enter the following transactions in the Sales Book.

		Rs.
2022		
Jan 1	Sold goods to Murthy on credit	6,000
Jan 5	Cash Sales	10,000
Jan 10	Goods sold to Sravan	3,000
Jan 15	Sold old furniture to Karthik	20,000
Jan 20	Sold 100 cases of goods @Rs.50/- each to Naveen	
Jan 25	Sold goods to Shyam (Trade discount 10%)	5,000

Solution

Sales Book

<i>Date</i>	<i>Particulars</i>	<i>Outward Invoice Number</i>	<i>L.F. No.</i>	<i>Details</i>	<i>Amount Rs.</i>
2022					
Jan 1	Murthy				6,000
Jan 10	Sravan				3,000
Jan 20	Naveen				5,000
Jan 25	Shyam			5,000	
	Less : Trade discount			<u>500</u>	4,500
	Total				18,500

Note : Jan 5 is Cash Sales and Jan 20 Sale of assets hence not recorded.

Sales Returns Book or Return Inwards Book

Sales Returns Book is a book of original entry in which transactions are related to the return of sold goods are recorded. It does not record return of goods sold on cash basis. There may be several reasons for returning the goods by the customer. Some of them are as under:

- On finding some defects in goods
- When there is delay in supply of goods to the customer
- When goods sent are not as per the sample or specifications.
- When there is a breach of agreement between the seller and the purchaser.

Credit Note :

It is a document prepared and sent to the customer to inform that his account is credited with the amount of goods returned to him sold earlier. Seller prepares a Credit Note in favour of the Buyer and serially numbered and dated. Usually it is made in Red Ink. It contains the following details.

- Name and address of the customer
- The value of goods returned
- The reasons for the return of goods

Format of Sales Returns Book

<i>Date</i>	<i>Particulars</i>	<i>Credit Note No.</i>	<i>L.F. No.</i>	<i>Amount Rs.</i>

Explanation to the Columns in Sales Returns Book

1. **Date Column** : The date on which goods are returned by the customer is recorded
2. **Particulars Column** : Name and address of the customers along with the details and description of the goods are recorded
3. **Credit Note Column** : Serial Number of the credit note is recorded
4. **L.F No Column** : Page number of the Debtor/Customer account is recorded
5. **Amount Column** : Net amount of the goods returned is recorded

Illustration 13

Prepare **Sales Returns Book** from the following

2020	Jan 1	Returned goods by Nagarjuna	Rs. 2,475
	Jan 5	Returned goods by Krishna	Rs. 3,120
	Jan 15	Returned goods by Satyam	Rs. 675

Solution**Sales Returns Book**

<i>Date</i>	<i>Particulars</i>	<i>Credit Note</i>	<i>L.F. No.</i>	<i>Amount Rs.</i>
2020				
Jan 1	Nagarjuna	1		2, 475
Jan 5	Krishna	2		3, 120
Jan 15	Satyam	3		675
	Total :			6, 270

Illustration 14

Enter the following transactions in to respective **Subsidiary Books**

2020	Jan 1	Purchased goods from Pranay, Palamuru	Rs. 900
	Jan 2	Sold goods to Sanjana, Sathupally	Rs. 1000
	Jan 4	Sold goods to Vinoda, Vikarabad	Rs. 2000
	Jan 10	Bought goods from Ravi, Rani gunj	Rs. 1,500
	Jan 14	Bought goods from Mohan, Mehdipatnam	Rs. 3000
	Jan 19	Sanjana returned goods to us	Rs. 200
	Jan 21	Returned goods to Pranay	Rs.200
	Jan 25	Returned goods to Mohan	Rs.500
	Jan 28	Sold goods to Nagesh, Nizamabad worth subjected to a Trade Discount of 10%	Rs. 5,000
	Jan 29	Vinoda returned goods to us	Rs. 300

Solution**Purchases Book**

<i>Date</i>	<i>Particulars</i>	<i>Inward Invoice No.</i>	<i>L.F.No.</i>	<i>Details</i>	<i>Amount Rs.</i>
2020					
Jan 1	Pranay, Palamuru				900
Jan 10	Ravi, Ranigunj				1,500
Jan 14	Mohan, Mehdipatnam				3,000
	Total				5,400

Purchases Returns Book

<i>Date</i>	<i>Particulars</i>	<i>Debit Note</i>	<i>L.F. No.</i>	<i>Amount Rs.</i>
2020				
Jan 21	Pranay, Palamuru			200
Jan 25	Mohan, Mehdipatnam			500
	Total :			700

Sales Book

<i>Date</i>	<i>Particulars</i>	<i>Outward Invoice Number</i>	<i>L.F. No.</i>	<i>Details</i>	<i>Amount Rs.</i>
2020					
Jan 2	Sanjana, Sathupally				1,000
Jan 4	Vinoda, Vikarabad				2,000
Jan 28	Nagesh, Nizamabad			5,000	
	Less : Trade Discount of 10%			500	4,500
	Total				7,500

Sales Returns Book

<i>Date</i>	<i>Particulars</i>	<i>Credit Note</i>	<i>L.F. No.</i>	<i>Amount Rs.</i>
2020				
Jan 19	Sanjana, Sathupally			200
Jan 29	Vinoda, Vikarabad			300
	Total :			500

Bills Receivable Book

In case of credit sales the trader draws a bill on the debtor or purchaser and its acceptance from the debtor, it becomes 'Bills Receivable'. The separate book is maintained to record all the bills received from the debtors by the trader is called 'Bills Receivable Book'.

Format of the Bills Receivable Book

<i>No. of Bills</i>	<i>Date Received</i>	<i>Date of Bill Drawn</i>	<i>Drawer</i>	<i>Acceptor</i>	<i>Place Where From</i>	<i>Term</i>	<i>Due Date</i>	<i>LF No.</i>	<i>Amount Rs.</i>

Bills receivable book is also just like other books, periodically totaled and closed entries therein are posted to the ledger. The total of bill receivable book is taken on the debit side of the bills receivable account, credited to the individual accounts of debtors or customer account.

Bills Payable Book

In case of Credit Purchases, trader accepts a bill which is drawn by the seller (Creditor) is known as Bill of Exchange and for the trader it becomes Bills Payable. The details of the bills that are accepted by the trader are entered in the special subsidiary book called Bills Payable Book.

Format of Bills Payable Book

<i>Date of Bill</i>	<i>To Whom it is Given</i>	<i>Drawer</i>	<i>Payee</i>	<i>Where it is payable</i>	<i>Term</i>	<i>Due Date</i>	<i>Date of Paid</i>	<i>LF No.</i>	<i>Amount Paid</i>

The bills payable book is also just like other books periodically totaled and closed by posting entries therein are posted to the ledger. The total of bills payable book is credited to the Bills Payable Account and debited to the individual accounts of creditors to whom the bills are accepted.

Journal Proper

Journal proper is the Eighth Subsidiary book is used to record all those transactions, which cannot be recorded in the other seven subsidiary books. The format of Journal proper is similar to the Ordinary Journal.

The main purpose of Journal Proper is to record the following items:

1. Opening entries
2. Closing entries
3. Adjustment entries
4. Transfer Entries
5. Rectification entries
6. Purchase of assets on Credit
7. Sale of Assets on Credit
8. Consignment transactions
9. Joint venture transactions.
10. Endorsement and Dishonor of bills of exchange
11. Withdrawal of goods by the proprietor for his personal use
12. Goods distributed as samples for advertisements
13. Loss of goods due to natural causes
14. Loss by goods by fire, theft and accident

Format of Journal Proper

<i>Date</i>	<i>Particulars</i>	<i>LF No.</i>	<i>Debit Amount (Rs.)</i>	<i>Credit Amount (Rs.)</i>

Illustration 15

The following balances stated in the books of Charan as on 31/12/2020

Cash in hand	Rs. 10,000
Cash at bank	Rs. 14,000
Stock of goods	Rs. 16,000
Plant	Rs. 20,000
Creditors	Rs. 10,000

Record above balances in the books of Charan on Jan 1, 2021

Solution:

In the books of Charan
Journal Proper

<i>Date</i>	<i>Particulars</i>	<i>LF No.</i>	<i>Debit Amount (Rs.)</i>	<i>Credit Amount (Rs.)</i>
2021				
Jan 1	Cash in hand A/c Dr.		10,000	
	Cash at bank A/c Dr.		14,000	
	Stock A/c Dr.		16,000	
	Plant A/c Dr.		20,000	
	To Creditors A/c			10,000
	To Capital A/c			50,000
	(Being Assets and Liabilities brought forward from the previous year)			

CASH BOOK

In every business there will be a large number of cash transaction i.e., receipts and payments of cash. So it is necessary to maintain a separate subsidiary book for recording the cash transactions. The separate subsidiary book maintained for recording cash transactions is called the Cash Book. Cash Book is a book of Prime or First Entry, because all cash transaction are first recorded in the Cash Book. It is also a book of 'Final Entry' (i.e. ledger) as cash book itself serves as Cash Account and Bank Account, separate Cash Account and Bank Account are not opened.

Importance of Cash Book

Cash book is very essential subsidiary book to all the organizations irrespective of the nature and size, because of huge number of transactions related to the payments and receipts. Cash book is essential to record all cash receipts and cash payments of organization to reveal the cash balance of organization on a particular date. Cash book provides all information regarding cash position of the business organization for a particular period. So, that effective policy for cash control can be formulated by the management. It is regarded as an important Book in view of following advantages:

1. It helps to record all Cash Receipts and Payments of organization on daily basis.
2. It gives the cash and Bank Balances of organization at any given period of time.
3. It helps to verify the actual cash balance with the balance shown by the cash book. If variation, mistakes and frauds can be detected easily

4. It helps to reconcile the bank balance as per the Pass Book with the balance shown in the bank column of Cash Book
5. As cash book acts as Cash account, preparation of separate cash account is not required. So, it will save the time and efforts.

Types of Cash Book

The following are the different types of Cash Book

1. Simple Cash Book or Cash Book with only Cash Column.
2. Two - Columns or Cash Book with Cash and Discount Columns.
3. Three - Columns or Cash Book with Cash, Discount and Bank Columns.
4. Analytical Petty Cash book

Simple Cash Book or Cash Book with only Cash Columns

A simple cash book makes a record of only cash transactions. It is like an ordinary Cash Account. It is maintained by small business concerns. It has two sides:

- i. Debit Side or Left Hand Side : For Recording Cash Receipts
- ii. Credit Side or Right Hand Side: For Recording Cash Payments

Format of Simple Cash Book

Dr **Single Column Cash Book** Cr

<i>Date</i>	<i>Particulars</i>	<i>L.F. No.</i>	<i>Amount Rs.</i>	<i>Date</i>	<i>Particulars</i>	<i>L.F. No.</i>	<i>Amount Rs.</i>

Explanation to the Columns in Cash Book

1. **Date Column:** On the debit side the date of receiving cash and on the credit side the date of paying cash is recorded.
2. **Particulars Column:** In particulars column on the Debit side the name of the Account from which cash is received is written and on Credit side the name of the Account to which payment is made is recorded.
3. **L.F. Column:** In this column the ledger folio of the account in which the transaction is posted is recorded.
4. **Amount Column:** Amount column is meant to record the amount received on Debit side and amount paid on the Credit side

Cash Discount and Trade Discount

It is a rebate or an allowance made by the receiver of cash to the payer. Cash discount arises when payment is made before a specified date. For instance, the supplier may say that if payment is made within one month a discount of 2% will be allowed. It means that a debt of 100 can be discharged by paying only 98 before the end of the month.

Thus cash discount allowed by the trader to his debtor is a loss to him and is called Discount Allowed and is recorded on the debit side of cash book. Whereas cash discount received by him from his creditor is gain and is known as Discount Received and is recorded on credit side of the Cash Book.

However, cash discount should not be confused with trade discount. Trade Discount is an allowance made by the manufacturer or wholesaler to retailer, off the catalogue price of goods sold. It is granted to old and regular customers in case of bulk sales or as a custom of trade. The main idea behind providing the trade discount is to enable the retail trader to sell of goods at catalogue price by keeping some margin to meet his business expenses and profit. Trade discount is deducted from catalogue price and the balance is recorded in the books of account. There is no entry made for trade discount in the books of the trader, it never appears in the books of account.

Difference between Cash Discount and Trade Discount

Cash Discount	Trade Discount
1. Cash Discount is an allowance made by the receiver of cash to the person paying it.	1. Trade Discount is an allowance given by the wholesaler to the retailer.
2. It is deducted from the amount of debt or net invoice price.	2. It is deducted from the Catalogue price in the invoice.
3. It occurs at the time of settlement i.e. when cash is received or paid.	3. It occurs at the time of sale or purchase.
4. The object is to induce the debtors to pay promptly within the period of credit.	4. Its object is to enable the retail to sell goods at the catalogue price and to keep margin of profit.
5. It is recorded in the books of debtor and creditor.	5. It is not recorded in the books of either seller or buyer.

In the cash column on the debit side actual cash received will be entered, the amount of the discount allowed, if any, to the customer concerned will be entered in the discount column. Similarly, actual cash paid will be entered in the cash column on the payments side and the discount received in the discount column.

Format of Double Column Cash Book

Dr

Two Column Cash Book

Cr

<i>Date</i>	<i>Particulars</i>	<i>L.F. No.</i>	<i>Discount Allowed</i>	<i>Cash Rs.</i>	<i>Date</i>	<i>Particulars</i>	<i>L.F. No.</i>	<i>Discount Received</i>	<i>Cash Rs.</i>

Balancing

It should be noted that discount columns are not balanced. They are merely totalled. The total of the discount column on the debit side shows the total discount allowed to customers and is debited to the discount account. The total of the discount column on the credit side shows total discount received and is credited to the Discount Account. The Cash Columns are balanced as shown in Single Column Cash Book.

Posting from the Cash Book with Cash and Discount Columns

When cash is received from a person and some discount is allowed to him, the person's account must be credited with both cash received and also discount allowed by writing 'By Cash' and 'By Discount'. In a similar way when cash is paid to some person and discount is allowed by him, the person's account must be debited are 'To Cash' and 'To Discount'. As said earlier, totals of discount allowed and discount received columns should be debited and credited respectively in Discount account.

Illustration 17

Record the following transactions in the Two Column Cash Book

- 2020, Jan. 1. Cash Balance Rs. 15,000
Jan.6 Sold goods to Sudesh Rs. 4,000
Jan.8 Purchased goods from Krishna Rs. 6,000
Jan.15 Cash received from Sudesh Rs. 3,900 in full settlement of his account
Jan.20 Paid to Krishna Rs. 5,930 in full settlement of his account
Jan.25 Sold goods to Sudhir Rs. 3,000
Jan. 31 Received cash from Sudhir Rs. 2,900 in full settlement of his account

Solution:

Dr

Two Column Cash Book

Cr

<i>Date</i>	<i>Particulars</i>	<i>L.F. No.</i>	<i>Dis- count Allowed</i>	<i>Cash Rs.</i>	<i>Date</i>	<i>Particulars</i>	<i>L.F. No.</i>	<i>Dis- count Received</i>	<i>Cash Rs.</i>
2020					2020				
Jan 1	To Balance b/d			15,000	Jan 20	By Krishna		70	5,930
15	To Sudesh		100	3,900	31	By Balance c/d		-	15,870
31	To Sudhir		100	2,900					
			200	21,800				70	21,800
Feb 1	To, Balance b/d		-	15,870					

Illustration 18

Prepare Two Column Cash Book from the following transactions.

2020		Rs.
Feb 1	Cash in Hand	9,000
Feb 2	Received cash from Srinidhi (Discount allowed Rs.400)	5,600
Feb 4	Commission received	1,800
Feb 7	Cash paid to Srihari (Discount allowed by her Rs. 40)	1,960
Feb 12	paid for stationery	800
Feb 16	Purchased machinery	3,200
Feb 18	Cash deposited in the Andhra Bank a/c	1,640
Feb 21	Received cash from Sridhar (Allowed him discount Rs. 100)	4,500
Feb 25	Paid cash to Srikanth (Discount received from him Rs. 400)	3,600
Feb 28	Purchases	2,000
Feb 28	Sold goods for cash	4,000

Solution:

Dr

Two Column Cash Book

Cr

<i>Date</i>	<i>Particulars</i>	<i>L.F. No.</i>	<i>Dis-count</i>	<i>Cash Rs.</i>	<i>Date</i>	<i>Particulars</i>	<i>L.F. No.</i>	<i>Dis-count</i>	<i>Cash Rs.</i>
2020					2020				
Feb 1	To Balance b/d			9,000	Feb 7	By Srihari		40	1,960
2	To Srinidhi		400	5,600	12	By Stationary			800
4	To Commission		1,800		16	By Machinery			3,200
21	To Sridhar		100	4,500	18	By Andhra Bank			1,640
31	To Sales			4,000	25	By Srikanth		400	3,600
					28	By Purchases			2,000
					29	By Balance c/d			11,700
			500	24,900				440	24,900
Mar 1	To Balance b/d			11,700					

Three Column Cash Book or Cash Book with Discount, Cash and Bank Columns

The Cash Book which contains Bank Column in addition to Discount and Cash Columns is called Three Column Cash Book or Cash Book with Discount, Cash and Bank Columns.

The following points must be noted while preparing Three Columns Cash Book

- 1. Opening Balance:** The opening balance of cash in hand and cash at bank is written on the debit side as 'To Balance b/d'. The amount of cash in hand is written in cash column and of cash at bank in Bank column. In case of bank overdraft, it is written on the credit side as 'By Balance b/d'.
- All the receipts will be written on the debit side. Cash receipts will be entered in cash column and cheques in bank column. If a cheque is received and deposited in the bank on the same day, then it should be entered in Bank Column on the debit side. A cheque received but not deposited in bank on the same day must be first debited in cash column and when it is deposited in bank on some other day it should be treated as deposit of cash in the bank. However, in the absence of any information cheque received may be entered in the Bank column on the assumption that it is deposited in bank for collection on the same day. If any discount is allowed while receiving cash or cheque then it should be entered in Discount column on the debit side.
- All payments are entered on the credit side cash payments in cash column and payments through cheque in Bank column. If any discount is received while making cash or bank payment, then it should be entered in Discount column on the credit side.

4. **Contra Entries:** If cash is deposited in the bank, it should be entered in the Bank column on the debit side as 'To Cash' and again on the credit side in Cash column as 'By Bank'. If cash is withdrawn from Bank for office use, it should be entered in cash column on the debit side as 'To Bank' and again on the credit side in the Bank column as 'By Cash'. For such entries letter 'C' is written in L.F column on each side to indicate that Contra effect of this transaction is recorded on the opposite side. Such entries are called '**Contra Entries**'.
5. If a cheque is drawn for personal use, it has to be entered in the Bank Column on the credit side as 'By Drawings Account'. In such a case, no contra entry is involved.
6. If there are bank charges debited by the Bank to the business concern, then it has to be entered in the Bank Column of the Cash Book on the credit side as 'Bank Charges'.
7. If interest or dividend on securities is collected by the Bank as per our standing instructions, then it has to be entered in the Bank column on the debit side as 'To Interest/Dividends on Securities'.
8. If a cheque received from a customer and deposited in the bank is dishonored, then the entry passed for receipt of cheque has to be cancelled by reversing it i.e. it should be entered on the credit side of Cash Book in the Bank Column as 'By Concerned Party Account' (name then the entry passed for the issue of cheque has to be cancelled by of the customer) Similarly if a cheque issued to creditor is dishonored reversing it, i.e. it should be written on the Debit side in Bank column as 'To Concerned Party Account' (Name of the creditor)
9. **Balancing:** The discount columns are totaled but not balanced. The cash columns are balanced exactly in the same manner as indicated for simple cash book. The process is similar for balancing the bank columns also.

It is possible that the bank may allow the firm to withdraw more than the amount deposited i.e. to have an overdraft. In such a case the total of the bank column on the credit side will be bigger than the debit side. The difference is written on the debit side as "To Balance c/d". Then the totals are written on the two sides opposite one another. For the next period the balance is entered on the credit side as 'By Balance b/d'.

Format of Three Column Cash Book

Dr **Three Column Cash Book** Cr

Date	Particulars	L.F. No.	Disc. Allowed	Cash Rs.	Bank Rs.	Date	Particulars	L.F. No.	Disc. Recd.	Cash Rs.	Bank Rs.

Illustration 19

From the following particulars in the books of Dinesh, Prepare Three Column Cash Book

2022		Rs.
Nov. 1	Cash in hand	750
	Cash in Bank	9700
2	Cash received from Bala Prasad Rs.1872 Discount given Rs.28	
4	Salaries paid for October	1500
4	Cash Sales	4700
5	Paid to Veerabadra through cheque 475 Discount received 25	
17	Cheque received from Raghu Ram (sent to bank) 391 Discount given 9	
19	Withdrawn from bank for personal expenses	2300
21	Deposited in the bank	862

Solution :

Dr **Three Column Cash Book** Cr

<i>Date</i>	<i>Particulars</i>	<i>L.F. No.</i>	<i>Disc.</i>	<i>Cash Rs.</i>	<i>Bank Rs.</i>	<i>Date</i>	<i>Particulars</i>	<i>L.F. No.</i>	<i>Disc.</i>	<i>Cash Rs.</i>	<i>Bank Rs.</i>	
2022						2022						
Nov1	To Balance b/d			750	9,700	Nov4	By Salaries			1,500		
2	To Bala Prasad		28	1,872		5	By Veerabadra		25		475	
4	To Sales			4,700		19	By Drawings				2,300	
17	To Raghu Ram		9		391	21	By Bank	C		862		
21	To Cash	C			862	30	By Balance b/d			-	4,960	8,178
			37	7,322	10,953				25	7,322	10,953	
Dec 1	To Balance b/d		-	4,960	8,178							

(C = Contra Entry)

Illustration 20

Prepare Triple Column Cash Book from the following transaction

2022		Rs.
Jan 1	Cash in hand Rs. 15,000 and Cash at bank Rs. 4,000	
Jan 4	Purchased machinery and payment made by cheque	2,000
Jan 6	Deposited in to bank	6,000
Jan 8	Bought goods for cash	2,500

Jan 10	Paid to Manoj Rs. 850 in full settlement of	900
Jan 14	Received Rs. 1,260 from David and allowed him discount Rs.40	
Jan 18	Paid through Debit Card to Satish for	1,750
Jan 20	Paid for purchase of goods	355
Jan 25	used 'PAYTM' for personal use	800

Solution:

Dr **Three Column Cash Book** Cr

<i>Date</i>	<i>Particulars</i>	<i>L.F. No.</i>	<i>Disc.</i>	<i>Cash Rs.</i>	<i>Bank Rs.</i>	<i>Date</i>	<i>Particulars</i>	<i>L.F. No.</i>	<i>Disc.</i>	<i>Cash Rs.</i>	<i>Bank Rs.</i>
2022						2022					
Jan 1	To Balance b/d			15,000	4,000	Jan 4	By Machinery				2,000
6	To Cash	C			6,000	6	By Bank	C		6,000	
14	To David		40	1,260		8	By Purchases			2,500	
						10	By Manoj		50	850	
						18	By Satish				1,750
						20	By Purchases			355	
						25	By Drawings				800
						31	By Balance c/d		-	6,555	5,450
			40	16,260	10,000				50	16,260	10,000
Feb 1	To Balance c/d		-	6,555	5,450						

(C = Contra Entry)

Analytical Petty Cash Book

In every organization in addition to bulk payments, some small payments are also incurred. If the small payments are recorded in cash book, it will become bulky and leads to confusion. In order to overcome this, petty cash book is prepared as ancillary to the Cash Book. Petty Cash Book is the book which is maintained by the business to record payment of petty cash expenses such as stationery, postage, cartage, etc., it involves payment of small amounts. A petty cashier who works under the supervision of the chief cashier is responsible for maintaining the petty cash book. He gets advance money in the beginning of a period which may be a month, fortnight, or a week to meet petty expenses. At the end of the period, the petty cashier submits a statement of account of the expenses incurred by him and gets a fresh advance.

Imprest System

Under this system management estimates the expenditure roughly for a period of week or month. Head cashier will give the petty cashier the estimated amount to start with. Petty cashier makes payments and records the transactions in petty cash book. At

the end of the period the petty cashier balances his book, then the chief cashier pays him the amount which he spent, so that original amount of petty cash with which he started is restored.

Imprest System is very useful specially if an Analytical petty cash book is used. Under this method a separate column is provided to record each head of petty expense along with a total column. Every payment is entered in the concerned head of petty expenses and in total column. All the payments made are analyzed in the column of petty cash book itself, under the different heads of expenses. Hence it is called Analytical petty Cash Book. By going through this book one can easily know the total expenditure and the expense under each head.

Features of a Petty Cash Book

- i. It is maintained besides main cash book to record payment of small expenses and receipt.
- ii. It has two sides - Dr. side records the amount of cash received from the main cashier. Cr. side records the payments of petty cash expenses.
- iii. The petty cash book always show a debit balance as the cash payments can never exceed the cash receipt. It's balance represents unspent cash in hand.
- iv. Recording is done on the basis of objective evidence that is vouchers. If external vouchers are not available, internal vouchers are verified by an authorised person, thus recording is done on the basis of internal as well as external vouchers.
- v. Petty Cash Book is a book of original entry as well as a book of final entry. It serves both Journal as Ledger.

Advantages of a Petty Cash book

1. It saves the time of chief cashier, recording of petty cash transactions in petty cash book saves the valuable time of the cashier.
2. It keeps a check on fraud and the possibility of misappropriations of cash are reduced
3. It also helps to control the petty expenses as it is kept within the limits and petty cashier avoids to spend more than the available cash balance
4. It also saves the effort and the time involved in posting as only periodical totals in petty cash book are posted to the respective ledger accounts.
5. It is a Journal of primary entry as well as a book of final entry, no separate Petty Cash Account is maintained in the ledger

Format of Petty Cash Book

<i>Receipt</i>	<i>Date</i>	<i>Particulars</i>	<i>Voucher No.</i>	<i>Total</i>	<i>Analysis of Payments</i>				
					<i>Printing & Stationery</i>	<i>Postage & Telegram</i>	<i>Conveyance & Cartage</i>	<i>Repairs & Cleaning</i>	<i>Sundry Exp</i>

Illustration 21

Enter the following transactions in an Analytical Petty Cash Book (kept under Imprest system)

2021	Rs.
April 1 Received from head cashier	300
4 Bought Postage & Stamps	15
8 Paid for Stationery	36
10 Paid for Cartage	12
15 Paid for taxi hire	22
22 Paid office expenses cleaning	33
25 Bought postage stamps	10
28 Paid 'X' against his account	18
30 Sent telegram to Bombay	24

Solution:**Analytical Petty Cash Book**

Rec- eipt	Date	Particulars	Voucher No.	Total	Analysis of Payments				
					Printing & Stationery	Postage & Telegram	Conveyance & Cartage	Repairs & Cleaning	Sundry Exp
300	2021								
	Apr 1	To Cash							
	4	By Postage		15		15			
	8	By Stationery		36	36				
	10	By Cartage		12			12		
	15	By Travelling		22			22		
	22	By Office Ex		33				33	
	25	By Postage		10		10			
	28	By 'X' A/c		18					18
	30	By Telegram		24		24			
30	By Balance c/d		130						
300				300	36	49	34	33	18
130	May 1	To Balance b/d							

2.10 Ledger

A ledger account may be defined as a summary statement of all the transactions relating to a person, asset, expense or income which have taken place during a given period of time and shows their net effect.

Features of Ledger

- Ledger is an account book that contains various accounts to which various business transactions of a business enterprise are posted.
- It is a book of final entry because the transactions that are first entered in the journal or special purpose Books are finally posted in the ledger. It is also called the Principal Book of Accounts.
- In the ledger all types of accounts relating to assets, liabilities, capitl, revenue and expenses are maintained.
- It is a permanent record of business transactions classified into relevant accounts.
- It is the 'reference book of accounting system and is used to classify and summarise transactions to facilitate the preparation of financial statements.

Format of a Ledger Sheet

The format of a ledger sheet is as follows :

Title of an Account

Dr.

Cr.

<i>Date</i>	<i>Particulars</i>	<i>JF</i>	<i>Amount Rs.</i>	<i>Date</i>	<i>Particulars</i>	<i>JF</i>	<i>Amount Rs.</i>

Difference between Journal and Ledger

1. The journal is a book of original (i.e., first) entry whereas the ledger is the book of second entry. In other words, transactions recorded in the journal have to be further processed by doing posting from the journal to the ledger.
2. In the journal, transactions are recorded in the chronological order as and when they occur whereas the ledger is a book for analytical record. Transactions pertaining to a particular account appear at one place. For example, there may be twenty transactions relating to Trade Expenses Account scattered at different places in the journal in order of their sequence of occurrence. These transactions will appear in Trade Expenses Account in the ledger at one place.
3. In case of disputes, the journal as a book of source entry has greater weight as legal evidence than the ledger. However, for accounting purpose, ledger is the main source of information.
4. The journal is a subsidiary book which helps in the preparation of the principal book of account (i.e., ledger).
5. The unit of classification of data in the journal is the transaction whereas the unit of classification of data in the ledger is the account.
6. The process of recording financial transactions in the journal is called journalising whereas the process of recording transactions in the ledger is known as posting.

Posting of Journal into ledger

Transferring items from the journal to the relevant account in the ledger is called posting of journal. Following procedure is followed for posting of journal to ledger :

1. Identify both the account 'debit' and 'credit' of the journal entry. Open the two account in the ledger.

2. Post the item in the first account by writing date in the date column, name of the account to be credited in the particulars column and the amount in the amount column of the 'debit' side of the account.
3. Write the page number of the journal from which the item is taken to the ledger in Folio column and write the page number of the ledger from which account is written in L.F. column of the journal.
4. Now take the second Account and give the similar treatment. Write the date in the 'date' column, name of the account to be debited in the particular column and the amount in the 'particulars' column of the account on its credit side in the ledger.
5. Write page number of journal in the 'folio' column of the ledger and page number of the ledger in the 'LF' of column of the journal.

Balancing of an Account

The following steps are followed in Balancing the Ledger Account :

- Total the two sides of an Account on a rough sheet.
- Determine the difference between the two sides. If the credit side is more than the debit side, the balance calculated is a credit balance.
- Put the difference on the 'Shorter side' of the account such that the totals of the two sides of the account are equal.
- If the difference amount is written on debit side (i.e., if credit, side is bigger) then write as "Balance c/d" (c/d stands for carried down). If difference is written on the credit side (i.e., if debit side is bigger) then write as "Balance c/d."
- Finally at the end of the year all the ledger account are closed by taking out the balance of each account.
- The Balance then should be brought down or carried forward to the next period. If the difference was put on credit side as "Balance c/d" it should now be written on the debit side of the account as "Balance b/d" (b/d stands for brought down) and vice-a-versa. Thus, debit balance will automatically be brought down on the debit side and a credit balance on the credit side.
- All asset accounts show debit balance and should be shown in balance sheet.
- All liabilities and capital show credit balance and should be shown in balance sheet.
- All incomes and expenses are not to be balanced that simple totalled up and should be shown on credit side or debit side of trial balance.

Illustration 22

Journalise the following transactions and post them into respective ledger accounts in the books Priya.

1. Building purchased for cash Rs. 3,00,000
2. Building purchased Rs. 30,000 from Ravi.
3. An old building sold for cash to Satish Rs. 5,000. There was a loss on sale Rs. 1,000
4. New rooms added to building costing Rs. 20,000

Solution :

Journal of Priya

<i>Date</i>	<i>Particulars</i>	<i>L.F.</i>	<i>Dr. Amount ₹</i>	<i>Cr. Amount ₹</i>
	Building A/c Dr. To Cash A/c (Being building purchased for cash)		3,00,000	3,00,000
	Building A/c Dr. To Ravi A/c (Being building purchased on credit from Ravi)		30,000	30,000
	Cash A/c Dr. Profit & Loss A/c Dr. To Building A/c (Being building sold for loss of Rs. 1,000)		5,000 1,000	6,000
	Building A/c Dr. To Cash A/c (Being additional rooms added)		20,000	20,000

Building A/c

Dr.

Cr.

Date	Particulars	J.F. No.	Amount Rs.	Date	Particulars	J.F. No.	Amount Rs.
	To Cash A/c		3,00,000		By Cash A/c		5,000
	To Ravi A/c		30,000		By P&L A/c		1,000
	To Cash A/c		20,000		By Balance c/d		3,44,000
			3,50,000				3,50,000
	To Balance b/d		3,44,000				

Cash A/c

Dr.

Cr.

Date	Particulars	J.F. No.	Amount Rs.	Date	Particulars	J.F. No.	Amount Rs.
	To Building A/c		5,000		By Building		3,00,000
	To Balance c/d		3,15,000		By Building		20,000
			3,20,000				3,20,000
					By Balance b/d		3,15,000

Profit and Loss A/c

Dr.

Cr.

Date	Particulars	J.F. No.	Amount Rs.	Date	Particulars	J.F. No.	Amount Rs.
	To Building A/c		1,000		By Balance c/d		1,000
			1,000				1,000
	To Balance b/d		1,000				

What you have learnt

- A business transaction is a transaction, which involves exchange of values between two parties. Every transaction involves Give and Take aspect.
- A voucher is documentary evidence in support of a transaction.
- The recording of business transaction in the book of account is based on a fundamental equation called Accounting Equation. i.e., $\text{Assets} = \text{liabilities} + \text{capital}$
- **Rules of Accounting**
 - “Increase in Asset is debited, and decrease in Asset is credited.”
 - “Increase in Expenses/Losses is debited, and decrease in Expenses/Losses is credited.”
 - “Increase in Liabilities is credited and decrease in Liabilities is debited.”
 - “Increase in Capital is credited and decrease in Capital is debited.”
 - “Increase in revenue/gains is credited and decrease in revenue/gain is debited.”
- The Book in which all business transactions are recorded, datewise i.e. chronological order is known as Journal.
- Brief explanation of a journal entry is known as Narration.
- A combination of two or more simple journal entries is known as compound entry.
- Cash discount is recorded in the journal whereas no entry is made for Trade Discount.
- When the amount paid or received is partly utilised by the end of an accounting year, and balance is for services to be provided in the next year or amount is yet to be paid or to be received for the services availed of in the current year, adjustment is required and adjusting entry will be made.
- Special Journals are used for recording specific transactions
Ex. : Cash Book, Purchase Book, Sales Book, Purchase Returns Book, Sale Returns Book, Bills Receivable Book, Bills Payable Book and Journal Proper.
- All those transactions which arise occasionally or do not find place in any of the special journals are recorded in Journal proper.
- Ledger is a register with pages ruled in account form to enable the preparation of accounts.
- Ledger is a permanent record of business transactions which are classified according to various accounts to which they pertain.
- The balance of an account is written on the side having lower total, so that its total becomes equal to the total of the other side.

QUESTIONS & PROBLEMS

I. SHORT ANSWER QUESTIONS

1. Business Transaction
2. Accounting Voucher
3. Cash Discount
4. Trade Discount
5. What is meant by Subsidiary Book ?
6. What is Debit Note?
7. What is Credit Note?
8. Journal Proper?
9. State the characteristics of Cash Book
10. Explain the advantages of Cash book.
11. Distinguish between trade discount and cash discount
12. What is meant by Contra Entry?
13. What is meant by Analytical Petty Cash Book?
14. Draw the format of Petty Cash Book.

II. THEORETICAL QUESTIONS

1. What is meant by double entry mechanism? Give its advantages.
2. Prepare accounting equation on the basis of following :
 - (i) Anup started business with cash Rs. 2,50,000
 - (ii) Purchased goods for cash Rs. 35,000
 - (iii) Purchased office furniture for cash Rs. 12,000
 - (iv) Paid rent Rs. 7,000
 - (v) Sold goods (costing Rs. 30,000) for Rs. 50,000 for cash
3. Distinguish between special journals and journal proper.
4. Journalise the following transactions :
 - (i) Started business with cash Rs. 3,00,000
 - (ii) Bought goods on credit for Rs. 5,000
 - (iii) Sold goods for cash Rs. 12,000 and on credit Rs. 8,000
5. Explain the process of Journalising transactions with examples
6. What are compound entries ? Explain with example.

7. What are adjusting entries ? Explain with example.
8. What do you mean by Subsidiary Books? What is the purpose of subdivision of journal?
9. What is Purchases Returns Book? Give the specimen of it.
10. What is Sales Book? Explain its contents and give the specimen of Sales Book.
11. What is a cash book? Explain the rules of posting to the Cash Book.
12. Explain the treatment of discount in the discount column of the Cash Book. Are they balanced?
13. Cash Book is both a book of Prime Entry and book of Final Entry. Explain
14. What is a contra entry? How it is different from other entries? Give an example.
15. What is a Petty Cash Book? Explain the meaning of Imprest System of Petty Cash Book.
16. What is meant by ledger ? Why it is prepared ?
17. How do you post a journal entry into ledger account ?
18. What is meant by balancing of account ? Explain the steps taken while balancing accounts.

III. PROBLEMS - SUBSIDIARY BOOKS

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

- (i) Manu started business with cash Rs. 6,00,000 and Goods Rs. 1,00,000.
- (ii) Purchased office machine for cash Rs. 90,000
- (iii) Sold goods (costing Rs. 60,000) for credit to Asha Rs. 70,000
- (iv) Purchased building for cash Rs. 1,30,000
- (v) Cash received from Ashu Rs. 80,000
- (vi) Purchased goods on credit from M/s Ashok Traders Rs. 70,000
- (vii) Salaries Paid Rs. 6,000
- (viii) Insurance prepaid Rs. 10,000
- (ix) Cash paid to M/s. Ashok Traders in full settlement Rs. 68,000

2. Enter the following transactions in Journal

2023

Jan. 1	Sushil & Co. started business with cash	1,00,000
Jan. 2	Paid into Bank	60,000

Jan. 4	Purchased Machinery and paid by cheque	30,000
Jan. 6	Bought goods from Naresh	20,000
Jan. 14	Paid salaries	5,000
Jan. 15	Sold goods to Rajesh Kumar	15,000
Jan. 17	Paid for Sundry Expenses	8,500
Jan. 18	Cash deposited into Bank	20,000
Jan. 19	Received Rent	6,000
Jan. 22	Paid Naresh by cheque in full settlement of his A/c	19,750

3. The following are the transactions of Kumar Swami for the month of January 2023. Journalise these transactions.

2023

Jan. 1	Capital paid into Bank	3,00,000
Jan. 2	Bought Stationery for cash	400
Jan. 3	Bought Postage Stamps	25,000
Jan. 5	Sold Goods for Cash	600
Jan. 6	Bought Office Furniture from Mahendra Bros.	40,000
Jan. 11	Sold goods to Jacob	12,000
Jan. 12	Received cheque from Jacob	12,000
Jan. 14	Paid Mahendra Bros. by cheque	40,000
Jan. 16	Sold goods to Ramesh & Co	5,000
Jan. 20	Bought from S. Seth & Bros	15,000

4. Record the following transactions in the Purchases Book. Rs.

2022	Mar 1 st	Purchased goods from Anil	2,000
	3 rd	Bought goods from Raju	4,000
	7 th	Purchased goods from Srikanth (Trade discount 10%)	5,000
	13 th	Goods purchased from Venkat	1,600
	18 th	Purchased goods from Mahesh	1,400
	24 th	Purchases	3,000
	26 th	Purchased goods from Ashok	2,500

(Answer: Purchases Book Total: Rs. 16,000)

5. Prepare Purchases Book from the following:			Rs.
2020	Apr 1 st	Purchased goods from Shaker	4,000
	4 th	Cash Purchases	2,000
	8 th	Bought goods from Shyam	8,000
		(Trade discount 5%)	
	12 th	Goods purchased from Karthik by cash	2,400
	18 th	Purchased goods from Nagesh	3,000
	25 th	Purchased furniture from Aakash	6,000

(Answer: Purchase Book Total: 14,600)

6. Prepare Purchases Book			Rs.
2022	Dec 1 st	Purchased goods from Pallavi	4,200
	5 th	Goods purchased from Teja	8,000
	10 th	Bought goods from Vedhagni	3,800
	14 th	Purchased goods from Sudhakar	6,000
		(Trade discount Rs.600)	
	18 th	Purchased goods from Rama Devi	2,000

(Answer: Purchases Book Total 23,400)

7. Enter the following transactions in Purchases Book and Purchase Returns Book.

2022			Rs.
	Aug 1 st	Purchased goods from Krishna	6,000
	4 th	Goods purchased from Mallesh	3,500
	8 th	Returned goods to Krishna	600
	13 th	Bought goods from Naveen	2,000
	16 th	Goods returned to Mallesh	400
	22 nd	Purchased goods from Ravi	4,000

(Answer: Purchase Book: 15,500; Purchase Return Book: 1,000)

8. Enter the following transactions in the proper Subsidiary Books.

2020			Rs.
	June 1 st	Purchased goods from Arun	2,500
	3 rd	Purchased goods from Prakash	7,000
	6 th	Return outwards to Arun	800

14 th	Purchased goods from Nagaraj (Trade Discount 10%)	10,000
19 th	Goods purchased from Nikhil for Cash	4,000
25 th	Goods returned to Nagaraj	1,200
28 th	Bought goods from Vishal	1,500

(Answer: Purchase Book - 20,000; Purchase Returns book - 2000)

9. Enter the following transactions in the Sales Book.

2020	Feb 1 st	Sold goods to Sampath	2,250
	6 th	Sold goods to Manohar	2,000
	10 th	Cash Sales	1,800
	16 th	Sold goods to Murali (Trade Discount 5%)	5,000
	20 th	Goods sold to Shankar on Credit	2,500

(Answer: Sales Book - 11,500)

10. Prepare Sales Book from the following particulars:

2021			Rs.
	May 1 st	Sold goods to Kiran	10,000
	8 th	Sold goods to Kalyan (Trade Discount 10%)	6,000
	12 th	Goods sold to Sanjeev for Cash	3,000
	18 th	Sold goods to Jeevan	4,600
	24 th	Sold old Machinery to Sandeep	2,500
	26 th	Goods sold to Vasu	8,000

(Answer: Sales Book -28,000)

11. Prepare the Sales Book.

2022	July 1 st	Sold goods to Nikhil Rs.7, 500 as per Invoice No. 410
	3 rd	Sold goods to Ruthwik on credit Rs.5,500 as per Invoice No.101
	12 th	Goods sold to Jairam Rs. 4,000 as per Invoice No. 370 (Trade discount 10%)
	18 th	Sold goods to Sharma for Cash Rs. 8,000

24th Goods sold to Arun Rs. 6,400, Invoice No.220

(Answer: Sales Book - 23,000)

12. Record the following transactions in Sales Book and Sales Returns Book.

2021		Rs.
Sep 1 st	Sold goods to Satyam	2,500
5 th	Sold goods to Ajay	7,200
7 th	Goods sold to Arun	2,800
10 th	Satyam returned goods	300
14 th	Sold goods to Akhila	4,000
16 th	Returns inwards from Arun	200
25 th	Goods sold to Karthik for Cash	3,000

(Answer: Sales Book - 16,500; Sales Returns Book - 500)

13. Prepare Sales Book and Sales Returns Book from the following Information

2020		Rs.
May 1 st	Sold goods to Rahul	6,500
3 rd	Sold goods to Manish	6,000
8 th	Returned goods by Rahul	700
11 th	Sold goods to Raj Kumar	12,000
14 th	Sold goods to Bharath	11,000
17 th	Returned goods from Raj Kumar	2,000
21 st	Sold goods to Anand	9,000

(Answer: Sales Book - 44,500; Sale Returns Books - 2,700)

14. Record the following transactions in proper Subsidiary Books

2022		Rs.
Oct 1 st	Sold goods to Archana	10,000
4 th	Goods purchased from Divya	6,000
8 th	Purchased goods from Manasvi	8,000
10 th	Goods returned by Archana	500
14 th	Goods sold to Shivani	3,000
16 th	Returned goods to Divya	300
18 th	Purchased goods from Madhuri	4,000

20 th	Shivani returned goods	200
21 st	Return outwards to Manasvi	400
25 th	Goods sold to Sharanya on Credit	7,000

(Answer: Purchases Book - Rs.18,000; Sales Book - 20,000; Purchase Returns Book -700; Sales Returns Book - 700)

15. Prepare proper Subsidiary Books from the following particulars

2020		Rs.
Nov 1 st	Purchased goods from Amar	2,000
4 th	Goods sold to Pavan	3,500
8 th	Goods returned to Amar	200
12 th	Sold goods to Srujan (Trade discount 5%)	8,000
15 th	Goods returned from Pavan	100
17 th	Purchased machinery from Raju	5,000
19 th	Goods purchased from Vaibhav	2,500
21 st	Returned goods from Srujan	150
24 th	Sold goods to Ramesh for cash	4,000
26 th	Purchased goods from Vineeth	8,500
28 th	Sold goods to Vamshi on credit	6,500
29 th	Goods returned to Vaibhav	250
30 th	Vamshi returned goods	500

(Answer: Purchases Book - Rs.13, 000; Sales Book - 17,600; Purchase Returns Book – 450; Sales Returns Book – 750)

JOURNAL PROPER

16. Write Opening Journal Entry as on 1 Jan 2020 from the following

	Rs.
Debtors	18,000
Furniture	10,000
Bank balance	20,000
Loan from Pavan	10,000
Bills payable	5,000

Land and buildings 15,000

(Answer : Capital – Rs. 48,000)

17. Write the Opening Journal Entry as on 1st April, 2020 from the following

	Rs.
Debtors	16,000
Creditors	12,000
Bills receivable	8,500
Furniture	4,500
Bank overdraft	5,000
Business premises	30,000

(Answer: Capital – Rs. 42,000)

18. Record the Opening Entry from the following Assets and Liabilities on 1st May 2020

	Rs.
Machinery	16,000
Bank	12,000
Bills receivable	14,000
Sundry Creditors	10,000
Trade Marks	8,000
Cash	10,000

(Answer: Capital Rs. 50,000)

CASH BOOK

19. Enter the following transactions of Arjun in Single column Cash Book.

2021	Rs.
Jan. 1 st Commenced business with	25,000
2 nd Paid into bank	20,000
4 th Purchased goods for cash	1,200
6 th Sold goods for cash	2,000
7 th Paid for Stationery	75
9 th Received from Shashikanth	1,125
13 th Paid to Gopal	525

15 th Purchased Office Furniture	625
17 th Paid for Advertisement	400
21 st Received Cash from Prasad Rao	1,500
23 rd Purchased goods from Malhotra for cash	900
27 th Cash withdrawn for personal use	350
29 th Paid Salary to Office Staff	450
30 th Received Cash from Sandeep	2,200
31 st Paid rent to landlord	300

(Ans. Cash Balance Rs. 7,000)

20. Enter the following transaction in Single Column Cash Book of Ram

2020 March 1	Ram had a cash of 5,000 in hand.	Rs.
5	Cash purchases	2,000
8	Wages paid	500
12	Cash withdrawn from bank for office use	3,000
15	Cash sales	2,500
20	Furniture purchased	4,000
25	Drawings by Ram in cash	400
28	Interest paid to Neeraj	100
31	Paid to Manoj Rs. 200 towards the rent of January	
31	Cash in excess of Rs. 500 paid into bank.	

(Ans: Cash Deposited in Bank Rs. 2,800)

21. Enter the following transactions in Cash Book with Cash and Discount columns and balance the same.

2020		Rs.
June 1	Balance of cash in hand	5,200
3	Received cash from Mohan	2,200
5	Paid Cash to Sohan	1,300
8	Paid to Ramgopal (discount received 10)	290
9	Purchased goods from Ashok for cash	500

10	Paid Mukesh	300
11	Received from Gupta (discount allowed 20)	980
15	Cash Sales	500
21	Paid to Mohanlal Tiwari (Discount 25)	725
23	Paid Wages	150
28	Received Commission from Uday	250
29	Paid to Nagesh (Discount 20)	380
30	Received interest	200

(Ans. Cash Balance 5,685)

22. Enter the following transaction in Three Column Cash Book and balance of the same as on 15-12-2020.

		Rs.
Dec 1	Cash in hand	1,800
1	Cash at bank	13,000
2	Paid into bank	500
6	Bought goods for cheque	1,300
7	Purchased furniture for cash	400
9	Received cash from Shyam Rs.790 Discount allowed Rs.10	
12	Drew from bank for office use	400
13	Received from Prakash cheque Rs. 600 Discount allowed Rs. 20	
15	Cheque of Prakash returned by the bank on dishonor	

(Ans: Cash in Hand 2,090; Cash at Bank 11,800)

23. Enter the following transactions in a Three Column Cash Book

2020		Rs.
June 1	Cash in hand	730
	Balance at bank	9,200
3	Received cheque from Indra with Rs. 868 discount Rs. 32	
5	Paid for advertising by cheque	300
6	Cash sales	500
8	Paid salaries	650
9	Amount withdraw from bank for office use	800
12	Drawn cash for personal use	400

14	Issued cheque in favour J.K. Rao Rs. 790	
	Discount Received Rs. 50	
18	Received cheque from Dinesh Rs. 986 and discount allowed Rs. 26	
20	Sale of machinery, received cheque	4,000
22	Bank returns cheque of Dinesh dishonoured	
24	New machinery purchased issued cheque	20,000
30	Bank charges as per pass book	20

(Ans. Cash in hand 980; Bank Overdraft 7,842)

24. Enter the following transactions in a Three - Column Cash Book.

2020		Rs.
Jan. 1	Cash in hand	410
	Balance at Bank	8,920
2	Cash Sales	4,500
3	Paid into Bank	4,000
5	Purchased stationery	100
8	Paid Mahesh by cheque Rs. 280 discount received Rs. 20	
12	Gave a cheque for cash purchases	1,500
15	Amount withdrawn from bank for personal use	500
18	Received from Suresh, a cheque for Rs.1,970 in full settlement of account Rs.2,000	
20	Drew from Bank	1,000
21	Paid Wages	100
25	Bank returns cheque of Suresh dishonored	
31	Bank charges as per Pass Book	10

(Ans: Closing Cash Balance Rs. 1,710; Bank Balance Rs. 9,630)

25. Prepare Triple Column Cash Book from the following information.

2020		Rs.
June 1	Cash in hand	12,500
	Cash at bank	14,800
3rd	Cash sales	3,000

7th	Purchased goods from Ashok and paid by cheque	5,000
10th	Cash paid into bank	1,800
12th	Cash paid to Laxmi Rs.1,850 Discount received Rs.150	
16 th	Cash with drawn from bank for office use	2,000
19 th	Sold machinery and amount received through 'paytm'	2,400
25 th	Advertisement expenses	150
28 th	Received cheque from Vishnu's Rs. 1,980 Discount allowed Rs. 120 (Vishnu's cheque deposited to bank)	
30th	Salaries paid by cheque	3,280

(Answer : Cash Balance Rs. 13,700; Bank Balance Rs. 10,700; Discount Allowed Rs. 120; Discount Received Rs. 150)

26. Prepare Three Column Cash Book from the following particulars.

2021		Rs.
July 1 st	Cash in hand	6,000
	Cash at bank	10,000
5th	Cash sales	1,900
7 th	Issued cheque to D-Mart Rs.1800 Discount received Rs. 200	
8 th	Received cash from Sai Traders Rs. 1850 Discount allowed Rs. 150	
14th	Cash withdrawn from bank for office use	550
22nd	Cash purchases	600
29th	Paid into bank	800
30th	Salaries paid by cheque	2,400
31 st	Bank charges as per bank Pass Book	50

(Answer: Cash Balance Rs. 8,900; Bank Balance Rs. 6,000, Discount Allowed Rs. 150; Discount Received Rs. 200)

27. Prepare Triple Column Cash Book.

		Rs.
2020	Feb 1 st Cash balance	12,000
	Bank balance	8,000
	3 rd Issued cheque to Rama Rs. 3,950 Discount Rs. 50	
	6 th Cash Sales	4,500

10 th	Cash deposited into bank	2,500
18 th	Received Cash from Mohan Rs. 2,800 Cheque Rs. 5,800 Discount Rs. 400 (Cheque deposited with bank)	
20 th	Purchases	3,400
23 rd	Mohan's cheque dishonored	
24 th	Rent paid by cheque	1,000
28 th	Drew from bank for office use	1,600

(Answer: Cash Balance Rs. 15,000; Bank Balance Rs. 3,950; Discount Allowed Rs. 400; Discount Received Rs. 50)

28. Make out the Three Column Cash Book of M/s Ram and Mohan from the following particulars.

2020	April 1	Cash in hand	300
		Bank Overdraft	450
		Paid salaries for March	250
	2	Purchased goods for cash Rs. 30 Cash Sales Rs. 80	
	3	Issued cheque in favour of Krishna & Co. to settle his account for 270 Rs.260	
	4	Received Cash from Dhawan (discount allowed 15)	235
	5	Received cheque from Ali Bros. (in full settlement of their debt of 200) 190	
	5	Cash sent to bank	200
	5	Cheque issued in favour of Ravi Bros. for purchase of furniture 150	
	6	Cheque of Ali Bros. dishonored, Bank debits Rs. 2 in respect of charges	
	6	Paid rent by cheque	100
	6	Bank collects interest on securities	150

(Ans. Cash in Hand Rs. 135; Bank Overdraft Rs. 612)

29. Anand owed Rs. 2,800 to the Bank and had cash Rs. 460 on Hand; prepare his Three Columnar Cash Book.

2020 April 2 He drew cash for office use Rs. 1,600 and paid wages Rs. 1,000.

7 He sold goods for cash Rs. 400 and bought goods for cash Rs. 300

9 He received cheque for Rs. 1,350, in full settlement for Rs. 1,400 from Ajit, Deposited the same in Bank.

11 He paid Ramvilas by cheque Rs.890, in full settlement for Rs. 900,

15 He received Rs. 215 for sale of old news papers.

17 He bought one bicycle by cheque for Rs. 1,150, paid municipal taxes Rs. 200 in cash

18 He received Ajit's cheque dishonoured from Bank. Bank charged Rs. 10

20 He received from Ajit a fresh cheque for the total amount (Including bank charges)

21 He deposited Ajit's Cheque into Bank

(Ans. Closing Cash in Hand Rs. 1,175; Bank Overdraft Rs. 5,090)

PETTY CASH BOOK

30. Prepare Analytical Petty Cash Book from the following particulars

		Rs.	
2021	Jan 1	Cheque received from Head Cashier	350
	3 rd	Postal charges	25
	6 th	Tea expenses	30
	7 th	Speed post charges	25
	9 th	Wages	55
	11 th	Refreshments	15
	15 th	Paid for stationery	28
	20 th	unloading charges	23
	21 st	carriage	32

(Answer : Balance Rs. 117)

31. Prepare Analytical Petty Cash Book.

		Rs.	
2020	Feb 1 st	Advance received from Head cashier	400
	4 th	Paid railway fare	39
	5 th	Paid repairs	45
	6 th	Paid for papers and envelops	26
	9 th	Stationery paid	18
	10 th	Paid to Praveen on account	50
	14 th	Tea expenses	40
	16 th	Paid for office expenses	35
	19 th	Paid travelling expenses	60

(Answer: Balance Rs. 87)

32. From the following particulars, prepare Analytical Petty Cash Book.

2020		Rs.	
	Mar 1	Received from head cashier	300
	2 th	Tiffin expenses	32
	5 th	Auto charges	16
	7 th	Telegram charges	18
	10 th	STD Charges	21
	14 th	Paid for Xerox	15
	18 th	Paid for Advertisement	20
	22 nd	Carriage paid	28
	24 th	Wages to office cleaner	14
	26 th	Paid Miscellaneous expanses	25
	28 th	Paid for entertainment	30

(Answer : Balance Rs. 81)

33. Prepare Columnar Petty Cash Book on Imprest System from the following particulars

2020		Rs.	
	June 1	Received for petty cash payments	1,000
	2	Paid for postage	80

5	Paid for stationery	50
8	Paid for Advertisement	100
12	Paid for wages	40
16	Paid for carriage	30
20	Paid for conveyance	44
25	Paid for Travelling expenses	160
27	Paid for postage	100
28	Wages to office cleaner	20
30	Paid for telegrams	40
30	Sent registered notice to landlord	6

(Ans : Balance Rs. 330)

Ledger

34. Journalise the following transactions and post them into necessary ledger accounts.

		Rs.
2023		
Jan 1	Commenced business with cash	50,000
Jan 3	Paid into bank	25,000
Jan 5	Purchased furniture for cash	5,000
Jan 8	Purchased goods and paid by cheque	15,000
Jan 8	Paid for carriage	500
Jan 14	Purchased Goods from K. Murthy	35,000
Jan 18	Cash Sales	32,000
Jan 20	Sold Goods to Ashok on credit	28,000
Jan 25	Paid cash to K. Murthy in full settlement	34,200
Jan 28	Cash received from Ashok	20,000
Jan 31	Paid Rent for the month	2,000
Jan 31	Withdrew from bank for private use	2,500

35. Following are the transactions of Dhani Ram and Sons fo the month of July 2023. Make Journal entries, post them into ledger and balance the account.

		Rs.
2023		
July 1	Commenced business with cash	60,000
July 2	Paid into bank	40,000
July 5	Purchased furniture for cash	5,000
July 7	Purchased Goods and paid for them by cheque	20,000
July 10	Sold Goods to Lata Gupta for cash	12,000
July 12	Sold Goods to Mahavir on credit	24,000
July 18	Purchased Goods from Harish	30,000
July 19	Withdrew cash for domestic use	2,500
July 20	Received a cheque from Mahavir on account	18,900
	Allowed him discount	100
July 27	Paid to Harish cash on account	16,800
	Discount allowed by him	200
July 31	Paid salary by cheque	1,800
	Paid cash for telephone bill	600

BANK RECONCILIATION STATEMENT

Every business organisation irrespective of the size and nature of the concern is maintaining a bank account so as to facilitate its payments and receipts through bank. The transactions like depositing cash or cheques related to the business with the bank are recorded in the bank column of the cash book. Deposits are recorded on the debit side of cash book and withdrawals on the credit side. Similarly, the transactions of the customers with the bank are recorded by the banker in the pass book. In the pass book deposits are shown on the credit side and withdrawals on the debit side. After the cash book has been balanced, it is common to check its transactions with the records of the firm's bank transactions as recorded by the bank. The amount of balance on a given date as shown in the cash book must tally with the balance as shown in the pass book or the bank statement. But usually these are found to be different. Therefore, it is inevitable to reconcile the cash book with pass book for which we have to ascertain the reasons or causes for such difference. A statement known as Bank Reconciliation Statement is prepared in order to reconcile the balances as shown by the cash book and pass book.

Learning Objectives

After studying this lesson, you will be able to:

- State the meaning and need for the preparation of bank reconciliation statement
- Identify the causes for differences between bank balance as per cash book and pass book, and
- Prepare the Bank Reconciliation Statement.

3.1 Bank Reconciliation Statement-Meaning and Need

Bank reconciliation statement is a statement prepared periodically to reconcile the difference between the balances as per the bank column of the cash book and pass book on any given date.

Need for preparing Bank Reconciliation Statement :

It is usually experienced that when a comparison is made between the bank balance as shown in the firm's cash book and pass book, the two balances do not tally on a given date. Hence, there is a need to ascertain the causes for such differences and then reflect them in a statement called Bank Reconciliation Statement to reconcile the two balances. In order to prepare bank reconciliation statement we need to have bank balance as per the cash book and pass book as on a particular date along with the details of transactions of both the books. If the two balances do not match, then the entries in both the books are

compared and the items on account of which the differences have arisen are discovered with the respective amounts accordingly the bank reconciliation statement is prepared.

3.2 Casuses of Differences Between Bank Balance as per Cash Book and Balance as per Pass Book

The reasons for difference in bank balance of cash book and pass book are as follows:

- I. Cheques issued by the trader but not yet presented for payment :**When the cheques are issued by the business firm in favour of its creditors, these are recorded on the payment side (credit side) of the bank column of the cash book. This reduces the bank balance as per cash book. The bank will debit the firms account only when these cheques are presented for payment. As there is a timing difference between the issue of cheque and its being presented in the bank for payment, the balance as shown as per cash book may not tally with that of the balance shown as per pass book.
- II. Cheques deposited into bank but not yet collected or credited by the bank :** When cheques are deposited into bank, the firm enters it on the debit side of the bank column of the cash book, which results in increase of bank balance as per the cash book. However, it takes time to realize the amount of cheques; hence bank balance does not increase on the same date on which cheque has been deposited in the bank. This may cause the difference in the bank balance between cash book and pass book.
- III. Amount directly deposited by customers/debtors in the bank account :** When the debtors/customers of the firm are given a choice to deposit the amount due from them in the firm's bank account, the bank credits the firm's account with the amount deposited which results in increase of bank balance as per pass book, but the same amount is not recorded in the cash book on the day it is deposited by the customer. As a result the balance in the cash book reflects less than the balance shown in the pass book.
- IV. Bank charges, interest on overdraft, insurance premium etc., charged by the bank :** The bank charges, fees or commission for various services provided by the banker and interest on overdraft from time to time are debited to the customer's account without any intimation to the customer. According to the standard instructions of the trader the bank may pay insurance premium and other expenses and debits the same to the trader account. As a result the balance according to the cash book will be higher than the balance shown in the pass book.
- V. Interest on investments, dividends, interest on deposits etc., received by the bank on behalf of the customer :** As per the standing instructions of the trader the bank may collect interest on investments, dividends and interest on deposits etc., and credit the pass book of the trader. The corresponding entry in the cash book is

not made till the trader receives the information. Until such time, the balances as per the cash book and pass book will not be same.

- VI. Cheques deposited but not entered in cash book :** Whenever cheques are received from the customers they are first entered on the debit side of cash book and then sent to the bank for collection. But, sometimes due to oversight the cheques may be sent to the bank without entering in the cash book. Due to this the cash book balance shows less and pass book balance shows more balance.
- VII. Cheques debited in cash book but omitted to be sent to bank :** When the cheques are received from the customers they are entered debited in the cash book and need to be sent to bank for collection. But, sometimes after making the entry in the cash book, the trader may forget to send the same to the bank. In such a case the balance as shown by the cash book will be higher than that of balance as shown in the pass book.
- VIII. Dishonour of cheques deposited/bills discounted with bank :** All the cheques received by the trader will be sent to bank for collection. If a cheque deposited by the firm is dishonoured or a bill of exchange drawn by the business firm is discounted with the bank is dishonoured on the date of maturity, in such case the bank debits firm's account and until the information of dishonoured is received by the trader the corresponding entry is not recorded in the cash book. Hence, the balance as per the cash book and pass book differs.
- IX. Errors committed in recording transactions by the firm :** The firm may commit certain errors e.g., errors of omission or wrong recording of transactions relating to cheques deposited, cheques issued and wrong balancing etc. In such cases there would be a difference between the balances as per cash book and pass book.
- X. Errors committed in recording transactions by the bank :** Not only customers, but sometimes, the bank may also commit errors while recording the transactions in the customer's account e.g., errors of omission or wrong recording of transactions relating to cheques deposited etc. As a result, the balance of the bank pass book and cash book will not tally.

3.3 Preparation of Bank Reconciliation Statement

Following three steps are involved in preparation of bank reconciliation statement :

Before preparing the bank reconciliation statement we need to

1. Make note of the date on which the reconciliation of cash book and pass book is to be done, as the bank reconciliation statement is prepared on a particular date and is shown on the top of the statement as part of the heading.
2. Identify the causes of difference between the balances of cash book and pass book.
3. Check whether the balance is favourable/positive for unfavourable/negative.

When the deposits are more than the withdrawals it is called favourable or positive balance. In case of favourable balance, the cash book shows debit balance and the pass book shows credit balance. On the other hand, when withdrawals are more than deposits then there is a bank overdraft which is called as unfavourable/negative balance, in this case cash book shows credit balance and pass book debit balance.

	Favourable/Positive Balance	Unfavourable/Negative Balance
Cash Book	Debit Balance	Credit Balance
Pass Book	Credit Balance	Debit Balance

We have four different situations while preparing the bank reconciliation statement. These are:

- When debit balance (favourable balance) as per cash book is given and the balance as per pass book is to be ascertained.
 - When credit balance (favourable balance) as per pass book is given and the balance as per cash book is to be ascertained.
 - When credit balance as per cash book (unfavourable balance/overdraft balance) is given and the balance as per pass book is to be ascertained.
 - When debit balance as per pass book (unfavourable balance/overdraft balance) is given and the balance as per cash book is to be ascertained.
4. To reconcile the cash book balance with the balance of the pass book, we need to consider all points of differences as given under :
- All the cheques issued but not yet presented for payment, amounts directly deposited in the bank account, all the credits given by the bank such as interest and dividends collected by the bank etc. are added.
 - Cheques deposited but not yet collected by the bank, all the items of charges such as interest on overdraft, payment by bank on standing instructions and debited by the bank in the pass book but not entered in cash book, bills and cheques dishonoured etc. are deducted.
 - Adjustment for errors made by the firm and bank are to be done according to the principles of rectification of errors.
5. The net balance shown by the statement after following all the above steps should be the same as shown by the pass book.

Note : If overdraft as per cash book is given, only the overdraft amount will be written in Minus (-) column, rest of the procedure will be the same.

In case of pass book credit balance or balance as per pass book is given, the reverse steps will be taken to reconcile the balance of the pass book with cash book. Same steps will be applied in case of an overdraft as per pass book to reconcile with cash book.

Format of Bank Reconciliation Statement

Bank reconciliation statement is statement and not an account. It can be prepared by using various formats. A simple and convenient format used for preparing bank reconciliation statement is given as follows:

Bank Reconciliation Statement of as on.....

Particulars	Plus Amount ₹	Minus Amount ₹
Balance as per the Cash Book (i.e. given balance)	XXXX	
Cheques issued, but not presented for payment	XXXX	
Cheques received and deposited in the bank, but not recorded in cash book	XXXX	
Interest credited in pass book but not entered in cash book	XXXX	
Dividend collected and credited in pass book but not entered in cash book	XXXX	
Cheques deposited but not credited in pass book		XXXX
Cheques entered in cash book, but not sent to bank		XXXX
Bank charges debited in pass book but not entered in cash book		XXXX
Insurance premium paid by the bank but not entered in cash book		XXXX
Cheques deposited/bills discounted with the bank dishonoured, but not recorded in cash book		XXXX
Pay order paid by the bank, not entered in cash book		XXXX
Bank Balance as per Pass Book		XXXX
	XXXX	XXXX

The following illustrations will help you to understand the preparation of bank reconciliation statement with the favourable balance as per cash book or pass book.

Illustration 1:

From the following particulars of M/s Anand&Co. prepare bank reconciliation statement as on December 31, 2022

1. Bank balance as per cash book ₹62,500
2. Cheques deposited into bank but not credited up to December 31, 2022 ₹6,900
3. Cheques issued but not presented for payment ₹14,500
4. Bank credited ₹2,000 dividend received through Electronic Clearing System
5. Bank charges debited by bank ₹200

Solution :

**Bank Reconciliation Statement of M/s. Anand & Co.
as on December 31, 2022**

Particulars	Plus Amount ₹	Minus Amount ₹
Balance as per the Cash Book	62,500	
1. Cheque deposited but not collected by the banker		6,900
2. Cheques issued but not presented for the payment	14,500	
3. Dividend received through ECS and credited by the banker	2,000	
4. Bank charged debited by the banker		200
Balance as per the Pass Book		71,900
	79,000	79,000

Illustration 2 :

Using the figures given in illustration 1, prepare bank reconciliation statement taking balance as per pass book i.e., ₹71,900 as the starting point.

Solution :

**Bank Reconciliation Statement of M/s. Anand & Co.
as on December 31, 2022**

Particulars	Plus Amount ₹	Minus Amount ₹
Balance as per the Pass Book	71,900	
1. Cheque deposited but not collected by the banker	6,900	
2. Cheques issued but not presented for the payment		14,500
3. Dividend received through ECS and credited by the banker		2,000
4. Bank charged debited by the banker	200	
Balance as per the Cash Book		62,500
	79,000	79,000

Illustration 3 :

From the following particulars of M/s Ramu Traders, prepare a bank reconciliation statement as on June 30, 2022.

1. Balance as per cash book ₹41,100
2. Charges towards credit card fee debited by banker which is not recorded in cash book ₹250.
3. Cheques for ₹8,350 deposited in the bank, but not yet collected by the bank.
4. There was also debit in the pass book of ₹2,500 in respect of a discounted bill dishonoured.

Solution :

Bank Reconciliation Statement of M/s. Ramu Traders as on June 30, 2022

Particulars	Plus Amount ₹	Minus Amount ₹
Balance as per the Cash Book	41,100	
1. Credit card fee charges debited by the bank		250
2. Cheques deposited but not credited by the bank		8,350
3. Discounted bill dishonoured debited in pass book, but not recorded in cash book		2,500
Balance as per the Pass Book		30,000
	41,000	41,000

Illustration 4 :

Bank pass book of M/s. Balaji Industries showed a credit balance of ₹37,500 on July 31, 2021. The following differences were found on that date between the cash book and the pass book.

1. Cheque issued before July 31, 2021, amounting to ₹9,000 had not been presented for payment.
2. Two cheques of ₹5,000 and ₹3,500 were deposited into bank on July 31, but the bank credited the same in the month of August.
3. Insurance premium directly paid by bank ₹2,000.

4. ₹3,000 wrongly debited to the firm account by the bank.

Prepare Bank Reconciliation Statement as on July 31, 2021.

Solution :

**Bank Reconciliation Statement of M/s. Balaji Industries
as on July 31, 2021**

Particulars	Plus Amount ₹	Minus Amount ₹
Balance as per the Pass Book	37,500	
1. Cheques issued but not presented for payment		9000
2. Two Cheques deposited but not credited by the bank in August	8,500	
3. Insurance premium directly paid by bank	2,000	
4. Wrongly debited by the Bank	3,000	
Balance as per the Cash Book		42,000
	51,000	51,000

Illustration 5 :

The cash book of Rasi iron works limited shows a bank balance of ₹9,800. On comparing the cash book with passbook the following discrepancies were identified:

1. Cheque deposited in bank but not credited ₹5,000
2. Cheque issued but not yet presented for payment ₹1,500
3. Insurance premium paid by the bank ₹2,000
4. Bank interest credited by the bank ₹500
5. Bank charges ₹200
6. Directly deposited by a customer ₹4,000

The bank reconciliation statement is shown below

Solution :

Bank Reconciliation Statement

Particulars	Plus Amount ₹	Minus Amount ₹
Balance as per the Cash Book	9,800	
1. Cheque deposited but not credited in the Pass Book		5,000
2. Cheques issued but not presented for the payment	1,500	
3. Insurance premium paid by bank		2,000
4. Bank interest credited by the bank	500	
5. Bank charges debited by the bank		200
6. Amount directly deposited by customer	4,000	
Balance as per the Pass Book		8,600
	15,800	15,800

Illustration 6 :

Bank balance of ₹50,000 showed by the cash book of Amar on December 31, 2022. It was found that three cheques of ₹3,000, ₹6,000 and ₹10,000 deposited during the month of December were not credited in the passbook till January 02, 2023. Two cheques of ₹7,000 and ₹8,000 issued on December 28, were not presented for payment till January 03, 2023. Further, the bank had credited Amar for ₹325 as interest and had debited him with ₹150 as bank charges for which there were no corresponding entries in the cash book.

Prepare a bank reconciliation statement as on December 31, 2022.

Solution :

Bank Reconciliation Statement of Amar as on December 31, 2022

Particulars	Plus Amount ₹	Minus Amount ₹
Balance as per the Cash Book	50,000	
1. Three Cheques deposited but not cleared in December		19,000
2. Two Cheques issued but not presented for payment in December	15,000	
3. Bank interest credited by the bank	325	
4. Bank charges debited by the bank		150
Balance as per the Cash Book		42,570
	65,325	65,325

Illustration 7 :

On comparing the cash book with the passbook of M/s. Naresh & Co., it is found that on March 31, 2021 balance of ₹30,960 showed by the cash book differs from the bank balance with regard to the following:

1. Bank charges ₹200 on March 31, 2021 are not entered in the cash book.
2. On March 21, 2021, a debtor paid ₹3,000 into the company's bank in settlement of his account, but no entry was made in the cash book of the company in respect of this.
3. Cheques totalling ₹12,980 were issued by the company and duly recorded in the cash book before March 31, 2021, but had not been presented at the bank for payment until after that date.
4. ₹3,520 is entered in the cash book as paid into bank on March 31, 2021, but not credited by the bank until the following day.
5. No entry has been made in the cash book to record the dishonour on March 15, 2021 of a cheque for ₹650 received from Bhanu.

Prepare a bank reconciliation statement as on March 31, 2021.

Solution :

**Bank Reconciliation Statement of M/s. Naresh & Co.
as on March 31, 2021**

Particulars	Plus Amount ₹	Minus Amount ₹
Balance as per the Cash Book	30,960	
1. Bank charges debited in pass book only		200
2. Amount directly paid by debtor into bank account, but not entered in cash book	3,000	
3. Cheques issued but not presented for payment	12,980	
4. Amount debited in bank column of the Cash Book, but not credited by the bank		3,520
5. Cheque dishonoured not recorded in the Cash Book		650
Balance as per the Pass Book		42,940
	46,940	46,940

Illustration 8 :

From the following particulars of M/s. Ashwini Traders prepare Bank Reconciliation Statement as at 31st December, 2021. Bank Balance as per Cash Book on 31st December, 2021 was 3,50,000

1. Cheques issued but not cashed prior to 31st December, 2021 was ₹20,000
2. Cheques paid into bank, but not cleared and credited before 31st December, 2021 were for ₹28,000
3. A cheque for ₹12,000 which was received from a customer was entered in the bank column of the cash book in December, 2021, but the same was paid into bank in January, 2022.
4. Interest on investments collected by the banker and credited in the pass book, but not recorded in cash book ₹8,000
5. Bank charges ₹800 debited in pass book but not entered in cash book.

Solution :

**Bank Reconciliation Statement of M/s. Ashwini Traders
as on 31st December, 2021**

Particulars	Plus Amount ₹	Minus Amount ₹
Balance as per the Cash Book	3,50,000	
1. Cheques issued but not presented for payment	20,000	
2. Cheques paid into bank, but not cleared and credited by the banker		28,000
3. Amount debited in bank column of the Cash Book, but not sent to the bank before 31 st December, 2021		12,000
4. Interest on investments collected credited by the banker, but not recorded in cash book.	8,000	
5. Bank charges debited in pass book, but not entered in cash book		800
Balance as per the Pass Book		3,37,200
	3,78,000	3,78,000

Illustration 9 :

Bank Pass book of M/s. Tara Industries showed a credit balance of ₹12,73,500 on July 31, 2022. The following differences were found on that date between the cash book and the pass book balances:

1. Cheques issued before July 31, 2022, amounting to ₹1,79,000 had not been presented for payment.
2. Two cheques of ₹50,000 and ₹35,000 were deposited into bank on July 31, but the bank credited the same in August.
3. Insurance premium directly paid by bank ₹50,000
4. 20,000 wrongly debited to the firm account by the bank.

Prepare Bank Reconciliation Statement as on July 31, 2022.

Solution :

Bank Reconciliation Statement of M/s. Tara Industries as on July 31st 2022

Particulars	Plus Amount ₹	Minus Amount ₹
Balance as per the Pass Book	12,73,500	
1. Cheques issued but not presented for payment		1,79,000
2. Cheques deposited but credited by the bank in August	85,000	
3. Insurance premium directly paid by the bank	50,000	
4. Wrongly debited by the bank	20,000	
Balance as per the Cash Book		12,49,500
	14,28,500	14,28,500

DEALING WITH UNFAVOURABLE OR BANK OVERDRAFT

So far we have dealt with preparation of bank reconciliation statement where bank balances are positive (i.e., favourable balance). But when there is an overdraft as per cash book or pass book it is treated as negative figure on a bank reconciliation statement and is shown in the Minus Column. Different items will be accordingly added or subtracted from the given overdraft balance as the case may be. However, it may be noted that when overdraft is treated as negative balance and taken in the minus column, all those items which appear in the minus column gets added to it automatically. Similarly, all items taken in the plus column gets deducted out of it.

The following solved illustrations will help you to understand the preparation of bank reconciliation statement when there is an overdraft.

Illustration 10 :

On December 31, 2020, the cash book of the M/s. Mohan Traders shows the credit balance of ₹8,500. Cheques amounting to ₹2,500 deposited into bank, but were not collected by the bank. Firm issued cheques of ₹1,000 which were not presented for payment. There was a debit in the pass book of ₹400 for interest and ₹200 for bank charges. Prepare Bank Reconciliation Statement.

Solution :

Bank Reconciliation Statement of M/s. Mohan Traders as on December 31, 2020

Particulars	Plus Amount ₹	Minus Amount ₹
Overdraft as per cash book		8,500
1. Cheques deposited but not credited by the bank		2,500
2. Cheques issued but not presented for payment	1,000	
3. Bank charges and interest charged debited in pass book only		600
Overdraft balance as per Bank Pass Book	10,600	
	11,600	11,600

Illustration 11:

Prepare Bank Reconciliation Statement of M/s. Akash Travels from the following information :

1. Bank overdraft as per Cash book on 31st July 2022, ₹25,000
2. Cheques issued but not presented for payment ₹7,500
3. Cheques deposited but not yet collected by the bank ₹9,600
4. Interest on investment collected by the bank ₹2,300
5. Bank charges 150 debited by the bank not yet entered in the cash book.

Solution :

Bank Reconciliation Statement of M/s. Akash Travels as on July, 2022

Particulars	Plus Amount ₹	Minus Amount ₹
Overdraft as per cash book		25,000
1. Cheques issued but not presented for payment	7,500	
2. Cheques deposited but not yet collected by the bank		9,600
3. Interest on investment collected by the bank		
4. Bank charges debited by the bank	2,300	150
Overdraft balance as per Bank Pass Book	24,950	
	34,750	34,750

Illustration 12 :

From the following particulars of Bajaj & Co. Prepare Bank Reconciliation Statement on March 31, 2022.

1. Overdraft as per pass book ₹26,500
2. Interest on overdraft ₹2,600
3. Insurance premium paid by the bank ₹1,800
4. Cheques deposited but not yet credited ₹7,500
5. Cheques issued but not presented for payment ₹3,000
6. Wrong credit to firm account by the bank ₹2,000

Solution :

Bank Reconciliation Statement of M/s. Bajaj & Co. as on March 31, 2022

Particulars	Plus Amount ₹	Minus Amount ₹
Overdraft as per pass book		26,500
1. Interest on overdraft	2,600	
2. Insurance premium paid by bank	1,800	
3. Cheques deposited but not credited by the bank	7,500	
4. Cheques issued but not presented for payment		30,000
5. Wrongly credited by the bank		2,000
Overdraft balance as per Cash Book	19,600	
	31,500	31,500

Illustration 13 :

Prepare bank reconciliation statement

1. Overdraft shown as per cash book on December 31, 2021 ₹20,000
2. Bank charges for the above period also debited in the passbook ₹200
3. Interest on overdraft for six months ending December 31, 2021 ₹280 debited in the passbook.
4. Cheques issued but not encashed till December 31, 2021 amounted to ₹3,150
5. Interest on investment collected by the bank and credited in the passbook ₹1,000
6. Cheques paid into bank but not cleared by December, 31 2021 were ₹2,100.

Solution :

Bank Reconciliation Statement as on December 31, 2021

Particulars	Plus Amount ₹	Minus Amount ₹
Overdraft as per the Cash Book		20,000
1. Bank charges debited in the pass book		200
2. Interest charged by bank on overdraft		280
3. Cheques issued but not presented for payment	3,150	
4. Interest on investment credited in the Pass Book, but not entered in the Cash Book	1,000	
5. Cheques deposited but cleared		2,100
Overdraft as per the Pass Book	18,430	
	22,580	22,580

Illustration 14 :

Overdraft shown by the passbook of Mr. Krishna is ₹25,000. Prepare bank reconciliation statement on dated December 31, 2022.

1. Bank charges debited as per passbook ₹500
2. Cheques recorded in the cash book but not sent to the bank for collection ₹4,500
3. Received a payment directly from customer ₹6,600
4. Cheque issued but not presented for payment ₹6,980
5. Interest credited by the bank ₹150
6. LIC premium paid by bank ₹4,500
7. Cheques deposited with the bank but not collected ₹5,500

The bank reconciliation statement for this question is given below:

Solution :

Bank Reconciliation Statement of Mr. Krishna as on December 31, 2022

Particulars	Plus Amount ₹	Minus Amount ₹
Overdraft as per the Pass Book		25,000
1. Bank charges debited in the pass book	500	
2. Cheque recorded in the Cash Book but not sent to bank for collection	4,500	
3. Amount directly paid by customer in the bank		6,600
4. Cheque issued but not presented for payment		6,980
5. Interest credited by the bank		150
6. LIC (insurance premium) paid by bank	4,500	
7. Cheques deposited but not cleared	5,500	
Overdraft as per the Cash Book	23,730	
	38,730	38,730

Illustration 15 :

From the following particulars of M/s. Aravind Printers prepare Bank Reconciliation Statement as at 31st December, 2021. Bank overdraft as per Cash Book on 31st December, 2021 was ₹1,50,000

1. Cheques issued but not cashed prior to 31st December, 2021 was ₹2,000
2. Cheques paid into bank, but not cleared and credited before 31st December, 2021 were for ₹8,000
3. A cheque for ₹12,000 which was received from a customer was entered in the bank column of the cash book in December, 2021, but the same was paid into bank in January, 2022.
4. Interest on investments collected by the banker and credited in the pass book, but not recorded in cash book ₹8,000
5. Bank charges 800 debited in pass book but not entered in cash book.

Solution :

Bank Reconciliation Statement of M/s. Ashwini Traders
as on 31st December, 2021

Particulars	Plus Amount ₹	Minus Amount ₹
Overdraft as per the Cash Book		1,50,000
1. Cheques issued but not presented for payment	2,000	
2. Cheques paid into bank, but not cleared and credited by the banker		8,000
3. Amount debited in bank column of the Cash Book, but not sent to the bank before 31 st December, 2021		12,000
4. Interest on investments collected credited by the banker, but not recorded in cash book.	8,000	
5. Bank charges debited in pass book, but not entered in cash book		800
Overdraft as per the Pass Book	1,60,800	
	1,70,800	1,70,800

Illustration 16 :

Bank Pass book of M/s. Karan Industries showed a debit balance of ₹2,73,500 on July 31, 2022. The following differences were found on that date between the cash book and the pass book balances:

1. Cheques issued before July 31, 2022, amounting to ₹79,000 had not been presented for payment.
2. Two cheques of ₹15,000 and ₹25,000 were deposited into bank on July 31, but the bank credited the same in August.
3. Insurance premium directly paid by bank ₹5,000
4. ₹ 20,000 wrongly debited to the firm account by the bank.

Prepare Bank Reconciliation Statement as on July 31, 2022.

Solution :

Bank Reconciliation Statement of M/s. Karan Industries as on July 31, 2022

Particulars	Plus Amount ₹	Minus Amount ₹
Overdraft as per the Pass Book		2,73,500
1. Cheques issued but not presented for payment		79,000
2. Cheques deposited but credited by the bank in August	40,000	
3. Insurance premium directly paid by the bank	5,000	
4. Wrongly debited by the bank	20,000	
Overdraft as per the Cash Book	2,87,500	
	3,52,500	3,52,500

WHAT YOU HAVE LEARNT

- Bank Reconciliation Statement is a statement prepared periodically with the purpose of enlisting the reasons of differences between the balances as per the bank column of cash book and pass book on any given date.
- A Bank Reconciliation Statement is a statement reconciling the balance as shown by the bank pass book and the balance as shown by the bank column of the cash book. The objective of preparing such a statement is to know the causes of difference between the two balances and to reconcile them.
- The reasons for difference in balance of the cash book and pass book are as under:
 - Cheques issued by the trader but not yet presented for payment
 - Cheques deposited into bank but not yet collected or credited by the bank
 - Amount directly deposited by customers/debtors in the bank account
 - Bank charges, interest on overdraft, insurance premium etc., charged by the bank
 - Interest on investments, dividends, interest on deposits etc., received by the bank on behalf of the customer
 - Cheques deposited but not entered in cash book
 - Cheques debited in cash book but omitted to be sent to bank
 - Dishonour of cheques deposited/bills discounted with bank

- Errors committed in recording transactions by the firm
- Errors committed in recording transactions by the bank
- Preparation of Bank Reconciliation Statement with favourable and unfavourable balances.

Terminal Exercise

Section - A

1. Cash Book
2. Pass Book
3. Bank Reconciliation Statement
4. Dishonour of Cheque
5. Overdraft

Section - B

1. What is the need for preparing Bank Reconciliation Statement?
2. Write any four causes of differences in the balance of cash book and pass book.
3. Explain the process of preparing a Bank Reconciliation Statement.
4. From the following particulars of Mr. Vimal, prepare bank reconciliation statement as on March 31, 2021.
 1. Bank balance as per cash book ₹60,000.
 2. Cheques issued but not presented for payment ₹8,000.
 3. The bank had directly collected dividend of ₹5,000 and credited to bank account but was not entered in the cash book.
 4. Bank charges of ₹200 were not entered in the cash book.
 5. A cheque for ₹5,000 was deposited but not collected by the bank.

Section - C

1. Enumerate the causes of differences in the balance of cash book and pass book.
2. From the following particulars of Sunil & Co. prepare a bank reconciliation statement as on August 31, 2021.
 1. Balance as per the cash book ₹34,000.
 2. 200 bank incidental charges debited to Sunil & Co. account, which is not recorded in cash book.
 3. Cheques for ₹4,500 is deposited in the bank but not yet collected by the bank.
 4. A cheque for ₹12,000 is issued by Sunil & Co. not presented for payment.

3. The bank passbook of M/s. Ross & Co. showed a balance of ₹38,000 on May 31, 2022.
 1. Cheques issued before May 31, 2022, amounting to ₹15,940 had not been presented for encashment.
 2. Two cheques of ₹2,900 and ₹4,350 were deposited into the bank on May 31 but the bank gave credit for the same in June, 2022.
 3. There was also a debit in the passbook of ₹3,500 in respect of a cheque dishonoured on 31.5.2022.

Prepare a bank reconciliation statement as on May 31, 2022.

4. Prepare bank reconciliation statement as on December 31, 2021. This day the passbook of Mr. Virat showed a balance of ₹17,000.
 1. Cheques of ₹4,000 directly deposited by a customer.
 2. The bank has credited Mr. Virat for ₹500 as interest.
 3. Cheques for ₹5000 were issued during the month of December, but of these cheques for ₹1,000 were not presented during the month of December.
5. From the following particulars prepare a bank reconciliation statement showing the balance as per cash book on December 31, 2020.
 1. Balance as per Pass book was ₹40,000
 2. Two cheques of ₹3,000 and ₹4,000 were paid into bank in October, 2020 but were not credited by the bank in the month of December.
 3. A cheque of ₹1,800 which was received from a customer was entered in the bank column of the cash book in December 2020, but was omitted to be banked in December, 2020.
 4. Cheques for ₹9,000 were deposited into bank in November 2020, but not credited by the bank on December 31, 2020.
 5. Interest on investment 1,000 collected by bank appeared in the passbook only.
6. Balance as per passbook of Mr. Kamal is ₹9,000.
 1. Cheque paid into bank but not yet cleared
 - Ram ₹1,000
 - Kishore ₹500
 2. Bank Charges ₹200
 3. Cheque issued but not presented
 - Hameed ₹4,000
 - Kapoor ₹600

4. Interest entered in the pass book but not entered in the cash book ₹400

Prepare a bank reconciliation statement.

7. On March 31, 2021, Mukesh had an overdraft of ₹12,000 as shown by his cash book. Cheques amounting to ₹4,000 had been paid in by him, but were not collected by the bank. He issued cheques of ₹600 which were not presented to the bank for payment. There was a debit in his passbook of ₹160 for interest and ₹150 for bank charges. Prepare bank reconciliation statement.

8. On March 31, 2022 the bank column of the cash book of Bansilal Traders showed a credit balance of ₹18,100 (Overdraft). On examining of the cash book and the bank statement, it was found that:

1. Cheques received and recorded in the cash book, but not sent to the bank of collection ₹2,400.
2. Payment received from a customer directly by the bank ₹7,300, but no entry was made in the cash book.
3. Cheques issued for ₹5,200 not presented for payment.
4. Interest of ₹800 charged by the bank was not entered in the cash book.

Prepare bank reconciliation statement.

9. From the following particulars of Pasha & Co. prepare a bank reconciliation statement on December 31, 2021.

1. Overdraft as per passbook ₹10,000
2. Interest on overdraft ₹1,000
3. Insurance premium paid by the bank ₹400
4. Cheque issued but not presented for payment ₹2,500
5. Cheque deposited but not yet cleared ₹3,000
6. Wrongly debited by the bank ₹200

10. Anil finds that the bank balance shown by his cash book on December 31, 2020 is ₹90,600 (Credit) but the passbook shows a difference due to the following reason:

1. A cheque (post dated) for ₹3,000 has been debited in the bank column of the cash book, but not presented for payment.
2. A cheque for ₹5,000 drawn in favour of Srinivas has not yet been presented for payment.
3. Cheques totalling ₹2,500 deposited in the bank have not yet been collected and cheque for ₹3,000 has been dishonoured.

Prepare Bank Reconciliation Statement.

11. Overdraft shown by the pass book of M/s. Rohit Traders is ₹30,000. Prepare Bank Reconciliation Statement as on December 31, 2022.

1. Bank charges debited as per the pass book ₹300
2. Received a payment directly from customer ₹5,000
3. Cheques wrongly recorded in debit side of cash book ₹2,000
4. Cheques issued but not presented for payment ₹4,800
5. Cheques deposited with the bank but not collected ₹5,500
6. Insurance premium paid by the bank ₹1,500

You know that now-a-days in business transactions on credit are on the rise. When goods are sold on credit a huge amount of capital is blocked. Then there is no certainty when the amount will be paid. A solution of the problem is giving this fact in writing in proper form so that the buyer or debtor has to pay a definite sum to the seller/creditor on demand or after the expiry of a certain period. Such a formal document duly signed by both the parties is called a Bill of Exchange.

When such a document is given by the debtor/buyer from his own side it is called a promissory note. These two documents when prepared as per provisions of the Negotiable Instruments Act, 1881 attains the position of money and are used for settlement of the amount due. In this lesson you will learn about these two instruments and their accounting treatment in the books of parties concerned.

Objectives

After studying this lesson you will be able to :

- define the terms 'Bill of Exchange' and 'Promissory Notes';
- distinguish between 'Bill of Exchange' and 'Promissory Note';
- define the terms such as drawer, drawee, days of grace, noting charges etc;
- make entries in the books of drawer and drawee/payee with respect to drawing & accepting the bill of exchange and meeting the bill of exchange on maturity;
- dishonour of a Bill;
- renewal of Bill;
- insolvency of the acceptor;
- retiring a bill under rebate;
- discounting the bill from bank; and
- dishonour of bill in various conditions.

4.1 Bill of Exchange - Meaning

According to section 5 of the Negotiable Instruments Act, 1881, a bill of exchange is an instrument in writing containing an unconditional order signed by the maker, directing a certain person to pay a certain sum of money only to, or to the order of, a certain person, or to the bearer of the instrument.

Features of Bill of Exchange

1. It is an instrument drawn by the creditor upon his debtor.
2. It contains an unconditional order to pay a specified amount.
3. The specified amount is payable to the person named in the bill or to his order or to the bearer.
4. The bill must be signed/accepted by the maker.
5. The bill specifies the date by which the amount should be paid.
6. It can be payable to the bearer.

Parties to a Bill of Exchange

1. **Drawer :** Drawer is a person who writes/makes the Bill of Exchange. He is generally the creditor who had sold goods on credit.
2. **Drawee :** Drawee is a person upon whom the bill is drawn. He is generally the debtor to whom goods have been sold on credit. Bill is generally signed and accepted by the Drawee.
3. **Acceptor :** He is the person who accepts the bill of exchange. Generally debtor/drawee is the acceptor but sometimes a bill of exchange may be accepted by some one also on behalf of the debtor/drawee. Normally the drawee and acceptor are the same parties.
4. **Payee :** Payee is the person named in the Bill of exchange. The amount in the bill is paid to the payee. In most cases Drawer and the payee will be the same.

SPECIMEN OF A BILL OF EXCHANGE

₹ 90,000	New Delhi, June 20, 2022
<div style="border: 1px solid black; width: 100px; height: 80px; display: flex; align-items: center; justify-content: center;">Stamp</div>	Three months after date pay Ch. Shiva or order the sum of Rupees Ninety Thousand only, value received
To	
Smt. Gowri Nayapul, Hyderabad.	Ganesh

4.2. Promissory Note

According to section 4 of the Negotiable Instruments Act, 1881, A Promissory Note is an instrument in writing (not being a bank note or a currency note) containing an unconditional undertaking signed by the maker to pay a certain sum of money only to or to the order of a certain person.

Promissory Note is an unconditional undertaking in writing by the maker to pay the specified amount to the specified person or to the bearer of the promissory note.

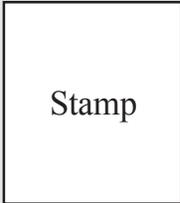
Features of a Promissory Note

1. It is an unconditional written undertaking to pay the specified amount.
2. It is drawn and signed by the maker/promisor.
3. It specifies the name of the payee.
4. The specific amount is payable to the specified person or to his order or to the bearer.
5. Proper stamp duty is paid on Promissory Note.
6. It is not payable to the bearer.

Parties of a Promissory Note

1. **Drawer** : He is the person who makes the promise to pay the amount. He is the debtor.
2. **Drawee** : He is the person in whose favour the promissory note is drawn. Generally he is the creditor. In a promissory note the drawee and payee are the same parties.
3. **The Payee** : The payee is a person to whom payment is to be made. He is the creditor.

SPECIMEN OF A PROMISSORY NOTE

₹ 50,000	New Delhi, June 20, 2022
	Three months after date we promise to pay M/s. Govind Enterprises or order a sum of Rupees Fifty Thousand only with interest at ten percent per annum, value received.
	Reddy Brothers

Difference between Bill of Exchange and Promissory Note

<i>Bill of Exchange</i>	<i>Promissory Note</i>
<ol style="list-style-type: none"> 1. It contains an order to pay. 2. It requires acceptance. 3. Creditor is the Drawer. 4. The liability of the drawer arises only if the acceptor does not pay. 5. The drawer, and payee are generally the same parties. Acceptor and drawee is the Same party. 	<ol style="list-style-type: none"> 1. It contains a promise to pay. 2. It does not need acceptance. 3. Debtor is the drawer. 4. The promisor has the primary liability to pay. 5. Drawee and Payee are the parties.

4.3. Terms of Bill

1. **Due Date :** It is the date on which the payment of the bill becomes due.
2. **Days of Grace :** To ascertain the period of the bill, three extra days are added, which can be called as 'Days of Grace' to calculate the date of maturity.
3. **Bill at Sight :** Bills which are payable on presentation to the Drawee are known as 'Bill at Sight or Demand'.
4. **Bill After Date :** The period is counted from the date of acceptance of the bill in 'Bill After Date'.
5. **Discounting of Bill :** The process of receiving the bill amount at a date earlier than the due date from the bank, is known as 'Discounting the Bill'. When the bill is discounted the bank credits the trader's account after deducting some discount. The discount is calculated at the lending rate of the bank for the period that extends between the date of discounting of the bill to the date of maturity.
6. **Endorsement of the Bill :** The drawer may transfer the bill in favour of his creditor to settle the creditor's account. The process of transferring the ownership of the bill in favour of somebody by putting the signature of the holder at the back of the instrument and delivering the same to transferee is known as endorsing the bill. The person who delivers it is endorser and the person to whom it is delivered is called the endorsee.
7. **Terms of the Bill :** Bills are generally drawn for a certain period, say for two months or three months. Bills may be drawn payable at sight on demand, on presentation, after date and so on.

8. **Date of Maturity** : It is the date of which the payment of the bill is due. It is calculated by adding three days of grace. For example a bill drawn on 1-1-2023 for a period of two months will mature on (2 months + 3 days) 3rd March, 2023.
9. **Dishonour of a Bill** : Dishonour means that the bill is not paid by a Drawee on the due date. It arises when the acceptor refuses or is unable to pay the amount of bill, *i.e.*, Bill of Exchange, Promissory Note or cheque.
10. **Notary Public** : Notary Public is an officer appointed by the Central or State Government to exercise the power and functions relating to noting and protesting of negotiable instruments for dishonour. 'Noting' authenticates the fact of dishonour.
11. **Noting Charges** : Noting Charges is the fee paid to the Notary Public for noting and protesting the Bill of Exchange of its dishonour.
12. **Renewal of Bill** : When the acceptor of a bill is not in a position to meet the bill on due date, he may, with the consent of the holder accept a fresh bill in place of the old bill, it is called **Renewal of a Bill**. The fresh bill may include interest for the extended period (or it may be paid separately), stamp duty and other incidental expenses incurred by the holder.
13. **Retirement of Bill** : When the Drawee pays the bill before its due date, it is called **Retirement of a Bill**. The holder allows him a rebate of certain amount calculated at a certain rate per cent per annum, from the date of retirement to the date of maturity.

4.4. Recording of Bill Transactions

Before starting recording the bill transactions there are certain important aspects related to recording that you must understand clearly. A bill transaction can be recorded in the books of all the parties related to a bill of exchange if that transaction affects the concerned party in any way. As you know that the person who draws the bill of exchange is called the drawer. He is generally a creditor of the person upon whom the bill of exchange is drawn. The person upon whom bill of exchange is drawn is called the drawee. He is generally the debtor of the person who draws the bill of exchange. For the drawer who receives the bill of exchange after its acceptance by the drawee, the bill of exchange is a bills receivable since he will receive the payment on the maturity of the bill. Bills receivables are assets. For the drawee upon whom the bill of exchange is drawn and who accepts it, the bill of exchange becomes a bills payable because he has to make the payment of the amount on the maturity of the bill when the bill will be presented to him. Bills payables are liabilities. The following procedure is followed for recording the bill transactions both in the books of the drawer/creditor and drawee/ acceptor/debtor in a comparative form.

payment.

Books of drawer

No entry

Since he had already discounted the bill from the bank, hence no entry will be passed.

Books of acceptor/drawee

Bills Payable A/c

Dr.

To Bank

- (iii) When the bill is endorsed by the receiver in favour of his creditor.

Books of Receiver/Drawer

Creditor's A/c

Dr.

To Bills Receivable

Books of Acceptor/Drawee

No entry. Since he will not be affected by the endorsement of the bill.

Books of drawer

No entry.

Since he is not affected

Bills Payable A/c

Dr.

To Bank

- (iv) When the bill is sent to the bank for collection a few days before maturity.

Books of Receiver/Drawer

a) For sending

Bill sent for collection Dr.

To Bills Receivable

Books of drawee/acceptor

No entry

Since he is not effected.

b) For collection of bill by bank

Bank A/c Dr.

To Bills sent for collection.

Bills Payable A/c Dr.

To Bank

Illustration 1

Radhika sold goods ₹10,000 to Madulika on credit. She drew a bill of exchange for the same amount upon Madulika payable after date two months. Madhulika accepted the bill and returned the same to Radhika. On the due date the bill was presented to Madhulika who met the same.

Pass the necessary journal entries in the books of Radhika and Madhulika under the following circumstances.

- i. When the bill was retained by Radhika till the date of its maturity.
- ii. When Radhika discounted the bill from the bank on the same day at 6% p.a.

- iii. When Radhika endorsed the bill in favour of his creditor Mounika.
 iv. When Radhika sent the bill a few days before its maturity to its bank for collections.

Solution :

Books of Radhika
Journal

<i>Date</i>	<i>Particulars</i>	<i>L.F.</i>	<i>Dr.</i> <i>Amount</i> ₹	<i>Cr.</i> <i>Amount</i> ₹
	(a) (i) Madhulika A/c Dr. To Sales (Sold goods to Madhulika)		10,000	10,000
	(ii) Bills Receivable A/c Dr. To Madhulika's A/c (Recieved Madhulika's acceptance payable after two months)		10,000	10,000
	Cash/Bank A/c Dr. To Bills receivable (Madhulika met her acceptance on maturity)		10,000	10,000
	(b) Entry (i) & (ii) will be same Bank A/c Dr. Discount A/c Dr. To Bill Receivable A/c Madhulika's acceptance discounted with Bank)		9,900 100	10,000
	(c) Entry (i) & (ii) to will be same as in (a) above. Mounika A/c Dr. To Bills Receivable A/c (Madhulika's acceptance in our favour endorsed in favour of Mounika)		10,000	10,000

(d) Entry (i) & (ii) will be same as in (a) above Bills sent for collection To Bills Receivable A/c (Madhulika acceptance in our favour sent to bank for collection)	Dr.	10,000	10,000
---	-----	--------	--------

Books of Madhulika *Journal*

(a) (b) (c) & (d) Purchases A/c To Radhika's A/c (Purchased goods)	Dr.	10,000	10,000
Radhika's A/c To Bills Payable (Accepted Radhika's draft)	Dr.	10,000	10,000
Bills Payable A/c To Cash/Bank (Our acceptance in favour of Radhika met on maturity)	Dr.	10,000	10,000

Note : Whatever may happen to the bill before the date of maturity the acceptor is not affected. He will meet the bill on maturity & pass the same entry is all the cases.

4.5. Dishonour of a Bill

If the acceptor fails to pay the amount of the bill on the due date, the bill is said to have been dishonoured. When the bill is dishonoured all the previous transactions in connection with the bill are treated as cancelled. Hence, the acceptor is liable to the drawer, the drawer to the endorsee and the endorsee to the bank, with which it is discounted.

The dishonoured bill must be noted with the Notary Public. When the dishonoured bill is noted with the Notary Public, it is a valid evidence of dishonour. The fees charged by the Notary Public is termed as 'Noting Charges.'

On Dishonour of a bill the journal entries will be as under :

In the books of Drawer

cancelled and a new bill is drawn. When the old bill is cancelled, it is treated as dishonoured. Drawee will be charged with interest for the extended period. If the interest is not paid in cash, the new bill amount will include interest also. Therefore, the cancellation of the existing bill and drawing a new bill in its place to allow more time to the acceptor is known as renewal of the bill. On renewal of a bill the entries will be as under :

<i>In the books of Drawer</i>		<i>In the books of Drawee</i>	
i.	Drawee To Bills Receivable (Being old bill cancelled)	Dr.	
ii.	Drawee To Interest (Being interest charged for the extended period)	Dr.	
iii.	Bills Receivable To Drawee (Being a new bill received from Drawee including the interest)	Dr.	
i.			Bill Payable To Drawer (Being cancellation of bill payable)
ii.			Interest To Drawer (Being interest due to Drawer for the extended period)
iii.			Drawer To Bills Payable (Being a new bill issued for the amount plus interest)

Illustration 2

X sold goods to Y for ₹ 20,000 and drew a bill on him for the same amount for 3 months. Before the due date, requests to cancel the bill, to accept ₹ 6,000 as part payment and to draw a fresh bill on him for ₹ 14,400 for a further period of 2 months - ₹ 400 being the interest for the extended period. agrees to the proposal. The new bill is duly honoured. Pass the necessary Journal entries and other party's account in the books of both the parties.

Solution :

Dr.**Y's Account****Cr.**

<i>Date</i>	<i>Particulars</i>	<i>J.F.</i>	<i>Amount</i> ₹	<i>Date</i>	<i>Particulars</i>	<i>J.F.</i>	<i>Amount</i> ₹
	To Sales A/c		20,000		By Bills Receivable A/c		20,000
	To Bills Receivable A/c		20,000		By Cash/Bank A/c		6,000
	To Interest A/c		400		By Bills Receivable A/c		14,400
			40,400				40,400

In the Books of Y**JOURNAL**

<i>Date</i>	<i>Particulars</i>	<i>L.F.</i>	<i>Dr.</i> <i>Amount</i> ₹	<i>Cr.</i> <i>Amount</i> ₹
	Purchases A/c ...Dr. To X (Being the goods purchased to Y on credit from X)		20,000	20,000
	X ...Dr. To Bill Payable A/c (Being the acceptance of a bill from X)		20,000	20,000
	Bills Payable A/c ...Dr. To X (Being the bill cancelled for renewal)		20,000	20,000
	X ...Dr. To Cash/Bank A/c (Being a part payment made)		6,000	6,000
	Interest A/c ...Dr. To X (Being the interest payable to X for the extension period)		400	400

Account A/c	...Dr.	14,400	14,400
To Bills Payable A/c (Being the acceptance of a new bill for the balance plus interest)			
Bills Payable A/c	...Dr.	14,400	14,400
To Cash/Bank A/c (Being the new bill honoured by payment)			

Dr. X's Account Cr.

Date	Particulars	J.F.	Amount ₹	Date	Particulars	J.F.	Amount ₹
	To Bills Payable		20,000		By Purchases		20,000
	To Bank		6,000		By Bills Payable		20,000
	To Bills Payable		14,400		By Interest		400
			40,400				40,400

Illustration 3 : (When the bill is renewed)

Ramesh owed to Suresh ₹ 1,20,000 on 1st January, 2023. On the same date, Suresh drew upon Ramesh a bill for the amount at 2 months and Ramesh returned the bill duly accepted. Suresh got the bill discounted at his bank @ 15% p.a. Before the bill was due for payment, Ramesh told Suresh that he was not able to pay the full amount and requested Suresh to accept ₹ 40,000 immediately and drew upon him another bill for the remaining amount for 2 months together with interest @ 18% p.a. Suresh agreed. The second bill was duly met. Give the Journal entries in the books of both Suresh and Ramesh.

Solution :

Suresh Journal

Date	Particulars	LF No.	Debit ₹	Credit ₹
2023 Jan. 1	Bills Receivable		1,20,000	
	To Ramesh			1,20,000
	(Being the receipt of Ramesh acceptance to clear the amount due from him)			

Jan. 1	Bank A/c ...Dr. Discount on Bill A/c ...Dr. To Bills Receivable A/c (Being discounting of the bill @ 15% for 2 months)	1,17,000 3,000	1,20,000
Mar. 4	Ramesh ...Dr. To Bank A/c (Being the dishonour [for renewal] of Ramesh Bill)	1,20,000	1,20,000
Mar. 4	Cash/Bank A/c ...Dr. To Ramesh (Being the receipt of ₹40,000 from Ramesh)	40,000	40,000
Mar. 4	Ramesh ...Dr. To Interest A/c (Being the interest due from Ramesh for 2 months on ₹80,000 @ 18% p.a.)	2,400	2,400
Mar. 4	Bills Receivable A/c ...Dr. To Ramesh (Being the new acceptance received from Ramesh for ₹80,000 balance, plus ₹2,400 interest)	82,400	82,400
Mar. 7	Cash/Bank A/c ...Dr. To Bill Receivable A/c (Being the amount of the bill received)	82,400	82,400

Ramesh Journal

<i>Date</i>	<i>Particulars</i>	<i>LF No.</i>	<i>Debit ₹</i>	<i>Credit ₹</i>
2023 Jan. 1	Suresh ...Dr. To Bills Payable A/c (Being the acceptance of Suresh draft)		1,20,000	1,20,000
Mar. 4	Bills Payable A/c ...Dr. To Suresh (Being the entry required to get the bill renewed)		1,20,000	1,20,000
Mar. 4	Suresh ...Dr. To Cash/Bank A/c (Being the amount paid to Suresh as per arrangement)		40,000	40,000
Mar. 4	Interest A/c ...Dr. To Suresh (Being the amount of interest due to Suresh on Rs. 80,000 for 2 months @ 18%)		2,400	2,400
Mar. 4	Suresh ...Dr. To Bills Payable A/c (Being the new acceptance in favour of Suresh)		82,400	82,400
Mar. 7	Bills Payable A/c ...Dr. To Cash/Bank A/c (Being the payment of the bill due this day)		82,400	82,400

4.7. Insolvency of the Acceptor

If the acceptor is unable to meet his liabilities, the court declares him as insolvent. In case the acceptor becomes bankrupt, his bills payable are considered as dishonoured. Any amount received from the insolvent person's property, will be debited in the cash account and credited in the Acceptor's Account. Any balance in his account, which is irrecoverable, is written off as bad debts. The Acceptor will transfer the balance in the account of the drawer to Deficiency Account.

The entries relating to insolvency are as follows :

In the books of Drawer

Drawee	Dr.
To Bill Receivable	
(Cancellation of bill)	
Cash	Dr.
Bad Debts	Dr.
To Drawee	

(Being the amount received and the amount written off on _____ 's insolvency)

In the books of Drawee

Bills Payable A/c	Dr.
To Drawer's A/c	
(Cancellation of own acceptance)	
Drawer	Dr.
To Cash	
To Deficiency A/c	
or	
To Profit & Loss A/c	

(Being the final payment to drawer and the balance transferred to deficiency A/c)

Illustration 4

Journalise the following in the books of Raj

- (i) Raju's acceptance to Sriju for ₹10,000 renewed at 3 months together with interest @ 18%
- (ii) Ram requests Raju to renew his acceptance for ₹7,500 for 2 months. Raju agrees to it, provided interest is paid @10% in cash.

Solution :

4.8. Retiring a Bill Under Rebate

Sometimes the acceptor pays the amount of his bills payable before the due date. The payment of bill amount by the acceptor to the holder before the due date, is known as 'retiring the bill'. In such cases, the holder of the bill would grant some concession to the acceptor. This concession is called as rebate. Rebate is a loss to the holder. It will be a gain to the acceptor

Entries for rebate are

In the books of Drawer

Cash	Dr.
Rebate	Dr.
To Bills Receivable	

(Being the B/R retired under rebate)

In the books of Drawee

Bills Payable	Dr.
To Cash	
To Rebate	

(Being B/P retired)

Illustration 5

Revanth draws a bill on Vikranth for ₹5,000 payable 3 months after date. The bill is duly accepted by Vikranth. One month before due date Vikranth meets the bill and gets a rebate @ 12% p.a. Make Journal entries in the books of Revanth and Vikranth.

In the books of Revanth

Bills Receivable	...Dr.	5,0000
To Vikranth		5,0000

(Received Vikranth's acceptance)

Cash A/c	...Dr.	4,950
Rebate A/c	...Dr.	50
To B/R A/c		5,000

In the books of Vikranth

Revanth	...Dr.	5,000
To B/P A/c		5,000

(Accepted Revanth's draft)

B/P A/c	...Dr.	5,000
To Cash A/c		4,950
To Rebate A/c		50

WHAT YOU HAVE LEARNT

- A Bill of Exchange is an instrument in writing containing an unconditional order signed by the maker, directing a certain person to pay a certain sum of money only to, or to the order of, a certain person or to the bearer of the instrument.
- Parties to a Bills of Exchange are :
 - i. The Drawer : The party who makes the bill.
 - ii. The Drawee : The party upon whom the bill is drawn.

- iii. The Payee : The party to whom the amount is to be paid.
 - iv. The Acceptor : The person who accepts the bill. Generally the drawee and acceptor may be the same parties.
- There may be four situations of a bill drawn :
 - i. It may be retained till due date.
 - ii. It may be discounted with bank.
 - iii. It may be endorsed.
 - iv. It may be sent to bank for collection.

Terminal Exercise

Section - A

- | | |
|--------------------------------|-----------------------|
| 1. Bill of Exchange | 2. Promissory Note |
| 3. Parties to Bill of Exchange | 4. Renewal of Bill |
| 5. Noting Charges | 6. Retirement of Bill |
| 7. Grace Period | |

Section - B

1. What do you mean by a bill of exchange. Distinguish between Bill of Exchange and Promissory Note.
2. Define Bill of Exchange. What are the features of Bill of Exchange?
3. Explain Bill of Exchange along with its advantages and disadvantages.
4. Who are the parties to bill of exchange? Explain them.
5. Explain the following terms :
 - i. Renewal of a bill
 - ii. Retirement of a bill
 - iii. Noting charges
 - iv. Retirement of a bill Days of grace
6. What is meant by a Promissory Note? Describe the parties to a Promissory Note.
7. Briefly explain the characteristics of a Promissory Note.
8. Rao Sold Rs. 800 goods to Sita on January 1, 2023 and drawn the bill for 3 months. Sita accepted the bill. Write journal entries in the books of Rao and Sita, when the bill was honoured and dishonoured.

Section - C

1. On 1st March, 2023 Tanuj sold goods to Rani for Rs. 6,000 and drawn the bill for three months. The bill was accepted. Tanuj purchased goods for Rs. 6,000 from Sani and endorsed the bill to Sani towards the debt due to him. The bill was dishonoured on the due date. Write journal entries in the books of Tanuj, Rani and Sani. Assume that the drawer paid the bill on behalf of the acceptor.
2. A drawn the bill on B for Rs. 200 for 2 months on 1-2-2023. Before the due date he paid Rs. 20 towards interest and asked him to write a new bill for Rs. 400 payable after 3 months due date. A accepted the proposal. The new bill was honoured on the due date. Write journal entries in the books of both the parties.
3. A draws a 3 months bill on D for Rs. 400. D approaches A before the due date and request him to take Rs. 210 including Rs. 10 interest and draw a new bill on him for the balance. A accepts the proposal. The renewed bill is dishonoured on the due date. Pass necessary entries in the books of both the parties.
4. Nidhi draws a three months bill on Ananya for Rs. 4,000 and Ananya duly accepted it. Before due date Ananya approaches Nidhi and requests the later to receive Rs. 2,100 including interest Rs. 100 and to draw a new bill for the balance. Nidhi accepts the proposal. Give entries in the books of Nidhi only.
5. On 1st March, 2023 *R* accepted a Bill of Exchange of ₹20,000 from *S* payable 3 months after date in full settlement of his dues. On the same day *S* endorsed the Bill of Exchange to *T* together with a cheque for ₹5,000 in settlement of his debt to the latter. On 2nd March, 2023, *T* discounted the bill of exchange @ 6% p.a. with his bankers. On maturity the Bill of Exchange was dishonoured.

Pass the Journal entries in the books of S and R.

6. Record the following transactions in the books of Mehra:
 - i. Ram's acceptance for ₹20,000 renewed for 3 months, plus interest at 5% p.a.
 - ii. Shyam's acceptance for ₹4,500, due this day, returned dishonoured. Noting charges, ₹10.
7. A sold goods to the value of ₹12,000 to B, taking a bill at 3 months, therefore dated 1st July, 2023. On 4th August, A discounted the bill at 5% p.a. with his bankers. At maturity the bill was renewed and drew another bill dishonoured, B paid ₹ 3,000 and noting charges and accept another bill at 3 months for ₹9,000 at 6% interest, but before maturity he had become insolvent, and ultimately paid his creditors 75 paise in the rupee.

Make the entries in A's Journal recording the above transactions.

TRIAL BALANCE AND RECTIFICATION OF ERRORS

Whenever you attempt a question in arithmetic you try to verify whether your answer is correct or not. If you attempt to solve any other type of problem you want to ensure that it has been correctly solved. For this you try to find out some ways or means. Similarly an accountant also wants to be sure that the ledger accounts he/she has prepared are correct in respect of amount, side, balance, etc. To check the accuracy of posting in the ledger a statement is prepared. This statement is called Trial Balance. You also know that accounts are prepared by applying double entry system. According to this system every debit of a transaction has corresponding credit for the same amount. Hence, the total of debit balances of different accounts in the ledger must be equal to the total of the credit balances in the remaining accounts, provided transactions have been correctly posted in the ledger. A statement is prepared containing these balances with two columns i.e. debit column containing debit balances and credit column containing credit balances and the debit column total is compared with credit column total. If the columnar totals are same it implies that ledger accounts are arithmetically accurate.

In this lesson, you will learn about meaning, objectives and preparation of Trial Balance.

Objectives

After studying this lesson you will be able to :

- state the meaning, objectives and preparation of Trial Balance;
- identify the need for a Suspense A/c in case the Trial Balance does not tally and
- meaning of accounting error and method of its location;
- classification of accounting errors and their rectification;

5.1 Meaning and Objectives of Preparing Trial Balance

If you recall the steps in the accounting procedure you find that at first the transactions are entered in the Journal and Special Purpose Books like Cash Book, Purchases Book, Sales Book, etc. From these books items are posted in the ledger in their respective accounts. Finally, at the end of the accounting year these accounts are balanced. To check

the accuracy of posting in the ledger a statement is prepared with two columns i.e. debit column and credit column which contains debit balances of accounts and credit balances of accounts respectively. Total of the two columns are if equal, it means the ledger posting is arithmetically correct. This statement is called Trial Balance.

Trial Balance may be defined as a statement which contains balances of all ledger accounts on a particular date.

Trial Balance consists of a debit column with all debit balances of accounts and credit column with all credit balances of accounts. The totals of these columns if tally it is presumed that ledger has been maintained correctly. However, Trial Balance proves only the arithmetical accuracy of posting in the ledger.

Objectives of Preparing a Trial Balance

Following are the objectives of preparing Trial Balance

- (i) **To Check Arithmetical Accuracy:** Arithmetical accuracy in ledger posting means writing correct amount, in the correct account and on its correct side while posting transactions from various original books of accounts, such as Cash Book, Purchases Book, Sales Book, etc. It also means not only the correct balance of ledger account but also the totals of the special purpose Books.
- (ii) **To Help in Preparing Financial Statements:** The ultimate objective of the accounting is to prepare financial statements i.e. Trading and Profit and Loss Account, and Balance sheet of a business enterprise at the end of an accounting year. These statements contain balances of various ledger accounts. As Trial Balance contains balances of all ledger accounts, in financial statements the balances of ledger accounts are carried from the Trial balance for proper analysis.
- (iii) **Helps in Locating Errors :** If total of two columns of the trial balance agrees it is a proof of arithmetical accuracy in the ledger posting. However, if the totals of the two columns do not tally it indicates that there are some mistake in the ledger accounts. This prompts the accountant to find out the errors.
- (iv) **Helps in Comparison :** Comparison of ledger account balances of one year with the corresponding balances with the previous year helps the management taking some important decisions. This is possible by using the Trial Balances of the two years.
- (v) **Helps in Making Adjustments :** While making financial statements adjustments closing stock, prepaid expenses, outstanding expenses etc are to be made. Trial balance helps in identifying the items requiring adjustments in preparing the financial statements.

Trial Balance is generally prepared at the end of the year. However it can be prepared at any time during the accounting year to check the accuracy of the posting.

5.2 Preparing of Trial Balance

Trial Balance is not an account. It is only a list or schedule of balances of ledger accounts having a debit balance are entered in the debit amount column and credit balance accounts are entered in the credit amount column. The totals of the two sides of the accounts may also be used to prepare trial balance. The sum of each column should be equal. The standard format of a trial balance is given below :

Trial Balance of
As at (closing date)

<i>Name of the Account</i>	<i>LF</i>	<i>Dr. Balance</i> ₹	<i>Cr. Balance</i> ₹

The name of the business firm is written on the top of the statement with Trial Balance Under this we write the date on which Trial Balance is prepared.

Trial Balance has three columns : Name of the Ledger Account, Debit Amount and Credit Amount.

In the ledger account column we write the name of the account. In the Debit amount column we write the amount of debit balance of the account (or the total of the debit side of the account). Similarly in the credit amount column we write the amount of credit balance of the account (or the total of the credit side of the account).

Finally, columnar total is done and compared.

Steps to prepare Trial Balance

- (i) At first ascertain the balance account wise of all the ledger accounts.
- (ii) Write the name of the ledger account in the ledger account column.

- (iii) Write against the name of the ledger account, the balance amount/total amount, debit balance/total in the debit column; and credit balance/total in the credit column.
- (iv) Add the debit balance/total amount column and credit balance/total amount column.

There are three methods of preparing Trial Balance

- (i) **Balance Method:** In Balance method, the balance of each account (which may be debit balance or credit balance) is extracted and written against each account; we write debit balance in the debit column and credit balance in the credit column.
- (ii) **Total Method:** In this method the total of both sides of every account in the ledger is written against the name of the respective account without balancing them in the form of debit and credit balances respectively.
- (iii) **Balance Total Method :** Trial Balance is prepared by combining the first and second methods.

However, in practice the trial balance is prepared with debit and credit balances of various accounts in the ledger. Normally balance method is used.

Illustration 1

From the following ledger accounts of a trader closed as on 31st January, 2023, prepare Trial Balance.

Capital A/c

Dr.

Cr.

<i>Date</i>	<i>Particulars</i>	<i>J.F.</i>	<i>Amount</i> ₹	<i>Date</i>	<i>Particulars</i>	<i>J.F.</i>	<i>Amount</i> ₹
2023 Jan.31	Balance c/d		1,00,000	2023 Jan.31	Bank A/c		1,00,000
			1,00,000				1,00,000
				Feb. 1	Balance b/d		1,00,000

Sales A/c

Dr.

Cr.

<i>Date</i>	<i>Particulars</i>	<i>J.F.</i>	<i>Amount</i> ₹	<i>Date</i>	<i>Particulars</i>	<i>J.F.</i>	<i>Amount</i> ₹
2023 Jan.31	Balance transferred to Trading A/c		70,000	2023 Jan.8	Bank A/c		24,000
				Jan. 15	Vikram's A/c		46,000
			70,000				70,000

Purchases A/c

Dr.

Cr.

<i>Date</i>	<i>Particulars</i>	<i>J.F.</i>	<i>Amount</i> ₹	<i>Date</i>	<i>Particulars</i>	<i>J.F.</i>	<i>Amount</i> ₹
2023 Jan. 5	Pranay's A/c		40,000	2023 Jan.31	Stock A/c		15,000
Jan. 14	Bank A/c		55,000	Jan.31	Balance transferred to Trading A/c		80,000
			95,000				95,000

Vikram's A/c

Dr.

Cr.

<i>Date</i>	<i>Particulars</i>	<i>J.F.</i>	<i>Amount</i> ₹	<i>Date</i>	<i>Particulars</i>	<i>J.F.</i>	<i>Amount</i> ₹
2023 Jan.15	Sales A/c		46,000	2023 Jan.31	Balance c/d		46,000
			46,000				46,000
Feb. 1	Balance b/d		46,000				

Rent Received A/c

Dr.

Cr.

Date	Particulars	J.F.	Amount ₹	Date	Particulars	J.F.	Amount ₹
2023				2023			
Jan.31	Balance transferred to Profit and Loss A/c		1,500	Jan.31	Bank A/c		1,500
			1,500				1,500

Bank A/c

Dr.

Cr.

Date	Particulars	J.F.	Amount ₹	Date	Particulars	J.F.	Amount ₹
	Capital A/c		1,00,000		Purchases A/c		55,000
	Sales A/c		24,000		Commission A/c		1,800
	Rent Received		1,500		Drawings A/c		2,000
			1,25,500		Balance c/d		66,700
							1,25,500

Commission A/c

Dr.

Cr.

Date	Particulars	J.F.	Amount ₹	Date	Particulars	J.F.	Amount ₹
2023				2023			
Jan. 20	Bank A/c		1,800	Jan.31	Balance transferred to Profit and Loss A/c		1,800
			1,800				1,800

Stock A/c

Dr.

Cr.

<i>Date</i>	<i>Particulars</i>	<i>J.F.</i>	<i>Amount</i> ₹	<i>Date</i>	<i>Particulars</i>	<i>J.F.</i>	<i>Amount</i> ₹
2023				2023			
Jan.31	Purchases A/c		15,000	Jan.31	Balance c/d		15,000
			15,000				15,000
Feb. 1	Balance b/d		15,000				

Drawings A/c

Dr.

Cr.

<i>Date</i>	<i>Particulars</i>	<i>J.F.</i>	<i>Amount</i> ₹	<i>Date</i>	<i>Particulars</i>	<i>J.F.</i>	<i>Amount</i> ₹
2023				2023			
Jan.31	Bank A/c		2,000	Jan.31	Balance c/d		2,000
			2,000				2,000
Feb. 1	Balance b/d		2,000				

Solution :**Trial Balance as on 31st Jan. 2023**

<i>Particulars</i>	<i>Dr. Balance ₹</i>	<i>Cr. Balance ₹</i>
Capital		1,00,000
Sales		70,000
Purchases	80,000	
Vikram	46,000	
Pranaya		40,000
Commission	1,800	
Rent received		1,500
Drawings	2,000	
Closing Stock	15,000	
Cash at Bank	66,700	
	2,11,500	2,11,500

Illustration 2

From the following ledger accounts of Rohan Bros Prepare Trial Balance by (i) total method (ii) combined method (both balance method and total method) :

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

<i>Date</i>	<i>Particulars</i>	<i>J.F.</i>	<i>Amount ₹</i>	<i>Date</i>	<i>Particulars</i>	<i>J.F.</i>	<i>Amount ₹</i>
2023				2023			
Jan. 1	Capital A/c		50,000	Jan. 2	Bank A/c		40,000
Jan. 28	Ranjeet		9,900	Jan. 12	Freight A/c		200
				Jan. 31	Salary A/c		3,000
				Jan. 31	Rent A/c		2,400
			59,900				45,600

Bank A/c

Dr.

Cr.

Date	Particulars	J.F.	Amount ₹	Date	Particulars	J.F.	Amount ₹
2023				2023			
Jan. 2	Cash A/c		40,000	Jan. 8	Furniture A/c		12,000
Jan. 14	Sales A/c		16,000	Jan. 10	Purchases A/c		20,000
				Jan. 20	Vikas		12,000
				Jan. 31	Drawing		4,000
			59,900				48,000

Furniture A/c

Dr.

Cr.

Date	Particulars	J.F.	Amount ₹	Date	Particulars	J.F.	Amount ₹
2023				2023			
Jan. 8	Bank A/c		12,000				
			12,000				

Capital A/c

Dr.

Cr.

Date	Particulars	J.F.	Amount ₹	Date	Particulars	J.F.	Amount ₹
				2023			
				Jan. 1	Cash A/c		50,000
							50,000

Purchases A/c

Dr.

Cr.

Date	Particulars	J.F.	Amount ₹	Date	Particulars	J.F.	Amount ₹
2023							
Jan. 10	Bank A/c		20,000				
Jan. 12	Vikas		15,000				
			35,000				

Sales A/c

Dr.

Cr.

Date	Particulars	J.F.	Amount ₹	Date	Particulars	J.F.	Amount ₹
				2023			
				Jan. 14	Bank A/c		16,000
				Jan. 20	Ranjeet		14,000
							30,000

Vikas A/c

Dr.

Cr.

Date	Particulars	J.F.	Amount ₹	Date	Particulars	J.F.	Amount ₹
2023				2023			
Jan. 20	Bank A/c		12,000	Jan. 12	Purchases A/c		15,000
			12,000				15,000

Ranjeet A/c

Dr.

Cr.

<i>Date</i>	<i>Particulars</i>	<i>J.F.</i>	<i>Amount</i> ₹	<i>Date</i>	<i>Particulars</i>	<i>J.F.</i>	<i>Amount</i> ₹
2023				2023			
Jan.20	Sales A/c		14,000	Jan.25	Cash A/c		9,900
				Jan.28	Discount A/c		100
			14,000				10,000

Freight A/c

Dr.

Cr.

<i>Date</i>	<i>Particulars</i>	<i>J.F.</i>	<i>Amount</i> ₹	<i>Date</i>	<i>Particulars</i>	<i>J.F.</i>	<i>Amount</i> ₹
2023				2023			
Jan.12	Cash A/c		200				
			200				

Salary A/c

Dr.

Cr.

<i>Date</i>	<i>Particulars</i>	<i>J.F.</i>	<i>Amount</i> ₹	<i>Date</i>	<i>Particulars</i>	<i>J.F.</i>	<i>Amount</i> ₹
2023							
Jan.31	Cash A/c		3,000				
			3,000				

Rent A/c

Dr.

Cr.

Date	Particulars	J.F.	Amount ₹	Date	Particulars	J.F.	Amount ₹
2023							
Jan.31	Cash A/c		2,400				
			2,400				

Drawings A/c

Dr.

Cr.

Date	Particulars	J.F.	Amount ₹	Date	Particulars	J.F.	Amount ₹
2023				2023			
Jan.31	Bank A/c		4,000				
			4,000				

Discount A/c

Dr.

Cr.

Date	Particulars	J.F.	Amount ₹	Date	Particulars	J.F.	Amount ₹
2023							
Jan.31	Ranjeet		100				
			100				

Solution :

**i. (Total Method) Trial Balance of Rohan Brothers
as on 31st January 2023**

<i>Name of the Ledger Account</i>	<i>Dr. Balance ₹</i>	<i>Cr. Balance ₹</i>
Cash	59,900	45,600
Bank	56,000	48,000
Furniture	12,000	—
Capital	—	50,000
Purchases	35,000	—
Sales	—	30,000
Vikas	12,000	15,000
Ranjeet	14,000	10,000
Freight	200	—
Salary	3,000	
Rent	2,400	
Drawings	4,000	
Discount	100	
	1,98,600	1,98,600

Solution :

**i. (Total Method) Trial Balance of Rohan Brothers
as on 31st January 2023**

<i>Name of the Ledger Account</i>	<i>Dr.</i>		<i>Cr.</i>	
	<i>Total ₹</i>	<i>Amount ₹</i>	<i>Balance ₹</i>	<i>Amounts ₹</i>
Cash	59,900	45,600	14,300	—
Bank	56,000	48,000	8,000	—

Furniture	12,000	—	12,000	—
Capital	—	50,000	—	50,000
Purchases	35,000	—	35,000	—
Sales	—	30,000	—	30,000
VI.kas	12,000	15,000		3,000
Ranjeet	14,000	10,000	4,000	—
Freight	200	—	200	—
Salary	3,000	—	3,000	—
Rent	2,400	—	2,400	—
Drawings	4,000	—	4,000	—
Discount	100	—	100	—
	1,98,600	1,98,600	83,000	83,000

5.3 Meaning of Accounting Errors and their location

In our life we make many mistakes. As soon as these are detected, he/she corrects them. In the similar manner, an accountant can also make mistakes or commit errors while recording and posting transactions. These are called ‘Accounting Errors’. So maintaining accounts of a business firm in the course of accounting process. These errors may be in the form of omitting the transactions to record, recording in wrong books, or wrong account or wrong totalling and so on.

Accounting errors can take the following forms :

- Omission of recording a business transaction in the Journal or Special purpose Books
- Not posting the recorded transactions in various books of accounts to the respective accounts in ledger
- Mistakes in totalling or in carrying forward the totals to the next page
- Mistake in recording amount wrongly, writing it in a wrong account or on the wrong side of the account.

Again there may be two types of accounting errors (i) That cause the disagreement of trial balance, (ii) That do not affect the agreement of Trial Balance.

Locating Errors

It is obvious that if there are errors they must be located at the earliest. After locating the errors, they are to be rectified. In accounting also once it is established there are some accounting errors these need to be located and detected as early as possible. How to locate the errors?

Steps to be taken to locate the accounting errors can be stated as follows:

(A) When the Trial Balance does not Agree

- (i) Check the columnar totals of Trial Balance
- (ii) Check that the balances of all accounts (including cash and bank balances) in the ledger have been written and are written in the correct column of trial balance i.e. debit balance in the debit column and credit balance in the credit column.
- (iii) Find the exact figure of difference with trial balance and see that:
 - (a) No account of a similar balance has been omitted to be shown in the Trial Balance or
 - (b) A balance amount which is half of the amount of difference amount but is written on the wrong side of the trial Balance.
- (iv) Recheck the totals of Special Purpose Books.
- (v) Check the balancing of the various accounts in the ledger.
- (vi) If difference is still not traced, check each and every posting from the Journal and various Special Purpose Books, one by one in the ledger.

(B) When the Trial Balance Agrees

You have already learnt that if the totals of the two amount columns of trial balance tally it is no conclusive proof of the accuracy of accounts. There may still be some accounting errors. These errors may not be immediately traced but may be detected at much later stage. These are rectified as and when detected.

Following are the errors which don't affect the trial balance:

- (i) Omission to record a transaction in a journal or in a Special Purpose Book. For example, goods purchased on credit but are not recorded in the Purchases Book at all.
- (ii) Recording a wrong amount of an item in journal or in a Special Purpose Book. For example, sale of ₹2550 on credit entered in the Sales Book as ₹5250.

- (iii) Posting the correct amount on the correct side but in wrong account. For example, cash received from Jagannathan was credited to Vishvanathan.
- (iv) An item of Capital Expenditure recorded as an item of Revenue Expenditure and vice-a-versa. For example, Repairs to Building was debited to Building A/c.

Why does the trial balance still agree though there may be above stated errors? Reason is that in the above cases the debits and credits are affected simultaneously by the same amount.

5.4 Classification of Accounting Errors

Various accounting errors can be classified as follows :

- A. On the basis of their nature
 - (a) Errors of omission
 - (b) Errors of commission
 - (c) Errors of principle
- B. On the basis of their impact on ledger accounts
 - (a) One sided errors
 - (b) Two sided errors

A. On the basis of their nature

- (a) **Errors of omission** : As a rule, a transaction is first recorded in books of accounts. However, accountant may not record it at all or record it partially. It is called an error of omission. For example, goods purchased on credit are not recorded in Purchases Book or discount allowed to a customer was not posted to Discount A/c in the ledger.

In the first case it is a complete omission. Therefore, both debit and credit are affected by the same amount. Therefore, it does not affect the Trial Balance.

The second example is the example of partial omission. It affects only one account i.e. Discount A/c. Therefore it affects Trial Balance.

- (b) **Errors of commission** : When the transaction has been recorded but an error is committed in the process of recording, it is called an error of commission. Error of commission can be of the following types:

- (i) Errors committed while recording a transaction in the Special Purpose books. It may be :
- Recording in the wrong book for example purchase of goods from Rakesh on credit is recorded in the Sales Book and not in the Purchases Book.
 - Recording in the book correctly but wrong amount is written. For example, goods sold to Shalini of ₹4200 was recorded in the Sales Book as ₹2400

In the above two cases two accounts are affected by the same amount, debit of one and the credit of the other. Therefore, trial balance will not be affected.

- (ii) **Wrong totalling** : There may be a mistake in totalling Special Purpose Book or accounts. The totalled amounts may be less than the actual amount or more than the actual amount. First is a case of undercasting and the other of overcasting. For example, the total of Purchases Book is written as ₹44800 while actual total is ₹44300, the total of Sales Day Book is written as ₹52500 while it is ₹52900.

It is a case of an error affecting one account hence it affects trial balance.

- (i) **Wrong balancing** : While closing the books of accounts at the end of the accounting period, the ledger accounts are balanced. Balance is calculated of the totals of the two sides of the account. It may be wrongly calculated. For example, the total of the debit column of Mohan's A/c is ₹8,600 and that of credit column is ₹6,800. The balance calculated is as ₹1,600 while the actual balance is ₹ 1,800.

It has affected one account only, therefore, the Trial Balance gets affected.

- (ii) **Wrong carry forward of balances or totals** : Totals or balances are carried forward to the next page. These may be carried forward incorrectly. For example, the total of one page of the Purchases Book of ₹35,600 is carried to next page as ₹36,500.

Again the error affects one account only. Therefore, Trial Balance gets affected.

- (iii) **Wrong Posting** : Transactions from the journal or special purpose books are posted to the respective accounts in the ledger. Error may be committed while carrying out posting. It may take various forms such as, posting to wrong account, to the wrong side of the account or posted twice to the same account. For example goods purchased of ₹5400 from Rajesh Mohanti was posted to the debit of Rajesh Mohanti or posted twice to his account or posted to the credit of Rakesh Mohanti.

In the above examples, only one account is affected because of the error therefore, Trial Balance is also affected.

Compensating Errors

Two or more errors when committed in such a way that there is increase or decrease in the debit side due to an error, also there is corresponding decrease or increase in the credit side due to another error by the same amount. Thus, the effect on the account is cancelled out. Such errors are called compensating errors. For example, Sohan's A/c is debited by ₹2500 while it was to be debited by ₹3500 and Mohan's A/c is debited by ₹3500 while the same was to be debited by ₹2500. Thus, excess debit of Mohan's A/c by ₹1000 is compensated by short credit of Sohan's A/c by ₹1000.

As the debit amount and the credit amount are equalised, such errors do not affect the agreement of Trial Balance, but the fact remains that there is still an error.

(c) **Error of Principle** : Items of income and expenditure are divided into capital and revenue categories. This is the basic principle of accounting that the capital receipts and capital expenditure should be recorded as capital item and revenue income and revenue expenditure should be recorded as revenue item. If transactions are recorded in violation of this principle, it is called error of principle i.e. the capital item has been recorded as revenue item and revenue item is recorded as capital item. For example, 5000 spent on the repairs of building is debited to Building A/c while it should have been debited to Repair to Building A/c. It is a case of error of principle because expenditure on repairs of building is a revenue expenditure, while it has been debited to Building A/c taking it as an item of capital expenditure.

As both the sides i.e. credit as well as debit remain affected, the trial Balance also is not affected by such errors.

B. On the basis of impact on ledger accounts

Errors may affect one side i.e. either debit or credit side of an account or its two sides i.e. both debit and credit thus errors may be divided as:

(a) **One sided errors** : Accounting errors that affect only one side of an account which may be either its debit side or credit side, is called one sided error. The reason of such error is that while posting a recorded transaction one account is correctly posted while the corresponding account is not correctly posted. For example, Sales Book is overcast by ₹1000. In this case only Sales A/c is wrongly credited by excess amount of ₹1000 while the corresponding account of the various debtors have been correctly debited. Another example of one sided error is ₹2500 received from Ishita is wrongly debited to her account. In this case, only Ishita's account is affected, amount in the cash-book is correctly written. This type of error does affect the trial

Illustration 1

Purchases book is overcast for the month of July, 2023 by ₹8,000

Accounts Affected : The total of the Purchase Book is posted to the debit of Purchase A/c. Therefore Purchase A/c. is affected.

Rectification : To nullify the effect of the error, the entry of 8,000 will be made on the credit side of the Purchase A/c. With the words written as. “The amount of Purchase Book is overcast for the month of July 2023.”

Purchases A/c

Dr.

Cr.

Date	Particulars	F.	Amount ₹	Date	Particulars	F.	Amount ₹
					Amount as per Purchase Book for the month of July, 2023		8,000

Illustration 2

A sum of ₹1,200 paid to Ashok has been wrongly credited to his account.

Solution

Accounts Affected : Ashok A/c is affected because his account has been credited instead of being debited.

Rectification : In this case Ashok A/c is to be debited to nullify the effect of its being wrongly credited at the same time it is to be debited for cash payment. Rectification is done as under :

Ashok A/c

Dr.

Cr.

Date	Particulars	F.	Amount ₹	Date	Particulars	F.	Amount ₹
	Amount paid wrongly credited		2,400		Cash A/c		1,200

Illustration 3

Purchase of furniture of ₹5,000 was entered in the Purchases Book.

Solution

Accounts Affected : Furniture Account and Purchases account have been affected. Furniture Account has been omitted to be debited while Purchases account is wrongly debited.

Rectification : In this case Purchases account is credited to nullify as it is wrongly debited as furniture account is debited in it was to be debited but was omitted.

Furniture A/c

Dr.

Cr.

<i>Date</i>	<i>Particulars</i>	<i>F.</i>	<i>Amount</i> ₹	<i>Date</i>	<i>Particulars</i>	<i>F.</i>	<i>Amount</i> ₹
2023 Jan.15	Amount transferred Purchase A/c		5,000				

Purchases A/c

Dr.

Cr.

<i>Date</i>	<i>Particulars</i>	<i>F.</i>	<i>Amount</i> ₹	<i>Date</i>	<i>Particulars</i>	<i>F.</i>	<i>Amount</i> ₹
				2023 Jan.15	Amount transferred Furniture A/c		5,000

Rectification Through Journal entry

In case of the above illustration journal entry for rectification made is :

<i>Date</i>	<i>Particulars</i>	<i>L.F.</i>	<i>Dr. Balance ₹</i>	<i>Cr. Balance ₹</i>
2023 Jan 15	Furniture A/c To Purchases A/c (Furniture purchased on credit is wrongly entered in the purchases Book is now corrected)		5,000	5,000

Illustration 4

Amount of ₹15,000 received from Govind was credited to Har Govind.

Solution

The two accounts affected are Govind's A/c which is not credited and Har Govind's A/c which is wrongly credited.

Rectification entry is Journal is :

Har Govind's A/c	Dr.	15,000	
To Govind's A/c			15,000

(Amount received from Govind wrongly credited
to Har Govind is now rectified.)

Illustration 5

Following are some accounting errors. Rectify them by making journal entries :

- Sales for ₹20,000 made to Malvika was not entered in the Sales Book.
- Salary on ₹7,500 paid to Accountant Raman was debited to his personal account
- Old furniture sold for ₹2,800 was entered in the Sales Book.
- Carriage paid ₹500 on purchase of a Machine was debited to Carriage A/c.
- Cash ₹50,000 paid to the creditor Atulya Ghosh was debited to Praful Ghosh's A/c

Solution**Journal**

<i>Date</i>	<i>Particulars</i>	<i>L.F.</i>	<i>Debit</i> ₹	<i>Credit</i> ₹
(i)	Malvika Dr. To Sales A/c (Sale of Malvika omitted to be entered in Sales Book is corrected)		20,000	20,000
(ii)	Salary A/c Dr. To Raman (Salary paid to Raman was debited to his personal account is now corrected)		7,500	7,500
(iii)	Sales A/c Dr. To Furniture A/c (Old furniture sold was entered in the sales Book is now corrected)		2,800	2,800
(iv)	Machine A/c Dr. To Carriage A/c (Amount paid for carriage on purchase of machine is debited to carriage A/c is now corrected)		500	500
(v)	Atulya Ghosh Dr. To Praful Ghosh (Amoun paid to Atulya Ghosh was debited to Praful Ghosh is corrected)		50,000	50,000

5.6 Rectification of Errors through Suspense Account

You have learnt that the Trial Balance prepared at the end of a period by the business concern must agree. It means the sum of its debit column and sum of credit column should agree. But if the totals do not agree the difference amount is written in a new account. This account is called Suspense Account. If the total of the debit side of the Trial Balance is more than the total of its credit side, the difference amount will be written in Suspense A/c on its credit side i.e. Suspense A/c is credited and vice-versa. You have also learnt that the two sides of the Trial Balance do not agree because there is some error or errors in the accounts, which is reflected in the Suspense Account. Thus, Suspense A/c is a summarised account showing net effect of errors.

Opening of a Suspense Account is a temporary arrangement. As soon as the errors that has led to creation of Suspense Account are rectified, this account will disappear. One point needs to be noted that balance shown in Suspense Account is the net result of one sided errors. So one sided errors are corrected through Suspense A/c. Completing the double entry when an error is corrected by placing the correct amount on the debit of the proper account, the credit is placed in Suspense Account or vice-versa. For example, Gopal's Account was debited short by ₹100. The error will be rectified through Suspense A/c by debiting Gopal A/c and crediting Suspense A/c by ₹100.

Journal entry for the same is as follows :

Gopal' A/c	Dr.	100	
To Suspense A/c			100

(Gopal's A/c debited short is now corrected)

Similarly, while correcting as one sided error the proper account is credited with the correct amount, the debit is placed in the Suspense A/c. For example, Sales Book for December, 2023 is undercast by ₹500. The error will be rectified by debiting Suspense A/c and crediting Sales A/c.

Journal Entry for the same will be as follows :

Suspense A/c	Dr.	500	
To Sales A/c			500

(Sales Book undercast is rectified)

Illustration 6

Following are some accounting errors. Rectify the same through Suspense A/c

- (i) Purchases Book has been overcast by 200
- (ii) Goods purchased from Manohar of ₹2,500 have been posted to the debit of his account.
- (iii) Cash of ₹4,500 paid to Munish was credited to Manish.
- (iv) Discount ₹100 allowed to Anthony was not debited to discount account.

Solution

- (i) **Accounting Effect** : Purchases *A/c* has been debited in excess by ₹200

Rectification : Purchases A/c is credited by ₹200 and Suspense A/c is debited by ₹ 200.

Journal Entry

Suspense A/c	Dr.	200	
	To Purchases A/c		200

(Purchases Book overcast is now corrected)

- (ii) **Accounting Effect** : Manohar *A/c* has been debited by ₹2,500 instead of it being credited by the same amount.

Rectification : Manohar *A/c* is credited by ₹5,000

Journal Entry

Suspense A/c	Dr.	5,000	
	To Manohar A/c		5,000

(Goods purchased from Manohar wrongly debited to his account now rectified)

- (iii) **Accounting Effect** : ManishA/c is credited by ₹4,500 while ManishA/c was to be debited by the same amount.

Rectification : Manish A/c is to be debited by ₹4,500 and Manish A/c is also be debited by ₹4,500 and Suspense A/c to be credited by ₹9,000

Journal Entry

Manish	Dr.	4,500	
Manish	Dr.	4,500	
To Suspense A/c			9,000

(Cash paid to Manish was wrongly credited to Manish, now corrected)

- (iv) **Accounting Effect** : Discount A/c is omitted to be debited by ₹100. This account is debited and Suspense A/c is credited.

Journal Entry

Discount A/c	Dr.	100	
To Suspense A/c			100

(Discount allowed is not debited to discount A/c.)

Illustration 7

Rectify the following accounting errors through Suspense Account by making journal entries:

1. Purchase of goods from Mohit for ₹2,500 was entered in the Sales Book, however Mohit's Account was correctly credited.
2. Cash received from Anil a debtor ₹3,200 was correctly entered in the Cash Book but was omitted to be posted to his account.
3. Sales Book was overcast by ₹1,500
4. Cash of ₹4,000 paid to Hanif was credited to Rafique A/c as ₹1,400.
5. The total of Purchase Returns Book of ₹3,150 was carried forward as ₹1,530.
6. Namita was paid cash ₹6,500 but Sumita was debited by ₹6,000.

Solution

<i>Date</i>	<i>Particulars</i>	<i>L.F.</i>	<i>Amount Dr. ₹</i>	<i>Amount Cr. ₹</i>
1.	Purchases A/c Dr. Sales A/c Dr. To Suspense A/c (Purchase of good was entered in the sale book now corrected)		2,000 2,500	5,000
2.	Suspense A/c Dr. To Anil A/c (Anil's account omitted to be credited now rectified)		3,200	3,200
3.	Sales A/c Dr. To Suspense A/c (Sales Book overcast is corrected)		1,500	1,500
4.	Hanif A/c Dr. Rafique A/c Dr. To Suspense A/c (Cash paid to Hanif was wrongly credited to Rafique the error is now rectified)		4,000 1,400	5,400
5.	Suspense A/c Dr. To Purchases Returns A/c (Purchase Return Book undercast is now rectified)		1,620	1,620
6.	Namita A/c Dr. To Sumita A/c To Suspense A/c (Cash paid to Namita ₹6,500 was debited to Sumita by ₹6,000 the error is rectified)		6,500	6,000 500

Rectification of Two sided Errors

Error which affects two different accounts on the same sides or different sides is called two sided error.

Illustration 8

Furniture purchased from M/s Furniture House on 15th January, 2023 for ₹5000 was wrongly entered in the Purchases Book.

Solution

Accounts affected are Furniture A/c which is omitted to be debited and Purchase A/c which is wrongly debited.

Rectification through Journal Entry

Furniture A/c	Dr	5000	
	To Purchases A/c		5000

(Furniture purchased wrongly entered in the Purchases Book now rectified)

What you have learnt

- Trial Balance is a statement containing balances of all ledger accounts of a business concern on a particular date
- Trial Balance is prepared to check the arithmetical accuracy of the ledger posting, it helps in preparing financial statement; it helps in locating accounting errors; helps in management as it enables comparison of account balances of different periods and helps in making adjustments while preparing financial statements.
- The totals of two columns of a trial balance should be equal because for each transaction there is debit and credit for the same amount.
- If the totals of two columns of Trial Balance do not agree, it means there is some mistake in the ledger posting.
- If the totals of two columns of Trial Balance do not agree the amount of difference is put to suspense A/c and the totals of Trial Balance are equated.
- Accounting errors are the errors committed by persons responsible for recording and maintaining accounts of a business firm in the course of accounting process.

- Errors can be in the form of omission of recording of transaction in various books or posting in ledger or mistake in totalling or recording wrong amount or in wrong account.
- There can be accounting errors which affect the agreement of trial balance and errors which do not affect the agreement of Trial Balance.
- On the basis of nature accounting errors can be
 - (a) Errors of omission
 - (b) Errors of commission
 - (c) Errors of principle
 - (d) Compensating errors
- On the basis of impact on ledger accounts errors can be :
 - (a) one sided errors
 - (b) two sided errors
- Errors should never be rectified by erasing or overwriting.
- Methods of rectification of errors are
 - (a) Before preparing trial balance, instant correction and correction in the affected account.
 - (b) After preparing trial balance through passing a rectifying journal entry.

Terminal Exercise

Section - A

1. Trial Balance
2. Explain in brief the objective of preparing Trial Balance
3. Why do the totals of two sides of Trial Balance are equal ? Explain
4. What is suspense a/c?
5. Accounting Error
6. Error of Omission
7. Error of Principle
8. Compensating Error

Section - B

1. Explain the steps that are taken to prepare a Trial Balance.
2. List the various reasons because of which the totals of two columns of Trial Balance do not tally?

3. Explain the role of suspense account in preparing trial balance?
4. Prepare Trial Balance of M/s Multiplying enterprise as on 31st December, 2022

Accounts	Balances (₹)	Accounts	Balances (₹)
Cash in hand	2,500	Debtors	18,200
Cash at Bank	14,500	Creditors	16,600
Capital	70,000	Opening Stock	8,700
Drawing	9,000	Wages	6,700
Purchases	60,000	Rent	5,000
Sales	82,000	Salary	8,400
Machine	35,000	Bills Payable	11,400
Furniture	12,000		

5. Prepare Trial Balance as on 31st March 2023 from the following balances of Sabana:

<i>Accounts</i>	<i>Dr. Balance ₹</i>	<i>Cr. Balance ₹</i>
Cash in hand	3,100	
Bank overdraft		18,250
Opening Stock	24,600	
Purchases	59,800	
Sales		72,350
Sabana's Capital		50,000
Drawings	12,000	
Carriage Inward	1,600	
Rent	2,400	
Commission		2,100
Interest	780	
Furniture	5,2220	
Creditors		13,600
Debitors	27,800	
Building	20,000	1,000
Suspense	1,57,300	1,57,300

Section - C

1. State the meaning of accounting errors and explain different types of errors?
2. When is a suspense Account opened? How are errors rectified through Suspense A/c ?
3. Rectify the following errors :
 - (i) Goods purchased on credit for ₹8,200 not recorded in the Purchases Book.
 - (ii) Purchase Returns Book is overcast by ₹1,000.
 - (iii) Salary of ₹3,200 paid to Gopal the accountant was debited to his personal account
 - (iv) Sales to Shakila of ₹2,400 was posted to her account
 - (v) Cash received from Suresh ₹2,000 was not entered in the books.
4. Rectify the following errors :
 - (i) Purchases Book is undercast by ₹1,500
 - (ii) Sales Return Book is overcast by ₹1,000
 - (iii) Sales Book is added short by ₹100
 - (iv) The total of Purchases journal of ₹7,580 has been posted to Purchases Account as ₹5,780
 - (v) The total of the page of Sales journal of ₹24,750 was carried to next page as ₹27,450
5. Pass necessary journal entries to rectify the following errors :
 - (i) Sale of an old machine for ₹4,500 was posted to Sales account
 - (ii) Rent of proprietors residence of ₹12,000 was posted to Rent Account.
 - (iii) A credit to Brij Mohan of ₹ 6,750 was posted to his account as ₹4,750
 - (iv) Furniture purchased from M/s Decorates for ₹ 22,500 was entered in the Purchases Book
 - (v) Salary paid to the accountant Sushil Gupta of ₹6,500 was debited to his personal Account.

6. The Book keeper of a firm found that his trial balance did not agree. Its credit total exceeded the debit total by ₹2,850. He placed the amount in Suspense A/c and subsequently found the following errors.

- (i) A credit item of ₹3,490 has been debited to his personal Account as ₹4,390.
- (ii) A sum of ₹2,650 written off as depreciation on machine has not been posted to Depreciation A/c..
- (iii) Goods of ₹5,300 sold were returned by the customer and were taken into stock before closing the books but were not entered in the books.
- (iv) ₹4,800 due from Lakhan Pal which had been written off as bad debt in a previous year was unexpectedly recorded and had been posted to the personal account of Lakhan Pal.
- (v) Sales Book is undercast by ₹1,500.
- (vi) ₹4,000 withdrawn for domestic use by the proprietor was debited to General Expenses A/c.
- (vii) Machine Purchased from Machine Mart for ₹18,000 were entered in the Purchases Book.
- (viii) Cash paid ₹1,200 to Lakshman was credited to Ram as ₹2,100

Expenditure on assets of the business like furniture, fixtures and fittings of the shop, motor vans, machines and equipments are neither goods nor expenses of a year. Expenditures of this nature give services to the business for many years and therefore called fixed assets. If the expenditure on the fixed assets is deducted from the profit of any one year, it would be wrong. Since their benefit is enjoyed by the business for more than one year. The correct thing will be to distribute their cost over the years of their useful life to the business. The portion of the cost of fixed assets charged each year as expense is named as depreciation.

In this lesson you will learn about the meaning and methods of charging depreciation and how depreciation is recorded in the books of accounts, together with the preparation of Fixed Assets account.

Objectives

After studying this lesson you will be able to :

- understand the meaning and concept of depreciation;
- explain the causes of depreciation
- explain the objectives of depreciation;
- explain the factors affecting depreciation
- learn methods of charging depreciation and
- prepare fixed asset account showing the amount of depreciations charged for every year.

6.1 Meaning of Depreciation

You already know the meaning of terms assets and liabilities. Assets are broadly divided into two categories- current assets (cash, debtors or customers balances, stock materials and goods) and fixed assets (buildings, furniture and fixtures, machinery and plant, motor vehicles).

Fixed assets are also called long term assets as they provide benefits to the business for

more than one year. Most fixed assets lose their value over time as these are put in use and as the years pass by. The fixed assets lose their usefulness due to arrival of new technologies and change of fashions etc. These are then generally required to be replaced as their useful life is over. Hence, the cost of a fixed asset is allocated over its useful life. Each year's allocation of the cost is charged as depreciation expense for that year.

For example an office chair is purchased for ₹2,500 and it is estimated that after ten years it will be scrapped. The useful life of the chair is ten years over which the cost of ₹2,500 will be distributed. Each year's allocation may be calculated as ₹250.

Thus, ₹250 is the depreciation expense for each year. Depreciation, thus, is an expense charged during a year for the reduction in the value of fixed assets, arising due to:

- Normal wear and tear out of its use and passage of time
- Obsolescence due to change in technology, fashion, taste and other market conditions

6.2 Causes of Depreciation

Following are the causes for which depreciation is provided:

i) Normal wear and tear

- (a) Due to usage - Every asset has a life for which it can run, produce or give service. Thus, as we put the asset to use its worth decreases. Like decrease in the efficiency and functioning of a bicycle due to its running and usage.
- (b) Due to passage of Time - As the time goes by elements of nature, wind, sun, rain etc, cause physical deterioration in the worth of an asset. Like reduction the worth of a piece of furniture due to passage of time even when it is not used.

ii) Obsolescence

- (a) Due to development of improved or superior equipment : Sometimes fixed assets are required to be discarded before they are actually worn out due either of the above reasons. Arrival of superior equipments and machines etc. allow production of goods at lower cost. This makes older equipments worthless as production of goods with their use will be costlier and non competitive. For example, Steam engines became obsolete with the arrival of diesel and electric locomotives.
- (b) Due to change in fashion, style, taste or market conditions: Obsolescence may also result due to decline in demand for certain goods and services with a change in fashion, style, taste or market conditions. The goods and services that are no longer in vogue lead to decrease in the value of the assets which were engaged in their

production - like factories or machines meant for making old fashioned hats, shoes, furniture etc.

Loss in the value of fixed assets for such reasons is called obsolescence and also charged as depreciation.

6.3 Objectives of Charging Depreciation

Following are the objectives of charging depreciation of Assets :

- i) **To show the True Financial Position of the Business :** Fixed Assets have some effective working life during which it can be economically operated. Depreciation is the gradual loss in the value of fixed assets. If depreciation is not provided, profit and loss A/c will not disclose the true profit made during the accounting period. At the same time, the Balance Sheet will not disclose the true Financial position as Fixed assets appearing in the Balance Sheet will be over valued. If depreciation is ignored year after year, ultimately when asset is worn out, the proprietor will not be in a position to continue the business smoothly.
- ii) **To retain funds in the business for replacement of the asset :** Net profit is the yield of the capital invested by proprietor and may be wholly withdrawn by him in the form of cash. If depreciation is provided, this figure of net profit will be reduced and the amount withdrawn by the proprietor will also be decreased. As such the cash equivalent to the charge for depreciation will be left over in the business. This accumulated amount will enable the proprietor to replace to a new asset.

6.4 Factor Affecting the Depreciation

Following are the factors that affect the amount of depreciation to be charged on an asset.

- i) **Cost of Asset :** Cost of asset is the purchase price of the asset and includes such expenses which are incurred before it is first put to use. For example expenses on loading, carriage, installation, transportation and unloading of the asset up to point of its location, expense on its erection and assembly.
- ii) **Useful Life of the Asset :** Useful life is the expected number of years for which the asset will remain in use.
- iii) **Scrap Value :** Scrap value is the residual value at which the asset could be sold to scrap dealer at the end of its useful life.
- iv) **Depreciable value of asset :** Depreciable value is the cost of asset minus the scrap value.

Illustration 1

A generator was purchased for ₹5,00,000. ₹1,500 was paid for the crane for loading on the truck, ₹7,000 was paid for transporting the generator to the factory ₹2,000 was spent on its unloading at the factory site. The generator was estimate to run for 10 years and thereafter would be saleable for ₹60,000. Calculate the depreciable value of the generator.

The cost of the asset is :

Purchase price	₹ 5,00,000
Expenses on Loading	₹ 1,500
Transportation	₹ 7,000
Expenses on unloading	₹ 2,000
Total	₹ 5,10,500

The useful life of the generator is 10 years*

$$\begin{aligned}\text{Depreciable Value} &= \text{Cost of Asset - Scrap Value} \\ &= ₹5,10,500 - ₹60,000 = ₹4,50,500\end{aligned}$$

6.5 Method of Charging Depreciation

Most popularly used methods for charging depreciation are : i. Straight Line Method and ii. Diminshing Balance Method

Straight Line Method of Charging Depreciation

Under this method, the amount of depreciation is uniform from year to year. Suppose, if an asset costs 1,00,000 and depreciations is fixed @ 10%, then 10,000 would be written off every year. That is why this method is also called 'Fixed Installment Method' or 'Original Cost Method'. In this method, the amount to be written off every year is arrived at as under :

$$\text{Depreciation of Each Year} = \frac{\text{Cost of Asset - Estimated Scrap Value}}{\text{Number of years of expected life}}$$

Out of the cost of the asset, its scrap value is deducted and it is divided by the number of years of its estimated life.

For example : a machine is purchased for 1,20,000 and it is estimated that its useful life is 10 years. After its useful life its scrap value is 20,000. Depreciation of one year can be calculated as under :

$$\text{Depreciation of one Year} = \frac{\text{₹ 1,20,000} - \text{₹ 20,000}}{10} = \text{₹ 10,000}$$

If its scrap can not be sold or no money can be realized from its scrap, then depreciation of one year is :

$$\text{Depreciation of one Year} = \frac{\text{₹ 1,20,000}}{\text{₹ 10}} = \text{₹ 12,000}$$

In this method the amount of depreciation is same for each year. Therefore, this method is called Straight Line Method, Fixed Installment Method or Original Cost Method.

Illustration 2

A machine was purchased on January 1, 2011 for ₹1,00,000 and its useful life is 10 years. After completing its useful life the machine will be scrapped and nothing will be realized from it. It is decided to charge depreciation on this machine @ 10% p.a. on Straight Line Method.

Calculate amount of depreciation for each year during the useful life of this machine.

Amount of depreciation is same every year, so this method is called 'Straight Method' or 'Fixed Instalment Method' or 'Original Cost Method'.

Year	Rate of Depreciation	Amount of Depreciation (₹)
2011	10%	10,000
2012	10%	10,000
2013	10%	10,000
2014	10%	10,000
2015	10%	10,000
2016	10%	10,000

2017	10%	10,000
2018	10%	10,000
2019	10%	10,000
2020	10%	10,000

Merits of Straight Line Method

- i) **Simplicity** : Calculation of depreciation under this method is very simple and therefore the method is widely popular. Once the amount of depreciation is calculated, the same amount is written off as depreciation each year. Hence, this method is simple calculations are easier to understand
- ii) **Asset is completely Written Off** : Under this method, the book value of asset is reduced to net scrap value or zero value. In other words, in the books of accounts the value of the asset at the end of its useful life is equal to zero or residual value.

Limitations of Straight Line Method

- i) **Difficulty in Computation** : When there are various machines having different life-spans, the computation of depreciation becomes complicated because depreciation on each machine will have to be calculated separately for each asset.
- ii) **Illogical** : It is well known that the expense on its repairs and maintenance increase as the asset becomes older. Thus, the total burden on Profit and Loss Account, depreciation plus repair expenses, is more in later years in comparison to earlier years. This is illogical because the efficiency and productivity of the asset is more in earlier years and less in later years.

Illustration 3

X limited purchased a machine on April 1, 2023 for ₹1,00,000 whose life was expected to be 10 years. Its estimated scrap value at the end of 10 years was ₹10,000. Find the amount of depreciation to be charged to Profit and Loss Account every year. Calculate the rate on which depreciation is to be charged every year.

Solution

In this question the information available is as under : The amount of depreciation that will be charged to Profit and Loss Account will be calculated as :

(i) Calculation of amount of depreciation

$$\text{Annual Depreciation} = \frac{\text{Cost of Machine} - \text{Estimated Scrap Value}}{\text{Expected Life of the Asset}}$$
$$\frac{\text{₹ 1,00,000} - \text{₹ 10,000}}{10} = \text{₹ 9,000}$$

(ii) Calculation of Rate of Depreciation

$$\text{Rate of Depreciation} = \frac{\text{Annual Depreciation Amount} \times 100}{\text{Cost of Asset}}$$
$$= \frac{\text{₹ 9,000} \times 100}{1,00,000} = 9\%$$

Illustration 4

Salman and Usman Bros. acquired a machine on July 1, 2020 at a cost of ₹70,000 and spent ₹5,000 on its installation. The firm writes off depreciation 10% on straight line method. The books are closed on December 31 every year. Show the machinery and depreciation account for three years.

Solution

Cost of Machine	₹70,000
Cost of Installation	₹5,000
Total	₹75,000
Rate of Depreciation	10%

Then annual depreciation will be 10% of 75000 = ₹7,500

Drawings A/c

Dr.

Cr.

Date	Particulars	J.F.	Amount ₹	Date	Particulars	J.F.	Amount ₹
2020				2020			
Dec.31	To Machinery A/c		3,750	Dec.31	By P & L A/c		3,750
2021				2021			
Dec.31	To Machinery A/c		7,500	Dec.31	By P & L A/c		7,500
2022				2022			
Dec.31	To Machinery A/c		7,500	Dec.31	By P & L A/c		7,500

Machinery A/c

Dr.

Cr.

Date	Particulars	J.F.	Amount ₹	Date	Particulars	J.F.	Amount ₹
2020				2020			
July 01	To Bank A/c		70,000	Dec.31	By Depreciatio A/c		3,750
					$70000 \times \frac{10}{100} \times \frac{6}{12}$		
July 01	To Bank A/c		5,000	Dec.31	By Balance c/d		71,250
			75,000				75,000
2021				2021			
Jan.01	To Balance b/d		71,250	Dec.31	By Depreciatio A/c		7,500
					$70000 \times \frac{10}{100}$		
			71,250		By Balance c/d		63,750
							71,250
2022				2022			
Jan.01	To Balalnce b/d		63,750	Dec.31	By Depreciatio A/c		7,500
					$75000 \times \frac{10}{100}$		
			63,750	Dec.31	By Balance c/d		56,250
							63,750

Illustration 5

On April 1 2019, a company purchased machinery worth ₹1,00,000. On October 1, 2021, it purchased additional machinery worth ₹20,000 and spent 2,000 on its erection. The accounts are closed each year on March 31. Assuming the annual depreciation to be 10%, show the Machinery Account for 5 years under the straight line method.

Machinery A/c

Dr.

Cr.

<i>Date</i>	<i>Particulars</i>	<i>J.F.</i>	<i>Amount</i>	<i>Date</i>	<i>Particulars</i>	<i>J.F.</i>	<i>Amount</i>
2019 Apr.01	To Bank A/c		1,00,000	2020 Mar.31	By Depreciatio A/c $1,00,000 \times \frac{10}{100}$		10,000
				Mar.31	By Balance c/d		90,000
			1,00,000				1,00,000
2020 Jan.01	To Balance b/d		90,000	2021 Dec.31	By Depreciatio A/c $1,00,000 \times \frac{10}{100}$		10,000
					By Balance c/d		80,000
			90,000				90,000
2021 Apr.01	To Balance A/c		80,000	2022 Mar.31	By Depreciatio A/c $1,00,000 \times \frac{10}{100}$		11,100
Dec.1	To Bank A/c		20,000		$22,000 \times \frac{10}{100} \times \frac{6}{12}$		
	To Bank A/c		2,000	Mar.31	By Balance c/d		90,900
			1,02,000				1,02,000

2022				2021		
Apr.1	To Balance b/d		90,900	Mar.31	By DepreciationA/c	12,200
					$1,00,000 \times \frac{10}{100}$	
					$22,000 \times \frac{10}{100}$	
				Mar.31	By Balance c/d	78,700
			90,900			90,900
2023				2021		
Apr.1	To Balance b/d		78,700	Mar.31	By DepreciationA/c	12,200
					$1,00,000 \times \frac{10}{100}$	
					$22,000 \times \frac{10}{100}$	
				Mar.31	By Balance c/d	66,500
			78,000			78,700
2024						
Apr.1	To Balance b/d		66,500			

Illustration 6

On 1st January, 2020 a Company purchased a plant for ₹20,000. On 1st July in the same year, it purchased additional plant worth ₹8,000 and spent ₹2,000 on its erection. On 1st July, 2021, the plant purchased on 1st Jan., 2020 having become obsolete, was sold off for ₹12,500. On 1st October, 2022, fresh plant was purchased for ₹28,000 and on the same date, the plant purchased on 1st July, 2022 was sold at ₹6,000.

Depreciation is provided at 10% per annum on original cost on 31st December every year. Show the plant account for 2022 to 2022.

Solution

Plant Account

Dr.

Cr.

Date	Particulars	J.F.	Rs.	Date	Particulars	J.F.	Rs.
2020				2020			
Jan.01	To Cash A/c		20,000	Dec.31	By Depreciation A/c		
July 01	To Cash A/c		8,000		(i) for a year 2,000		
	To Cash A/c				(ii) for six months 500		2,500
	(expenses)		2,000		By Balance c/d		
					(i) 18,000		
					(ii) 9,500		27,500
			30,000				30,000
2021				2021			
Jan.1	To Balance b/d			July 1	By Cash A/c (sale)		12,500
	(i) 18,000			Dec.31	By Depreciation A/c (i)		1,000
	(ii) 9,500		27,500		By Profit & Loss A/c		4,500
				Dec.31	By Depreciation A/c (ii)		1,000
				Dec.31	By Balance c/d		
					(9,500-1,000)		8,500
			27,500				27,500
2022				2022			
Jan.1	To Balance b/d (ii)		8,500	Oct.1	By Cash A/c (sale)		6,000
Oct.1	To Cash A/c (iii)		28,000	Oct.1	By Depreciation A/c (ii)		750
				Oct.1	By Profit & Loss A/c (loss)		1,750
				Dec.31	By Depreciation A/c (iii)		
					(28,000 x 10/100 x 3/12)		700
				Dec.31	By Balance c/d		
					(28,000 - 700)		27,300
			36,500				36,500

Note : Calculation of loss on sale of plant :

(i)	On 1-1-2021 book value of the plant sold [Plant (i)]	18,000
	e Depreciation for 6 months i.e. $20,000 \times 10 / 100 \times 6/12$	1,000
	On 1-7-2021 book value of plant sold	17,000

e Sale price of plant	12,500
Loss on sale of plant	<u>4,500</u>
(ii) On 1-1-2022 book value of the plant sold [Plant (ii)]	8,500
e Depreciation for 9 months i.e. $10,000 \times 10 / 100 \times 9/12$	750
On 1-10-2022 book value of plant sold	<u>7,750</u>
e Sale price of plant	6,000
Loss on Sale of Plant	<u>1,750</u>

(2) Diminishing Balance Sheet

Under this method, as the value of asset goes on diminishing year after year, the amount of depreciation charged every year goes on declining. The amount of depreciation is calculated as a fixed percentage of the diminishing value of the asset shown in the books at the beginning of each year. Under this method the value of an asset never comes to zero.

Suppose, the cost of the asset is 40,000 and the percentage to be written off each year is 10%. In the first year the amount of the depreciation will be 4,000 i.e., 10% of 40,000. This will reduce the book value to 36,000 i.e. 40,000-4,000. Now, at the beginning of the next year the book value is 36,000. The amount of the depreciation for the next year will be 3,600, i.e., 10% of 36,000. Thus, every year the amount of the depreciation will go on reducing. This method of charging depreciation is also known as Reducing Balance Method or written down value method.

Illustration 7

A machine was purchased on January 1, 2014 for 1,00,000 and its useful life is 10 years. After completing its useful life the machine will be scraped and 4,000 will be realized from it. it is decided to charge depreciation on this machine @ 10% p.a. on Diminishing Balance Method.

Solution

Year	Rate of Depreciation	Amount of Depreciation (₹)
2020	10%	10,000

2021	10%	9,000
2022	10%	8,100
2023	10%	7,290
2024	10%	6,561
2025	10%	5,905
2026	10%	5,314
2027	10%	4,783
2028	10%	4,305
2029	10%	3,874

Amount of depreciation is decreased year after year in this method that is why this method is called ‘Diminishing Balance Method’ or ‘Reducing balance method’ or ‘written down value method’.

Merits of Diminishing Balance Method

Equal Burden on Profit & Loss Account

During the initial years the productivity of the asset is more hence its contribution to profit is also relative greater. Therefore, the cost charged in terms of depreciation should also be greater.

In the initial year, the depreciation charges are more and repair expenses are less. In later years, depreciation charges are less and repair expenses are more. Hence the total burden of depreciation plus repair expenses, is some what equal on Profit & Loss Account for each year.

Demerits of Diminishing Balance Method

- i) **Asset cannot be completely written off** : Under this method, the value of an asset is not reduced to zero even when there is no scrap value.
- ii) **Complexity** : Under this method, the rate of depreciation cannot be determined easily.

Illustration 8

Widson enterprise purchased Plant and Machinery for 1,00,000 on 1st October 2018 It decided to write off depreciation 20% per annum on Written Down Value Method. On 1st January, 2021 purchased additional Machinery for 40,000.

Show Machinery Account upto the year ending 31st March, 2022. The accounting year ends on 31st March.

Solution

Plant and Machinery Account

Dr.

Cr.

Date	Particulars	J.F.	Rs.	Date	Particulars	J.F.	Rs.
2018				2019			
Oct.01	To Bank		1,00,000	Mar.31	By Depreciation (for six months)		10,000
					By Balance c/d		90,000
			1,00,000				1,00,000
2019				2020			
Apr.01	To Balance b/d		90,000	Mar.31	By Depreciation (on 90,000 for one year)		18,000
					By Balance c/d		72,000
			90,000				90,000
2020				2021			
Apr.01	To Balance b/d		72,000	Mar.31	By Depreciation (On 72,000 for one year 14,400 on 40,000 for 3 months 2,000)		16,400
2021					By Balance c/d		95,600
Jan.01	To Bank		40,000				1,12,000
			1,12,000				
2021				2022			
Apr.01	To Balance b/d		95,600	Mar.31	By Depreciation (On 95,600 for one year)		76,480
					By Balance c/d		95,600
			95,600				95,600
2022							
Apr.01	To Balance b/d		76,480				

Illustration 9

On April 1, 2020 Ganga Bros. purchased two machines for 75,000 each. Depreciation at the rate of 10% on diminishing balance method was provided. On March 31, 2022 one machine was sold for 55,000. An improved model with a cost of 80,000 was purchased on the same day. You are required to show the Machinery Account for 2020-21 to 2022-23. the accounting year ends on 31st March.

Solution

Machinery Account

Dr.

Cr.

Date	Particulars	J.F.	Rs.	Date	Particulars	J.F.	Rs.
2020				2021			
Apr.01	To Bank		1,50,000	Mar.31	By Depreciation A/c		10,000
				Mar.31	By Balance c/d		1,35,000
			1,50,00				1,50,000
2021				2022			
Apr.01	To Balance b/d		1,35,000	Mar.31	By Depreciation A/c		13,500
2022							
Mar.31	To Bank A/c		80,000	Mar.31	By Bank A/c		55,000
					By P & L A/c		5,750
					By Balance c/d		1,40,750
			2,15,000				2,15,000
2022							
Apr.01	To Balance b/d		1,40,750				

Note : Calculation of loss on sale of plant :

Initial Cost	75,000
Dep. in 2021	-7,500
Book Value in 2021	67,500
Dep. in 2022	-6,750
Book Value in 2022	60,750
Sale Price	-55,000
Loss on Sale	5,750

Illustration 10

On October 1, 2020, the Akash Transport Company purchased a Truck for 8,00,000. On April 1, 2022, this Truck was involved in an accident and was completely destroyed and 6,00,000 were received from Insurance Company in full settlement. On the same date another Truck was purchased by the company for 10,00,000. The company writes off 20% depreciation p.a. on written down value method. Give the Truck Account from 2020 to 2022. The accounting year ends on 31st December.

Solution

Truck Account

Dr.

Cr.

<i>Date</i>	<i>Particulars</i>	<i>J.F.</i>	<i>Amount</i>	<i>Date</i>	<i>Particulars</i>	<i>J.F.</i>	<i>Amount</i>
2020				2020			
Apr.01	To Bank A/c		8,00,000	Mar.31	By Depreciatio A/c		40,000
					$8,00,000 \times \frac{20}{100} \times \frac{3}{12}$		
				Mar.31	By Balance c/d		7,60,000
			8,00,000				8,00,000
2021				2021			
Jan.01	To Balance b/d		7,60,000	Dec.31	By Depreciatio A/c		1,52,000
					$7,60,000 \times \frac{20}{100}$		
					By Balance c/d		6,08,000
			7,60,000				7,60,000
2022				2022			
Jan.01	Balance b/d		6,08,000	Apr.01	By Bank A/c		6,00,000
Apr.01	To P & LA/c		22,400	Apr.01	By Depreciation A/c		30,400
					$6,08,000 \times \frac{20}{100} \times \frac{3}{12}$		
Apr.01			10,00,000	Dec.31	By Depreciation A/c		1,50,000
					$10,08,000 \times \frac{20}{100} \times \frac{9}{12}$		
				Dec.31	By Balance c/d		8,50,000
			16,30,400				16,30,400

(iii) For profit on Sale of Asset
Assets Disposal A/c
To Profit & Loss A/c

(iv) For loss on Sale of asset
Profit & Loss A/c
To Assets Disposal A/c

I. When Provision for Depreciation Account is maintained : (Accumulated Depreciation Account) : Under this method, depreciation is not directly charged to the asset account. The amount of depreciation to be provided for the period is debited to depreciation account and credited to 'Provisions for Depreciation Account' or 'Accumulated Depreciation Account'. Thus entry will be as follows :

(i) For asset purchased :
Assets Disposal A/c: Dr.
To Cash/Bank A/c

(ii) For depreciation charged :
Depreciation A/c Dr.
To provision for Depreciation A/c

(iii) For transfer of depreciation to Profit and Loss Account
Profit & Loss A/c Dr.
To Depreciation A/c

In the balance sheet, the appears at its original cost and provision for depreciation (or accumulated depreciation) appears on the liabilities side.

As the year passes, the balance of the accumulated depreciation goes on increasing since constant credit is given to this account in each accounting year. After the expiry of useful life, these two accounts are closed by debiting Accumulated Depreciation Account and crediting Asset Account and balance in asset account is transferred to Profit & Loss Account Entry will be :

Provision for Depreciation A/c Dr.
To Asset A/c
(Balance of Prov. for depreciation to Asset A/c)

Profit & Loss A/c Dr.
To Asset A/c
(For loss on asset)

OR

Asset A/c	Dr.
To Profit & Loss A/c	
(For profit on asset)	

What you have learnt

- Depreciation is the gradual and permanent decrease in the value of an asset due to efflux of time, wear and tear, obsolescence or any other reason.

Causes of Depreciation

- Physical Wear and Tear due to usage
- Physical wear and tear due to passage of time
- Obsolescence due to advancement in technology

Objective of Depreciation

- To show the True Financial Position of the business.
- To retain funds in the business for replacement of the Asset.

Methods of Charging Depreciation

- Straight Line Method
- Diminishing Balance Method

Demerits of Straight Line Method

- Difficulty in Computation
- Illogical

Merits of Diminishing Balance Method

- Equal burden on Profit & Loss Account.
- Balance of Asset is never written Off to Zero

Demerits of Diminishing Balance Method

- Asset cannot be completely written off
- Complexity

Terminal Exercise

Section - A

1. What is Depreciation?
2. Write any two causes for providing depreciation
3. Write any two methods of providing depreciation

Section - B

1. What is depreciation? Write the various objectives of providing depreciation.
2. What are the causes of providing depreciation?
3. What are the two methods of providing depreciation? Explain their merits and demerits.
4. Distinguish between Straight Line Method and Diminishing Balance Method Depreciation.

Section - C

1. Krishnamohan Limited purchased a machinery on October 1, 2018 for 90,000 and spent 10,000 on its erection. The depreciation is to be charged @10% p.a. on original cost. Show the Machinery Account for three years if books are closed on March 31 every year.
2. On April 1, 2018 Aashi Limited purchased a machinery for 80,000 and spent 20,000 on its repairs and installation. On September 30, 2021, the machinery was sold for 60,000. Prepare Machinery Account for the year 2018 to 2021, if depreciation is charged @ 10% p.a. by Straight Line Method.
3. Ajay Kumar and Company purchased machinery for 20,000 on April 1, 2019. The Machinery is depreciated at 10% per annum on the straight line method. On October 1, 2020, the machinery was sold for 8,000.
4. A plant is purchased for 80,000 on January 1, 2018. It is estimated that the residual value of the plant at the end of its working life of 10 years will be 27,894. Depreciation is to be provided at 10% p.a. on diminishing balance method.

You are required to show the Plant Account for 4 years assuming that the books are closed on March 31 every year.

5. On January 1, 2019 Machinery Account showed a balance of 10,000. On 1st July, 2018 a new machine costing 6,000 was purchased. On 30th June, 2020 Machinery other than the machine bought on 1st July, 2018, was disposed off for 6,000.

Show the Machinery Account for four years. The accounting year ends on 31st December, and depreciation is to be provided at 10% p.a. on written down value.

6. On 1.1.2020 X Ltd., purchased a machinery of Rs. 2,00,000 and spent 50,000 on its erection. Depreciation on the machinery was to be charged @ 20% p.a. on straight line method. On 30.6.2022 a piece of machinery included in machinery purchased on 1.1.2020 costing 20,000 was sold for 12,000.

Prepare machinery account, machinery disposal account and provision for depreciation account.

With the expansion of business the number of transactions increased. The manual method of keeping and maintaining records was found to be unmanageable. With the introduction of computers in business, the manual method of accounting is being gradually replaced. And finally, the database technology has revolutionised the accounts department of the business organisations. In this lesson, we will study about characteristics of computer, role of computers in accounting, need of computerised accounting, etc.

Objectives

After studying this lesson, you will be able to:

- state the meaning and characteristics of computer;
- describe the components of Computer and limitations of computer.
- explain the role of computer in accounting.
- explain the meaning and features of computerised Account.
- differentiate between manual accounting and computerised accounting;
- explain the Accounting Information System;
- describe the basic requirements of computerised accounting and
- understand the sourcing of accounting system

7.1 Computer and its Characteristics

Computer is an electronic device that can perform a variety of operations in accordance with a set of instructions called programme. It is a fast data processing electronic machine. It can provide solutions to all complicated situations. It accepts data from the user, converts the data into information and gives the desired result. Therefore, we may define computer as a device that transforms data into information. Data can be any thing like marks obtained in various subjects. It can also be name, age, sex, weigh height, etc of all the students, savings, investments, etc., of a country. Computer defined in terms of its functions.

Computer is a device that accepts data, stores data processes data as desired retrieves the stored data as and when required and prints the result in desired format.

Characteristics of Computer

A Computer is better than human being. It possesses some characteristics. These are as follows

- i. **Speed :** It can access and process data millions times faster than humans can It can store data and information in its memory, process them and produce the desired results. It is used essentially as a data processor. All the computer operations are caused by electrical pulses and travels at the speed of light. Most of the modern computers are capable of performing 100 million calculations per second
- i. **Storage :** Computers have very large storage capacity. They have the capability of storing vast amount of data or information Computers have huge capacity to store data in a very small physical space

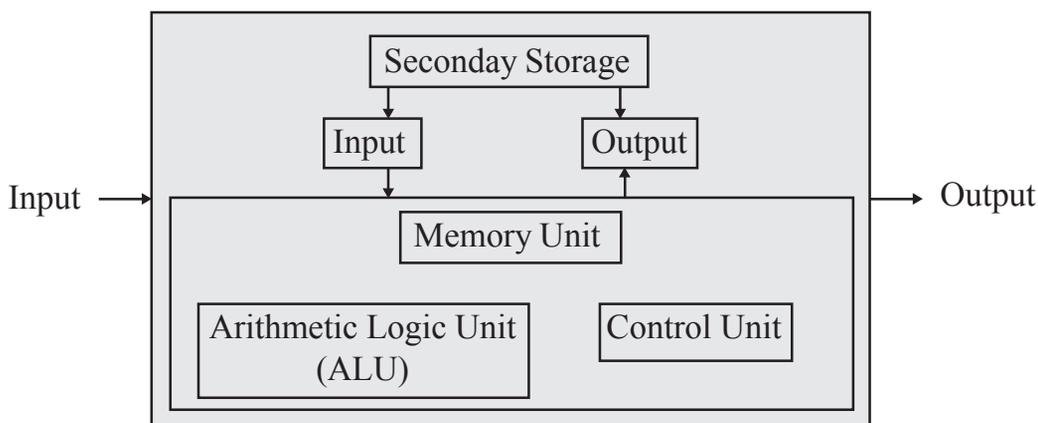
Apart from storing information, today's computers are also capable of storing pictures and sound in digital form

- iii. **Accuracy :** The accuracy of computer is very high and every calculation is performed with the same accuracy. Errors occur because of human beings rather than technological weakness, main sources of errors are wrong program by the user or inaccurate data.
- iv. **Diligence :** A computer is free from tiredness and lack of concentration. Even if it has to do 10 million calculations, it will do even the last one with the same accuracy and speed as the first.
- v. **Versatility :** Computer can perform wide range of jobs with speed, accuracy and diligence. In any organisation, often it is the same computer that is used for diverse purposes such as accounting, playing games, preparing electric bills. sending e-mail and so on.
- vi. **Communication :** Computers are being used as powerful communication tools All the computers within an office are connected by cable and it is possible to communicate with others in the office through the network of computer.
- vii. **Processing Power :** Computer has come a long way today. They began as mere prototypes at research laboratories and went on to help the business organisations,

and today, their reach is so extensive that they are used almost everywhere. In the course of this evolution, they have become faster, smaller, cheaper, more reliable and user friendly.

7.2 Components of Computer

A computer consists of the major components *i.e.*, Input Unit, Central Processing Unit and Output Unit Diagrammatically, these components may be presented as follows:



Components of Computer

- **Input Unit :** Input unit is controlling the various input devices which are used for entering data into the computer. The mostly used input devices are keyboard, mouse, and scanner. Other such devices are magnetic tape, magnetic disk, light pen, bar code reader, smart card reader, etc. Besides, there are other devices which respond to voice and physical touch. Physical touch system is installed at airport for obtaining the online information about departure and arrival of flight. The input unit is responsible for taking input and converting it into binary system.
- **Central Processing Unit (CPU) :** The CPU is the control centre for a computer. It guides, directs and governs its performance. It is the brain of the computer. The main unit inside the computer is the Central Processing Unit. Central Processing Unit is to computer as the brain is to human body. This is used to store program, photos, graphics, and data and obey the instructions in program. It is divided into three subunits :
 - (a) **Control Unit :** Control unit controls and co-ordinates the activities of all the components of the computer. This unit accepts input data and converts it into computer binary system.
 - (b) **Memory Unit :** This unit stores data before being actually processed. The data so stored is accessed and processed according to instructions which are also stored in the memory section of computer well before such data is transmitted to the memory from input devices.

(c) **Arithmetic and Logic Unit** : It is responsible for performing all the arithmetical calculations and computations such as addition, subtraction, division and multiplication. It also performs logical functions involving comparison variable and data items.

- **Output Unit** : After processing the data, it ensures the convertibility of output into human readable form that is understandable by the user. The commonly output devices include monitor also called Visual Display Unit, printer etc.

7.3 Limitation of a Computer

The limitations of computer are depending upon the operating environment they work in. These limitations are given below as:

- **Cost of Installation** : Computer hardware and software needs to be updated from time to time with availability of new versions. As a result heavy cost is incurred to purchase a new hardware and software from time to time.
- **Cost of Training** : To ensure efficient use of computer in accounting, new versions of hardware and software are introduced. This requires training and cost is incurred to train the staff personnel.
- **Self Decision Making** : The computer cannot make a decision like human beings. It is to be guided by the user.
- **Maintenance** : Computer requires to be maintained properly to help maintain its efficiency. It requires a neat, clean and controlled temperature to work efficiently.
- **Dangers for Health** : Extensive use of computer may lead to many health problems such as muscular pain, eyestrain, and backache, etc. This affects adversely the working efficiency and increasing medical expenditure.

7.4 Advantages of Computerised Accounting System

A computerised accounting system has many advantages, as discussed below :

- Large Volume of Transactions** : In the present-day business environment, the transactions of a business are normally large in volume. The computerised accounting system can store and process such voluminous transactions with speed and accuracy.
- Scalability** : A computerised accounting system is scalable to handle the growing transactions.
- Security** : The accounting data under the computerised environment is safer than

the accounting data under the manual system. The data can be kept secure by using a password, *i.e.*, allowing only authorised users to access the data.

- iv. **Timely Reporting** : Availability of reports on time enables the management to take quick decisions, which is an important element for the success of an enterprise. A computerised accounting system makes these reports available as and when required.
- v. **Lower Cost** : The cost of maintaining books of accounts under the computerised process is lower than in comparison to the manual process.
- vi. **Less Paper Work** : Under the computerised process, there is less paper work as compared to the paper work in the manual process.
- vi. **Flexible Reporting** : Reporting under the computerised process is flexible in comparison to the manual process. The database can be processed further to obtain the desired report. For example, data relating to debtors can be analysed to ascertain the list of customers to whom sales above Rs. 1,00,000 has been made in an accounting year or of the regular customers of the enterprises and so on.
- viii. **Queries** : Replies to queries based on external factors can be obtained easily under a computerised process. For example, list of debtors who have not paid on time can be taken out by processing the database.
- ix. **Accurate** : Computer statements are far more accurate in comparison to manual statements.
- x. **Updating** : Updating and treatment of wrong transactions are easily done.
- xi. **Financial Statements** : From the day book, the Voucher Pasting software can manage the General Ledger, Trial Balance and Balance Sheet.

7.5 Limitations of Computerised Accounting System

However, computerised accounting suffers from the following limitations :

- i. **Controls** : It adequate controls are not built and, where build, are not followed, it can lead to loss of data. It is important to take back-ups at regular intervals to avoid such a situation.
- ii. **Data Corruption** : The data can get corrupted through viruses that may come in through the internet or the use of external input devices without scanning them for viruses.
- iii. **Trained Computer Operators** : Untrained computer operators can lead to loss of data.

- iv. **Limitations of Software :** The software is developed on the basis of the experiences of the team of developers. As such, it may not be able to deal with a specific problem that may arise.

7.6 Comparison of the Manual and Computer Accounting Systems

Accounting is a process of identifying, recording, classifying and summarising financial transactions to produce financial statements. Let us discuss the processes of under the two accounting processes, *i.e.*, manual process and computerised process, for the purpose of comparison.

- **Identifying Financial Transactions :** Identifying Financial Transactions and recording them in the books of accounts by applying the principle of accounting is a manual process carried out by an authorised person or on the basis of the accounting manual. This process is, thus, common under both the processes.
- **Recording :** The process of Recording transaction in the books of original entry, posting them in the ledger accounts, performing mathematical functions, *ie.*, adding subtraction and totalling, are carried out manually under the manual process. In the computerised process, transactions are recorded in the books of accounts and the remaining functions are performed without any further process or command being carried out manually.
- **Classification :** In the manual process, the transactions are recorded in the book of original entry and are posted into the ledger accounts. It means that, after recording the transaction, another process of posting process is carried out by internal sorting of data, *i.e.*, with the help of utility or application software, without any further process.
- **Summarising :** In the manual system of accounting, the data under each Ledger is summarised and a balance of each account is ascertained to prepare a Trial Balance. As a result, preparing ledger accounts is essential to prepare a Trial Balance. In the computerised process, a transaction or event, once recorded, is stored in the database and can be processed to produce a Trial Balance directly.
- **Adjustments Entries :** Adjustment Entries are passed to rectify an error or to follow the matching concept of accounting, *ie.*, matching the cost with revenue, The process of passing adjustment entries can be equated with the recording process. These entries are identified and recorded in the books of accounts. The remaining process is the same as discussed above.
- **Grouping of Accounts :** One of the basics of correct accounting is determining whether a transaction is capital or revenue in nature and, accordingly, which account head is to be debited or credited. Once this decision is taken, the account is grouped

as an asset, a liability, an income or an expense at the time of preparing the financial statements. The above process is followed when the manual system of accounting is adopted. However, in computerised accounting, whether an account head is an asset, a liability, an income or an expense, is decided at the time the transaction takes place, as in the case of manual accounting. It is also defined whether the particular head of account shall be shown as an asset or liability, or an income or expense.

Financial Statements : In the manual process, availability of the Trial Balance is essential to prepare the Financial Statements. In the computerised process, financial statements are generated from the system itself and, hence, there is no need to have a Trial Balance.

Difference between Manual Accounting and Computerised Accounting

<i>Point of Difference</i>	<i>Manual Accounting</i>	<i>Computerised Accounting</i>
1. Recording	Recording of financial transactions is through books of original entry.	Data content of these transactions is stored in well designed data base.
2. Classification	Transactions recorded in the books of original entry are further classified by posting them into ledger accounts. This results in transaction data duplicity.	No such data duplications is made. In order to produce ledger accounts the stored transaction data is processed to appear as classified so that same is presented in the form of report.
3. Summarising	Transactions are summarised to produce trial balance by ascertaining the balances of various accounts.	The generation of ledger accounts is not necessary condition for trial balance.
4. Adjusting entries	Adjusting entries are made to adhere the principle of matching.	There is nothing like making adjusting entries for errors and rectifications.
5. Financial Statements	The preparation of financial statements assumes the availability of trial balance.	The preparation of financial statements is independent of producing the trial balance.

7.7 Factors Affecting the Decision of Selection and Accounting Software

It is essential to consider some factors before Sourcing an Accounting Software, i.e.,

- i. **Flexibility** : A computerized accounting system must be flexible in respect of data entry, retrieval of data and generating designs of report. The user should be able to run the software on a variety of computer environments and machines, that is, on any configuration of computers and available operating systems.
- ii. **Cost of Installation and Maintenance** : It is a must to consider that the cost of the accounting software, its relevant hardware and the maintenance, cost of addition of modules, training of staff, updating of versions and data recovery in case of data failure are negotiable and within the ability of the organization to afford it.
- iii. **Size of Organization** : An accounting system must be according to the size of the organization, i.e., volume of business transactions, multi-user requirements.
- iv. **Ease of Adaptation and Training Needs** : Some accounting softwares are user-friendly and require a simple training to the users. However, some other complex software packages, linked to other information systems, require intensive training on a continuous basis. The software must be capable of attracting users.
- v. **Expected Level of Secrecy (Software and Data)** : Security features of an accounting system software are also important. Software should ensure that it prevents unauthorized access and manipulation of data. In tailored software, the user rights may be restricted according to the departments and their relevant accounting software functions.
- vi. **Exporting/Importing Data Facility** : The software should allow easy data transfer option for flexible reporting, such as transfer of information directly from the ledger into the spreadsheet software like Lotus or Excel.

7.8 Computerised Accounting

Transaction processing system (TPS) is the first stage of computerised accounting system. The purpose of any TPS is to record, process, validate and store transactions that occur in various functional areas of a business for subsequent retrieval and usage. TPS involves following steps in processing a transaction: Data Entry, Data Validation, Processing and Revalidation, Storage, Information and Reporting.

It is one of the transaction processing systems which is concerned with financial transactions only. When a system contains only human resources it is called manual system; when it uses only computer resources, it is called computerised system and when it uses both human and computer resources, it is called computer-based system.

These steps can be explained with an example making use of Automated Teller Machine (ATM) facility by a Bank-Customer.

1. **Data Entry :** Processing presumes data entry. A bank customer operates an ATM facility to make a withdrawal. The actions taken by the customer constitute data which is processed after validation by the computerised personal banking system.
2. **Data Validation :** It ensures the accuracy and reliability of input data by comparing the same with some predefined standards or known data. This validation is made by the "Error Detection" and "Error Correction" procedures. The control mechanism, wherein actual input data is compared with predetermined norm is meant to detect errors while error correction procedures make suggestions for entering correct data input. The Personal Identification Number (PIN) of the customer is validated with the known data. If it is incorrect, a suggestion is made to indicate the PIN is invalid. Once the PIN is validated, the amount of withdrawal being made is also checked to ensure that it does not exceed a pre-specified limit of withdrawal.
3. **Processing and Revalidation :** The processing of data occurs almost instantaneously in case of Online Transaction Processing (OLTP) provided a valid data has been fed to the system. This is called check input validity. Revalidation occurs to ensure that the transaction in terms of delivery of money by ATM has been duly completed. This is called check output validity.
4. **Storage :** Processed actions, as described above, result into financial transaction data i.e. withdrawal of money by a particular customer, are stored in a database of computerized personal banking system. This makes it absolutely clear that only valid transactions are stored in the database.
5. **Information :** The stored data is processed making use of the Query facility to produce desired information.
6. **Reporting :** Reports can be prepared on the basis of the required information content according to the decision usefulness of the report.

7.9 Need and Requirements of Computerised Accounting

The need for computerised accounting arises from advantages of speed, accuracy and lower cost of handling the business transactions.

- **Numerous Transactions :** The computerised accounting system is capable of handling large number of transactions with speed and accuracy.
- **Instant Reporting :** The computerised accounting system is capable of offering quick and quality reporting because of its speed and accuracy.

- **Reduction in Paper Work :** A manual accounting system requires large physical storage space to keep accounting records/books and vouchers/documents. The requirement of stationery and books of accounts along with vouchers and documents is directly dependent on the volume of transactions beyond a certain point. There is a dire need to reduce the paper work and dispense with large volumes of books of accounts. This can be achieved by introducing computerised accounting system.
- **Flexible Reporting :** The reporting is flexible in computerised accounting system as compared to manual accounting system. The reports of a manual accounting system reveal balances of accounts on periodic basis while computerised accounting system is capable of generating reports of any balance as when required and for any duration which is within the accounting period.
- **Accounting Queries :** There are accounting queries which are based on some external parameters. For example, a query to identify customers who have not made the payments within the permissible credit period can be easily answered by using the structured query language (SQL) support of database technology in the computerised accounting system. But such an exercise in a manual accounting system is quite difficult and expensive in terms of manpower used. It will still be worse in case the credit period is changed.
- **On-line Facility :** Computerised accounting system offers online facility to store and process transaction data so as to retrieve information to generate and view financial reports.
- **Scalability :** Computerised accounting system are fully equipped with handling the growing transactions of a fast growing business enterprise. The requirement of additional manpower in Accounts department is restricted to only the data operators for storing additional vouchers. There is absolutely no additional cost of processing additional transaction data.
- **Accuracy :** The information content of reports generated by the computerised accounting system is accurate and therefore quite reliable for decision-making. In a manual accounting system the reports and information are likely to be distorted, inaccurate and therefore cannot be relied upon. It is so because it is being processed by many people, especially when the number of transactions to be processed to produce such information and report is quite large.
- **Security :** Under manual accounting system it is very difficult to secure such information because it is open to inspection by any eyes dealing with the books of accounts. However, in computerised accounting system only the authorised users are permitted to have access to accounting data. Security provided by the computerised accounting system is far superior compared to any security offered by the manual accounting system.

Basic Requirements of the Computerised Accounting System

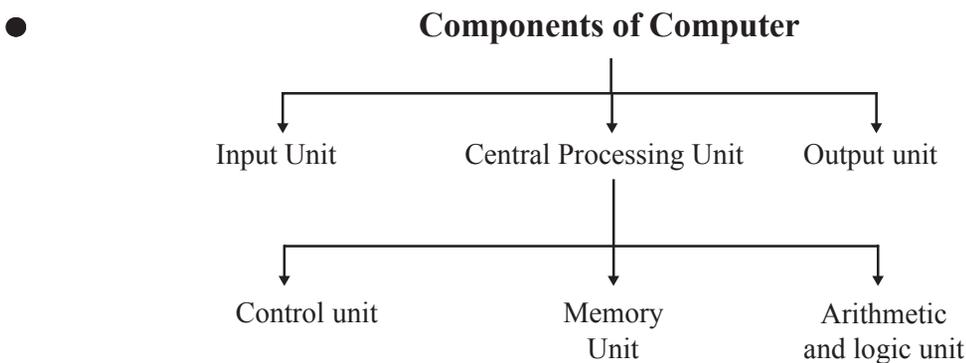
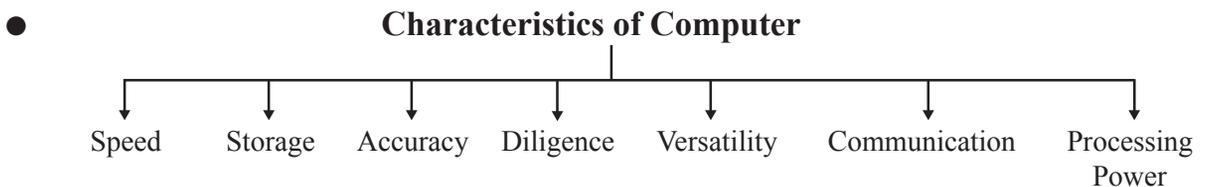
The basic requirements of any computerised accounting system are the followings:

- **Accounting Framework :** It is the application environment of the computerised accounting system. A healthy accounting framework in terms of accounting principles, coding and grouping structure is a pre-condition for any computerised accounting system.
- **Operating Procedure :** A well-conceived and designed operating procedure blended with suitable operating environment of the enterprise is necessary to work with the computerised accounting system.

The computerised accounting is one of the database-oriented applications wherein the transaction data is stored in well-organized database. The user operates on such database using the required interface and also takes the required reports by suitable transformations of stored data into information. Therefore, the fundamentals of computerised accounting include all the basic requirements of any database-oriented application in computers.

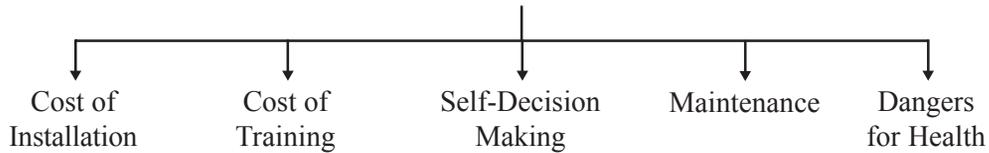
What you have learnt

- Computer is an electronic device that can perform a variety of operations in accordance with a set of instructions called programme. It is a fast data processing electronic machine. It can provide solutions to all complicated situations.



-

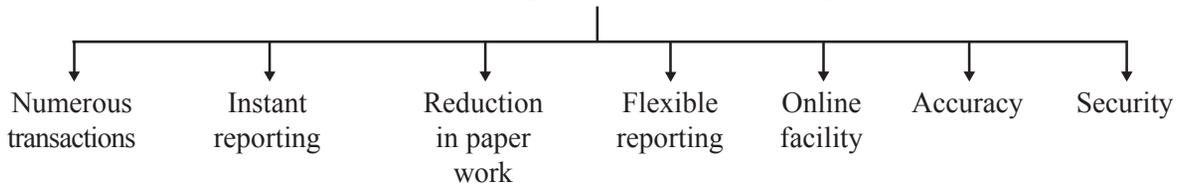
Limitations of a Computer



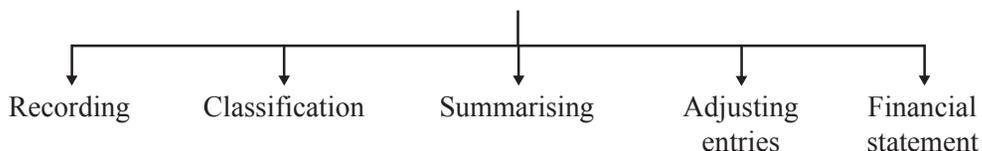
- Salient features of CAS simple & Inegrated Transparency and Control Accuracy & Speed Scalability Reliability.
- Accounting Equaiton is $A = L + C$.
- Computerised Accounting : Transaction Processing System (TPS) is the first stage of computerised accounting system.

-

Need for Computerised Accounting



- Advantages of CAS include speed, efficiency, arithmetic accuracy, cost saving, confidentiality of data.
- Advantages of CAS include speed, efficiency, arithmetic accuracy, cost saving, confidentiality of data.
- Limitation of CAS include provision for (a) fast obsolescence of technology, (b) data loss due to either power interruption or damage to hard disk, (c) virus and other security hazards.
- Accounting Information System is an integration of various sub-systems such as : (i) cash sub-system, (ii) sales and accounts receivable sub-system, (iii) inventory sub-system, (iv) purchase and accounts payable sub-system, (vii) expense accounting sub-system, (viii) tax accounting sub-system, (ix) final account sub-system, (x) costing sub-system, (xi) budget sub-system, (xii) management information sub-system.
- Difference between manual accounting and computerised accounting.



Terminal Exercise

Section - A

1. Computer
2. Write any two components of computer
3. Computerised accounting
4. Software
5. Hardware

Section - B

1. State any four characteristics of Computer.
2. Explain the components of computer.
3. Explain the limitations of a Computer.
4. Explain the role of Computers in Accounting.

Section - C

1. Differentiate between Manual accounting and Computerised accounting system.
2. Enumerate the basic requirements of any computerised accounting system.
3. Explain the components of Computerised Accounting Software.
4. Describe the salient features of Computerised Accounting Software.
5. How does Computerised Accounting Software ensures data security, safety and confidentiality ? Explain.
6. Explain in brief various softwares of Computerised Accounting Software.
7. Describe any six sub systems of Accounting Informations Systems.

FINAL ACCOUNTS OF SOLE PROPRIETORSHIP

Introduction - Meaning - Objectives of Preparation of final accounts – Users of Financial statements –Preparation of Profit & Loss Account-Advantages and Limitations. Meaning of Capital and Revenue items - Preparation of Final accounts - adjustments - Problems.

INTRODUCTION

In the previous lessons you have learnt to record the business transactions which begins with Journal (Journalising), Ledger (Posting), and preparation of Trial Balance. You have also learnt about balancing the account and preparing the trial balance. One of the most important purposes of accounting is to ascertain financial results, i.e., profit or loss of the business operations of a business enterprise after a certain period and financial position on a particular date. For this certain financial statements are prepared which are termed as income statement (i.e. Trading and Profit & Loss Account) to know what the business has earned during a particular period and the Position Statement (i.e. Balance Sheet) to know the financial position of the business enterprise on a particular date. In this lesson you will learn about the financial statements that are prepared by a profit Organisations, the distinction between capital and revenue items, importance, nature of financial statements and preparation of financial statements.

LEARNING OBJECTIVES :

After studying this chapter, students are able to understand

1. Understand the meaning, objectives of financial statements;
2. Identify the various users of financial statements;
3. Distinguish between the capital and revenue expenditure and receipts;
4. Understanding the financial statements of sole proprietorship; and
5. Understand the accounting treatment of the adjustments in Trading A/c, Profit and Loss A/c and Balance Sheet.

8.1 Meaning, Objectives, Users and Presentation of Financial Statements

Meaning : Every business enterprise wants to know the result of its activities of a particular period which is generally one year and what is its financial position on a particular date which is at the end of this period. For this, it prepares various statements which are called the financial statements. Financial statements are prepared to ascertain the profits earned or losses incurred by a business concern during a specified period and also to ascertain its financial position at the end of that specified period. Financial statements are generally of two types (a) Income Statement which comprises of Trading Account and Profit & Loss Account, and (b) Position Statement i.e., the Balance Sheet. A complete set of financial statements is known as Final Accounts which includes the following:

- i. An Income Statement also known as Trading and Profit and Loss Account:** Income Statement has two parts 1) Trading Account that shows the Gross Profit or Gross Loss for the accounting period and 2) Statement of Profit and Loss Account that shows the Net Profit or Net Loss for the accounting period.
- ii. A Position Statement also known as Balance Sheet:** Balance Sheet is a statement that shows financial position of the business concern. It is prepared at the end of the accounting period on a particular date in form of assets held and liabilities owed.

OBJECTIVES OF FINANCIAL STATEMENTS: Objectives of financial statements are to be understood separately for each of the following:

1. Objectives of Preparing Trading and Profit and Loss Account/Income Statement:

- i. To identify the gross profit or gross loss :** A Trading Account records all the incomes and expenses directly related to the trading activities and helps identify the gross profit or gross loss on account of such operations.
- ii. To identify the net profit or net loss :** A Profit and Loss Account records all the incomes and expenses not directly related to the trading activities and helps identify the net profit or net loss.
- iii. To facilitate comparison:** Preparation of such income statement facilitates comparison of entity's financial performance over a period of time and draw necessary conclusions.
- iv. To record complete details of incomes and expense:** An income statement shows complete record of all the incomes earned and expenses incurred during the course of business.
- v. To determine the amount of reserves:** The amount of profits derived with the help of such income statement helps to decide how much of the amount is to be kept aside for future uncertainties in the form of reserves.

- vi. **To facilitate calculation of ratios:** Expenses and incomes recorded and profits derived with the help of an Income Statement are used to compute various accounting ratios which helps an entity to take appropriate financial and investment decisions.

2. Objectives of Preparing Balance Sheet/Position Statement:

- i. **To identify the financial position:** A balance sheet presents the exact values of the assets and liabilities of the business on a particular date which helps to identify the actual financial position of an entity on a particular date.
- ii. **To facilitate comparison:** In order to determine and analyse the change in the financial position of an entity over a period of time, different items presented in the balance sheet are compared and necessary conclusions are drawn.
- iii. **To identify the solvency position:** The figures and items presented in the Balance Sheet are used to compute the various accounting ratios like current ratio, liquid ratio, debt to equity ratio, etc. which are used in identifying the solvency position of an entity.

USERS OF FINANCIAL STATEMENTS :

Internal Users :

- i. **Owners :** These are those who invest in the business and provide funds to carry out the business operations. These users are interested to know the profit earned or losses incurred from such business operations in order to determine the returns on their investments. Such information is provided to them from the financial statements prepared by the entity.
- ii. **Management :** These are those who are responsible for carrying out the business operations and taking all the important decisions taken. In order to carry out these functions effectively, information in the financial statements is used by the management.
- iii. **Employees and Trade Unions :** These are those who are concerned with the wages, bonus, etc., that they are entitled to receive in the course of their employment. In order to determine the entity's capability to pay such amounts, information in the financial statements plays a vital role.

External Users :

- i. **Public :** In order to determine whether the business entity makes considerable contribution to the economy in terms of development, employment, etc. public

at large is always interested in the profitability and financial position of the business.

- ii. **Government Authorities:** These are those who compile the national income accounts and use such information to take appropriate policy decisions. Also, the taxes that are levied by various Government departments (GST & Income Tax), it is the financial statements that are referred to assess the correct tax dues.
- iii. **Researchers :** These users make use of the financial statements to study the financial information and use it for survey related projects.
- iv. **Banks and Financial Institutions:** These are those who provide loans and credits to the business entities based on the financial position of the entity. In order to decide whether to grant loans and other services, these users analyse the financial statements of the entity over a period of time.
- v. **Creditors :** These are the parties who supply goods or provide services on credit. Before granting any credit these users satisfy themselves about the stability and credit-worthiness of the entity based on the financial statements of the entity over a period of time.

METHODS OF PRESENTING FINANCIAL STATEMENTS

There are two forms of presenting financial statements as follows :

1. Horizontal Form :

- i. It presents the financial statements (i.e., Trading and Profit and Loss Account and Balance Sheet) in 'T' form where the statements are divided into 2 parts as left hand side and right hand side.
- ii. Left hand side comprises of debit items (in case of Trading and Profit and Loss Account) or Liabilities plus Capital (in case of Balance Sheet).
- iii. Right hand side comprises of credit items (in case of Trading and Profit and Loss Account) or Assets (in case of Balance Sheet).

2. Vertical Form :

- i. It presents the financial statements in a single column statement.
- ii. It does not divide the statements in parts, instead presents all the items in a single column one below the other by categorising each of them based on an appropriate parameter.

- iii. It presents the items in the income statement in the same sequence or flow in which the amounts are to be derived, i.e., first the gross profit is determined, then the operating profit and then the net profit which is then transferred to the Capital Account.
- iv. In the Balance Sheet, all the sources of funds are listed first and then the application of funds are listed by categorising each of them based on an appropriate parameter. Methods of Presenting Financials

Difference between Profit and Loss Account and Balance Sheet :

Sr. No.	Basis	Profit and Loss Account	Balance Sheet
1	Time/Period	It is prepared for a particular accounting period	It is prepared on a particular date which is the last day of the accounting period
2	Purpose	It is prepared to determine the profitability of the business	It is prepared to get an idea of the financial position of the business
3	Items Recorded	It records all the incomes and expenses	It records all the assets and liabilities
4	Balance	Its balance is transferred to the Capital Account	It has balances of assets and liabilities which become the opening balances of the next period.

Importance of Financial Statements

- i. **Pertaining to Finance :** Financial statements are related to all non-entry transactions which are shown in summarised form.
- ii. **Facilitate in Decision Making :** Not only is it important for you, but for the management and stockholders as well. It's important for the management because financial statements speak of the company's success and competence, whereas stockholders refer to financial statements to know whether or not to invest in a company. In other words, financial statements tell whether the company made or lost money.

- iii. **Showing the Operational Performance :** Financial statement hold the secrets of a company. Apart from stating whether the company earns or loses money, they also provide clues on where the management might find more resources to boost its revenue. In addition, financial statements reveal a company's past performance and potential.

8.2 Capital Expenditure and Revenue Expenditure, Capital Receipts and Revenue Receipts

The preparation of Trading Account and Profit and Loss Account requires the knowledge of revenue expenditure, revenue receipts and capital expenditure and capital receipts. The knowledge shall facilitate the classification of revenue items and put them in the Trading account and Profit and Loss Account on one hand and prepare Balance Sheet based on capital items (expenditure as well as receipts) on the other hand.

Capital Expenditure : It refers to the expenditure incurred for acquiring fixed assets or assets which increase the earning capacity of the business. The benefits of capital expenditure to the firm extend to number of years. Examples of capital expenditure are expenditure incurred for acquiring a fixed asset such as building, plant and machinery etc.

Revenue expenditure : On the other hand, is an expenditure incurred in the course of normal business transactions of concern and its benefits are availed of during the same accounting year. Salaries, carriage etc. are examples of revenue expenditure.

There is another category of expenditure called **deferred revenue expenditure**. These are the expenses incurred during one accounting year but benefits from the same are available wholly or in part in future periods also. These expenditures are otherwise of a revenue nature. Example of deferred revenue expenditure are heavy expenditure on advertisement say for introducing a new product in the market, expenditure incurred on research and development, etc.

Meaning of Capital Expenditure :

- It is that expenditure which results in acquiring or bringing into existence an asset or advantage of enduring benefit.
- It is incurred to acquire fixed assets for use in business which will increase the earning capacity of the business.
- It is shown in the Balance Sheet on the asset side.

- It includes expenditure incurred on extension, improvement, installation or erection of new fixed assets (tangible or intangible), reconditioning of old fixed assets, legal expenses on acquiring such fixed assets, etc.
- Includes expenditure incurred for procuring both Tangible and intangible fixed assets including Goodwill, Patents, etc.

Meaning of Revenue Expenditure :

- It is that expenditure the benefit of which is exhausted within the accounting year in which it is incurred.
- It is incurred to run the business and earn more profits.
- It is shown in the Trading or Profit and Loss Account as an expense.
- It includes the day-to-day running expenses like rent, salaries, electricity, repairs, etc. Also, amount of depreciation, purchase of materials, etc. are considered as revenue expenditure.

Meaning of Deferred Revenue Expenditure :

- It is the amount of expenditure which is incurred during an accounting period but it is estimated that its benefits will extend beyond that accounting period i.e., it will not exhaust within the accounting period.
- The amount involved is normally larger than the usual expenditure under the revenue expenditure, say, huge advertisement expenses incurred for the promotion of a new product. Such huge amount of expense will give benefit in the periods beyond the accounting period in which it was incurred.
- It is therefore, spread over a period for which benefit will be derived and not debited completely to the Profit and Loss Account for the year in which the expense is incurred. The amount which is not charged to the Profit and Loss Account is shown in the Balance Sheet as an asset.

Points to remember to classify an expenditure as Capital and Revenue :

An expenditure to be treated as capital or revenue is determined after considering nature of the expenditure. Wrong classification and further treatment results in wrong accounting. If an item of revenue expenditure is debited to Asset Account, this will overstate the Assets in the Balance Sheet and even the Profits in the Income Statement and vice versa.

Some important points to be considered while classifying expenditure :

Nature in the hands of Recipient : An amount may revenue income for one party but may be of capital nature expenditure for the recipient of the item. E.g. for a builder amount received against sale of flat is of revenue nature but for the purchases it is capital expenditure.

Source of Payment : Usually the payment of capital expenditure is made out of the capital whereas, the payment of revenue expenditure is made out the revenue receipts but it should not be considered as a general rule.

Periodic or Lump Sum Payment : Usually the payment of capital expenditure is not frequent and is made at a time, in lump sum. On the other hand, the revenue expenditure is paid periodically such as salary. However, it is important to note that it is possible that sometimes even capital expenditures can be made frequently based on the need to purchase assets and its use in the business operations.

Payment Amount : Normally, the amount of capital expenditure is larger as compared to the payment amount of revenue expenditure. However, it is possible that the amount of capital expenditure is paid in instalments, in which case, even though the instalment amounts are small, they will still be classified as capital expenditures.

Difference between Capital and Revenue Expenditure :

Sr. No.	Basis	Capital Expenditure	Revenue Expenditure
1	Meaning	It is that expenditure which results in acquiring or bringing into existence an asset or advantage of enduring benefit.	It is that expenditure the benefit of which is exhausted within the accounting year in which it is incurred.
2	Purpose	It is incurred to acquire fixed assets for use in business which will increase the earning capacity of the business.	It is incurred to run the business and earn more profits.
3	Type of Account	It is an Real Account.	It is an Nominal Account.
4	Disclosure	It is shown in the Balance Sheet	It is shown in the Trading or Profit and Loss Account

Some Important Capital Expenses that appear to be revenue expenses :

- a) Expenses including Interest on Loan raised to acquire an asset up to the point of time it is ready for use.
- b) Expenses incurred on repairs and whitewashing for first time on the purchase of an old building so as to make it useable
- c) Expenses incurred for purchase of land or building including registration fees, legal charges, etc.
- d) Wages paid to produce tools/peripherals to be used in the factory or to fix any machine to be used in production.

Understanding Capital and Revenue Receipts :

Meaning of Capital Receipts :

- It is an amount which is received on sale of fixed assets or received as loans or capital introduced which are not received in the normal course of business.
- It is usually of a non-recurring nature and is therefore, not available for payment to the owner of the business as profits.
- It is recorded in the Balance Sheet under the most appropriate head based on the nature of the amount.
- It includes amounts of capital contribution, loan received and proceeds from sale of fixed assets.

Meaning of Revenue Receipts :

- It is an amount received for sale of goods and/or rendering of services in the normal course of business.
- It is usually of a recurring nature and is therefore, available for distribution to the owner of the business. The amounts of revenue receipts net off revenue expenses and expired portion of Capital/Deferred Revenue Expenditure can be distributed to the owners of the business.
- It is recorded in the Trading or Profit and Loss Account as these amounts are related to the normal business operations of the enterprise.
- It includes the amounts received as consideration for sale of goods, amounts received as bad debts recovery and all others which are received in the normal course of business.

Difference between Capital and Revenue Receipt :

Sr. No.	Basis	Capital Receipt	Revenue Receipt
1	Type of Transactions	It is an amount which is received on sale of fixed assets or received as loans or capital introduced which are not received in the normal course of business.	It is an amount received for sale of goods and/or rendering of services in the normal course of business.
2	Nature	It is usually of a non-recurring nature	It is usually of a recurring nature
3	Utilisation of receipts	It is normally not available for payment to the owner of the business as profits.	It is normally available for distribution to the owner of the business i.e., amounts of revenue receipts net of revenue expenses and expired portion of Capital/Deferred Revenue Expenditure can be distributed to the owners of the business
4	Disclosure	It is recorded in the Balance Sheet and disclosed under the appropriate heading.	It is recorded in the Trading and Profit and Loss Account as it is related to the operating activities undertaken in the course of business.

8.3 Trading Account

Trading and Profit and Loss account is prepared to know the profit earned or loss. Income statement consists of Trading and Profit and Loss Account. Let us, first study the Trading Account. A business firm either purchases goods from others and sells them or manufactures and sells them to earn profit. These are known as trading activities. A statement is prepared to know the results in terms of profit or loss of these activities. This statement is called Trading and Profit and Loss account. Debit balances representing expenses and losses which are transferred to the debit side of the Trading and a Profit and Loss account and credit balance representing revenues/gains which are transferred to its credit side.

Trading Account is prepared to ascertain the results of the trading activities of the business enterprise. It shows whether the selling of goods purchased or manufactured has earned profit or incurred loss for the business unit. Cost of goods sold is subtracted from the net sales of the business of that accounting year. In case the total sales value exceeds the cost of goods sold, the difference is called Gross Profit. On the other hand, if the cost of goods sold exceeds the total net sales, the difference is Gross Loss. All accounts related to cost of goods sold such as opening stock, net purchases i.e. purchase less returns outward, direct expenses such as wages, carriage inward etc. and closing stock with net sales (i.e. Sales minus Sales returns) are posted to the Trading Account. Then this account is balanced. Credit balance shows the gross profit and debit balance shows the gross loss

Meaning :

- It is the first stage of preparation of final accounts.
- It records the transactions related to the buying and selling of goods and/or services during an accounting period.
- It has two sides where the left-hand side is known as debit side and the right-hand side is called the credit side. The debit side records items like opening stock, purchases net off returns and direct expenses and the credit side records items like sales or services rendered and closing stock.
- It totals the debit and credit sides to determine if there is any difference. If the debit side total is greater than the credit side total then it is termed as Gross Loss and if the credit side total is greater than the debit side total then it is termed as Gross Profit.

Features :

1. **Records trading transactions only:** It records net sales and costs directly related to the trading activities.
2. **Computation of Gross Profit or Gross Loss:** It records all the net sales and costs directly related to the trading activities in order to determine the Gross Profit or Loss from such activities.
3. **Transfer of Gross Profit or Gross Loss:** Such Gross Profit or Gross Loss computed in the Trading Account is to be transferred to the Profit and Loss Account.
4. **First Stage in preparation of final accounts:** Computation of such Gross Profit or Gross Loss is the first stage in the preparation of final accounts for a trading entity.

Relevant Items in Trading Account : The different items appearing in the trading account are explained hereunder:

Items on the debit side

- (i) **Opening stock** : It is the stock of goods in hand at the beginning of the accounting year. This is the stock of goods which has been carried forward from the previous year and remains unchanged during the year and appears in the trial balance. In the trading account it appears on the debit side because it forms the part of cost of goods sold for the current accounting year.
- (ii) **Purchases less returns** : Goods, which have been bought for resale appears as purchases on the debit side of the trading account. They include both cash as well as credit purchases. Goods which are returned to suppliers are termed as purchases return. It is shown by way of deduction from purchases and the computed amount is known as Net purchases.
- (iii) **Wages** : Wages refer to remuneration paid to workers who are directly engaged in factory for loading, unloading and production of goods and are debited to trading account.
- (iv) **Carriage inwards/Freight inwards** : These expenses are the items of transport expenses, which are incurred on bringing materials/goods purchased to the place of business. These items are paid in respect of purchases made during the year and are debited to the trading account.
- (v) **Fuel/Water/Power/Gas** : These items are used in the production process and hence are part of expenses.

It is necessary to understand the meaning of cost of goods sold before preparing Trading Account.

Cost of goods sold and gross profit

A business enterprise either purchases goods or manufactures goods to sell in the market. Cost of goods sold is computed to know the profit earned (Gross Profit) or loss incurred (Gross Loss) from the trading activities of a business unit for a particular period.

Cost of goods sold = the amount of goods purchased + expenses incurred in bringing the goods to the place of sale or expenses incurred on manufacturing the goods (called direct expenses). In case there is a stock of goods to be sold in the beginning of the year or at the end of the year, the cost of goods is calculated as follows :

$$\begin{aligned}\text{Cost of goods sold} &= \text{Opening stock} + \text{Net purchases} + \\ &\quad \text{All direct expenses} - \text{Closing stock} \\ \text{Gross Profit} &= \text{Net sales} - \text{Cost of goods sold}\end{aligned}$$

FORMAT OF TRADING ACCOUNT

TRADING ACCOUNT for the year ended

Dr.

Cr.

<i>Particulars</i>	<i>Amount</i>	<i>Particulars</i>	<i>Amount</i>
To Opening Stock	XXX	By Sales...	XXX
To Purchases XXX		Less Returns	
Less: Returns		(Returns Inward) <u>XXX</u>	XXX
(Returns Outward) <u>XXX</u>	XXX	By Scrap Sales	
To Wages and Salaries		By Closing Stock	XXX
or Wages	XXX	By Gross Loss	
To Gas, Fuel and Power	XXX	(if any) transferred to	
To Carriage on	XXX	P and L A/c	XXX
Purchases/Carriage	XXX	(Balancing Figure	
inwards/Carriage	XXX		
To Freight, Octroi and	XXX		
Cartage	XXX		
To Manufacturing Expenses	XXX		
To Gross Profit (if any)			
transferred to P and L			
A/c (Balancing Figure)	XXX		
	XXX		XXX

Items on Credit side :

- i. **Sales :** This account shows the amount of total sales of the goods during the year and will always have a credit balance.
- ii. **Returns Inwards or Sales Returns :** This account shows the amount of goods returned by the customers and always has a debit balance. These amounts are shown as a deduction from sales on the credit side of the Trading Account as Net Sales, where

$$\text{Net Sales} = \text{Sales} - \text{Sales Return.}$$
- iii. **Closing Inventory :** It is the amount of stock of unsold goods, i.e., raw material, semi-finished, finished goods or goods traded in at the end of the current accounting period. It is taken and valued at the year end and is shown on the credit side of the Trading Account. It is valued as per the Convention of Conservatism, according to which it is valued at cost or Net Realisable Value whichever less is.

Balancing of Trading Account :

- Once all the above items are recorded in the Trading Account, balance is calculated to determine the Gross Profit or Gross Loss.
- When the credit side total is more than the debit side total, the difference is termed as Gross Profit and when the debit side total is more than the credit side total, the difference is termed as Gross Loss.
- Such Gross Profit or Loss is then transferred to the Profit and Loss Account where Gross Profit is transferred to the credit side and the Gross Loss is transferred to the debit side of the Profit and Loss Account.

Closing Journal Entries passed in Journal Proper :

For items on the debit side :

Trading A/c ...Dr.

To Opening Stock A/c

To Purchases A/c (Net)

To Direct Expenses A/c

For items on the credit side :

Sales A/c (Net) ...Dr.

Closing Stock A/c ...Dr.

To Trading A/cCr.

For Gross Profit:

Trading A/c ...Dr.

To Profit and Loss A/c Cr.

For Gross Loss :

Profit and Loss A/c ...Dr.

To Trading A/c Cr.

8.4 Profit and Loss Account

Profit and loss (P&L) statement refers to a financial statement that summarizes the revenues, costs, and expenses incurred during an accounting period. These records provide information about a company's ability or inability to generate profit by increasing revenue, reducing costs, or both. Profit & Loss statements are often presented on a cash or accrual basis.

Meaning :

- It is prepared after preparing the Trading Account for a particular period.
- It determines the net profit earned or loss incurred by the business during an accounting period.
- It starts with the Gross Profit or Gross Loss that is computed by balancing the Trading Account.
- All the indirect incomes and gains are credited to the Profit and Loss Account and all the indirect expenses and losses are debited to the Profit and Loss Account. Difference between the debit and credit side determines the Net Profit or Net Loss.

Features of Profit & Loss Account :

- It is prepared for particular accounting period and follows accrual basis of accounting.
- It is credited with the gross profit and income from other sources and debited with indirect expenses and losses. The difference between the debit and credit side total is determined. If the debit side total is more than the credit side total, then the difference is termed as Net Loss and if the credit side total is more than the debit side total, then the difference is termed as Net Profit
- Such Net Profit or Loss is transferred to the capital account where, net profit will increase the capital and net loss will reduce the capital.
- Computation of Net Profit or Loss from Profit and Loss Account is the second stage in the preparation of the final accounts. ·

Purpose/Objectives of preparing Profit and Loss Account :

- It is prepared to measure the profitability of the business in terms of net profit.
- To measure the rationality of indirect expenses incurred.
- To facilitate the comparison of the current year's actual performance with the desired and planned performance.
- To provide for various provisions and reserves for unforeseen future conditions which will strengthen the financial position of the business.

FORMAT OF PROFIT AND LOSS ACCOUNT

Profit and Loss Account for the year ending.....of.....Ltd.

Relevant Items in Profit and Loss Account :

Dr.

Cr.

<i>Particulars</i>	<i>Amount</i>	<i>Particulars</i>	<i>Amount</i>
To Gross Loss b/d	XXX	By Gross Profit b/d	
To Salaries	XXX	(Transferred from Trading A/c)	XXX
To Rent	XXX	By Rent Received	XXX
To Printing and Stationary	XXX	By Interest and Fixed Deposits	XXX
To Lighting	XXX	By Discount received	XXX
To Travelling Expenses	XXX	By Interest on drawings	XXX
To Insurance	XXX	By Interest on Investments	XXX
To Establishment Expenses	XXX	By Cash Discount	XXX
To Legal Charges	XXX	By Bad debts recovered	XXX
To Audit Fees	XXX	By Commission Received	XXX
To Telephones Charges	XXX	By Dividend on Shares	XXX
To Postage and Telegram	XXX	By Gain on sale of fixed assets	XXX
To General Expenses	XXX	By Income from other sources	XXX
To Advertisement	XXX		
To Packing Charges	XXX		
To Delivery Van Expenses	XXX	By Net Loss (if any)	XXX
To Commission	XXX	transferred to P and L A/c	
To Depreciation	XXX	(Balancing Figure)	
To Bank Charges	XXX		
To Loss and Sale of Assets	XXX		
To Bad-debts	XXX		
To Net Profit (if any)	XXX		
transferred to P and L A/c			
(Balancing Figure)			
	XXX		XXX

The different items appearing in the trading account are explained hereunder:

Items on the debit side

- i. **Salaries :** It is the amount of consideration to the employees for the services rendered by them. Some salaries like salaries to Factory Manager, Purchase Manager, Wages and Salaries Account, etc. are directly related to manufacturing/trading and therefore, debited to the Trading Account. On the other hand, Salaries and Wages Account is debited to Profit and Loss Account considering it as an indirect expense.
- ii. **Office Rent and Electricity :** These are the expenses which are not directly related to manufacturing/trading but incurred for the purposes of administration and sale and therefore, considered as indirect expenses.
- iii. **Printing and Stationery :** It is that expense which is related more with administration and sale rather than manufacturing or trading and therefore, considered as an indirect expense.
- iv. **Freight and Carriage on Sales (Carriage Outward) :** It is related to sale and therefore, considered as an indirect expense.
- v. **Insurance :** It is the amount of insurance premium paid for insuring the assets, goods, etc. and therefore, considered as an indirect expense.
- vi. **Advertising :** It is the expense incurred towards advertisement for advertising goods or recruiting staff and therefore, considered as an indirect expense.
- vii. **Discount Allowed :** It is the concession or discount allowed to the debtors for timely payments made by them and therefore, considered as an indirect expense.
- viii. **Bad Debt :** It is considered as an indirect expense as it is that part of the debtors which has become irrecoverable.
- ix. **Depreciation :** It is the cost of assets written off over their useful life. It is also referred as to the fall in the value of the assets on account of wear or tear, use or lapse of time. It is therefore, considered as an indirect expense.
- x. **Loss by fire or theft or damage :** It is the loss to the business on account of fire, theft or any other type of damage and is therefore, debited to the Profit and Loss Account. If the goods are insured, insurance company account is debited and if the goods are not insured, amount of loss is debited to the Profit and Loss Account.
- xi. **Interest paid:** Interest paid on loans, bank overdraft, renewal of bills of exchange, etc. is an expense and is debited to profit and loss account.

- xii. **Commission paid:** Commission paid or payable on business transactions undertaken through the agents is an item of expense and is debited to profit and loss account.
- xiii. **Repairs:** Repairs and small renewals/ replacements relating to plant and machinery, furniture, fixtures, fittings, etc. for keeping them in working condition are included under this head. Such expenditure is debited to profit and loss account.
- xiv. **Miscellaneous expenses:** This amount involves all those expenses which are small in amounts and being not material are clubbed together into one account. Though expenses are classified and booked under different heads, but certain expenses being of small amount clubbed together and are called miscellaneous expenses. In normal usage these expenses are called Sundry expenses or Trade expenses.

Items on the Credit side :

It is that side of the Profit and Loss Account which records all the other Incomes which are earned from the use of firm's resources other than the main business of the firm and includes the following items:

- i. Rent received
- ii. Interest on fixed deposits
- iii. Interest on drawings and interest on investments
- iv. Cash discount / Discount Received
- v. Bad debts recovered
- vi. Gain on sale of fixed assets

Balancing of Profit and Loss Account :

Once all the above items are recorded in the Profit and Loss Account, balance is calculated to determine the Net Profit or Net Loss.

When the credit side total is more than the debit side total, the difference is termed as Net Profit and when the debit side total is more than the credit side total, the difference is termed as Net Loss. Such Net Profit or Loss is then transferred to the Capital Account of the proprietor.

Closing Entries in the Profit and Loss Account :

For closing all the indirect expenses or losses by transferring their balances to the debit of the Profit and Loss Account:

Profit and Loss A/c ...Dr.

To Salaries A/c

To Rent A/c

To Interest A/c

To Advertising A/c

To Miscellaneous Expenses A/c

For closing all the indirect incomes or gains by transferring their balances to the credit of the Profit and Loss Account:

Interest Received A/c ...Dr.

Discount Received A/c ...Dr.

Bad Debts Recovered A/c ...Dr.

Miscellaneous Income A/c ...Dr.

To Profit and Loss A/c

For Net Profit :

Profit and Loss A/c ...Dr.

To Capital A/c

For Net Loss :

Capital A/c ...Dr.

To Profit and Loss A/c

Operating Profit and Net Profit :

Operating Profit :

It is the amount of profit earned through the normal operating activities of the business and is computed by deducting the Operating Expenses from the Gross Profit.

Net Profit :

It is the amount of profit earned through the operating and non-operating activities of the business. It is the excess of revenue (operating + non-operating) over expenses and losses (operating + non-operating).

Operating Expenses : These are the amounts of expenses incurred by an enterprise that are associated with its operating activities and therefore, cost of goods sold besides salaries to staff in purchase departments, store electricity bill, salaries to sale staff or accountants,

etc. are operating expenses. Expenses like rent, repairs, depreciation, etc. are operating expenses because without such expense the enterprise cannot carry out its operating activities. All of these expenses are debited to the Profit and Loss Account.

Non-Operating Expenses : These are the amounts of expenses which do not relate to the main activity of the enterprise such as donation, loss on sale of fixed assets or loss by fire, etc. Such non-operating expenses are also debited to the Profit and Loss Account.

Operating Incomes : These are the incomes earned by an enterprise that are associated with its operating activities and also includes incomes earned while carrying out operating activities, say, cash discount received, commission received, etc. All these are recorded on the credit side of the Profit and Loss Account.

Non-Operating Incomes : These are the incomes which do not relate to the main operating activities of the enterprise such as interest, gain on sale of fixed assets, etc. All of these expenses are recorded on the credit side of the Profit and Loss Account.

Note: It is important to know the following equation in order to understand the relationship of all the above items:

Operating Profit = Net Sales - Operating Cost (OR)

Operating Profit = Gross Profit - Operating Expenses (OR)

**Operating Profit = Net Profit + Non-Operating Expenses
Non-Operating Incomes**

8.5 Balance Sheet :

The balance sheet is a statement prepared for showing the financial position of the business summarising its assets and liabilities at a given date. The assets reflect debit balances and liabilities (including capital) reflect credit balances. It is prepared at the end of the accounting period after the trading and profit and loss account have been prepared. It is called balance sheet because it is a statement of balances of ledger accounts that have not been transferred to trading and profit and loss account and are to be carried forward to the next year with the help of an opening entry made in the journal at the beginning of the next year. While Preparing Balance Sheet All the account of assets, liabilities and capital are shown in the balance sheet. Accounts of capital and liabilities are shown on the left hand side, known as Liabilities. Assets and other debit balances are shown on the right hand side, known as Assets.

Meaning :

- It is a statement prepared to determine the financial position of a business entity on a particular date.

- It comprises of all the assets and liabilities of the business along with the capital of the entity. Capital is usually referred to as excess of assets over the liabilities of the business.
- As per Francis R. Stead, “Balance Sheet is a screen picture of the financial position of a going business at a particular point of time and comprises only of Real and Personal Accounts.”

Purpose : It is prepared

- To help in determining the nature and book value of various assets.
- To ascertain the nature and amount of various liabilities.
- To disclose important information related to the additional capital invested, drawings of the owners etc.
- To help in assessing the solvency of a business.
- To reveal the true financial position of a business.
- To have a base for Opening entry for the next accounting year.

Format of Preparing Balance sheet

There is no prescribed form of Balance sheet, for a proprietary and partnership firms. (However, Schedule III Part I of the Companies Act 2013 prescribes the format and the order in which the assets and liabilities of a company should be shown). The horizontal format in which the balance sheet is prepared is shown below.

Balance sheet of.....as on

<i>Liabilities</i>		<i>Amount</i>	<i>Assets</i>		<i>Amount</i>
Sundry Creditors		XXX	Cash in Hand		XXX
Bills Payable		XXX	Cash in Bank		XXX
Loans taken		XXX	Bill Receivable		XXX
Reserves or Reserve Fund		XXX	Sundry Debtors		XXX
Capital :			Loans given		XXX
Opening Balance	XXX		Closing Stock		XXX
Add : Net Profit	<u>XXX</u>		Investment		XXX
	XXX		Plant and Machinery		XXX
Less : Drawings	XXX		Land and Building		XXX
		XXX	Goodwill, Patents, etc.		XXX
		XXX			XXX

Understanding Grouping, Marshalling and Classification of Assets and Liabilities

Meaning :

- Grouping is to bring all the items of similar nature under a common accounting head and Marshalling is arrangement of all the assets and liabilities in a particular order.
- In other words, it is the arrangement of all the assets and liabilities in appropriate groups and in a particular order of liquidity or permanence.
- It presents or categorises all the Assets and Liabilities in the Balance Sheet in the order of Liquidity or in the order of Permanence as follows:
 - i. **Order of Liquidity :** Here, the assets that can be converted into cash in least possible time are recorded first followed by the lesser liquid assets. In the same way, liabilities that are to be paid first, are recorded first followed by the lower priority ones. If this method of arrangement is followed, Balance Sheet is prepared as follows:

Balance sheet of.....as on

<i>Liabilities</i>		<i>Amount</i>	<i>Assets</i>		<i>Amount</i>
Bills Payable		XXX	Cash in Hand		XXX
Sundry Creditors		XXX	Cash in Bank		XXX
Loans taken		XXX	Bill Receivable		XXX
Capital :			Sundry Debtors		XXX
Opening Balance	XXX		Loans given		XXX
Add : Net Profit	XXX		Closing Stock		XXX
Less : Drawings	<u>XXX</u>	XXX	Investment		XXX
			Plant and Machinery	XXX	
			Less : Depreciation	<u>XXX</u>	
			Land and Building	XXX	XXX
			Less : Depreciation	XXX	
			Goodwill		XXX
		XXX			XXX

- i. **Order of Permanence :** Here, the assets and liabilities are arranged in their reducing level of permanence. The assets and liabilities with higher degree of permanence are recorded first followed by the assets and liabilities with lower degree of permanence. If this method of arrangement is followed, Balance Sheet is prepared as follows

Balance sheet of.....as on

<i>Liabilities</i>		<i>Amount</i>	<i>Assets</i>		<i>Amount</i>
Capital :		XXX	Goodwill		XXX
Opening Balance	XXX		Plant and Machinery		XXX
Add : Net Profit	<u>XXX</u>		Investment		XXX
	XXX		Closing Stock Sundry		XXX
Less : Drawings	<u>XXX</u>	XXX	Debtors		XXX
Bills Payable			Cash in Bank		XXX
Sundry Creditors			Cash in Hand		XXX
Loans taken		XXX			
		XXX			XXX

Classification of Assets and Liabilities :

- **Assets :** These are categorised in the following :
 1. **Fixed Assets:** These are the assets which are not held by the company for the purpose of trade or resale. Instead they are used to earn more and more profits. These are further categorised as follows:
 - i. **Tangible :** Assets which can be seen, touched and have a physical existence are termed as Tangible Assets. These are shown in the Balance Sheet at cost less depreciation.
 - ii. **Intangible :** Assets which cannot be seen, touched and do not have a physical existence are termed as Intangible Assets. These are shown in the Balance Sheet at cost less amortisation. (Note : There are also some other items known as Investments and Fictitious Assets. Investments are the amounts spent on purchase of bonds, debentures, shares, etc. with an intention to earn returns in the form of interest, dividends, etc. Such Investments are shown separately in the Balance Sheet). Fictitious assets are the losses which are yet to be written off which includes discount on issue of debentures, debit balance of profit and loss, etc.

2. **Current Assets :** As per Schedule III of the Companies Act, 2013, a current asset is the one which satisfies any of the following conditions:
 - i. It is to be realised or intended for sale or consumption within the company's operating cycle or
 - ii. To be realised within 12 months after the reporting date or
 - iii. Primarily held for the purpose of being traded or
 - iv. Cash and cash equivalents unless they are restricted from being exchanged or used to settle a liability for at least 12 months after the reporting date
- **Liabilities :** These are divided as follows:
 1. **Non-Current Liabilities:** As per Schedule III of the Companies Act, 2013, these are those liabilities which are not current liabilities. These include long term borrowings, deferred tax liabilities, etc.
 2. **Current Liabilities:** As per Schedule III of the Companies Act, 2013, a current liability is the one which satisfies any of the following conditions:
 - i. To be settled within the company's operating cycle or
 - ii. To be settled within 12 months after the reporting date or
 - iii. Primarily held for the purpose of being traded or
 - iv. There is no unconditional right to defer settlement for at least 12 months after the reporting date.
 3. **Owner's Funds :** It is the amount that an entity owes to its proprietor and includes the undistributed profits and reserves besides capital. It is described as a difference between assets and liabilities.

Note : It also includes contingent liabilities which is a liability that becomes payable on the happening of an event. If the event does not happen, no amount is payable. Such liabilities are not accounted in the Balance Sheet but are disclosed in the note to accounts. These include liabilities related to bills discounted, disputed claims, etc.

8.6 Adjustments in Preparation of Financial Statements

Need for Adjustments

The primary reason for the need for adjustments in final accounts is that according to Accrual concept of accounting says that all incomes earned and expenses incurred during an accounting period should be recorded whether or not money has exchanged hands or not. The profit or loss for an accounting year is not based on the revenues realised in cash and the expenses paid in cash during that year. There may also exist previous year or next year receipts and expenses in the current year and there is also possibility of exist of incomes and expenses relating to the current year that still need to be brought into books of account. The above reasons may leads to unfair view of the state of affairs of the business. Hence, such items duly adjusted for the true and fair final accounts. Accounting adjustments are required because of the following purposes:

1. To ascertain the accurate net profit or net loss of the concern for an accounting year.
2. To know the Actual financial position of the business by making necessary adjustments
3. To make necessary adjustments related to outstanding expenses (Previous dues).
4. To make necessary adjustments related to prepaid expenses (Paid in advance or future expenses).
5. To provide depreciation on fixed assets.

Types of Adjustments in Final Accounts

1. Closing Stock
2. Outstanding Expenses
3. Prepaid or Unexpired Expenses
4. Depreciation
5. Accrued Income
6. Income received in advance
7. Interest on capital
8. Interest on drawings
9. Further Bad Debts

10. Provision of Bad and Doubtful Debts
11. Provision for discount on debtors
12. Managers Commission
13. Abnormal Loss
14. Drawing of Goods by the Proprietor
15. Goods Distributed as free Sample

1. Adjustment of Closing Stock

Closing stock is the stock of goods which remains unsold at the end of the accounting year. This becomes the opening stock of the very next period. Oftentimes **closing stock is not shown in the trial balance**. It appears outside the trial balance as additional information. Journal Entry for Adjustment of Closing Stock in Final Accounts.

Treatment of Closing Stock Adjustment in Financial Statements

- **Trading Account:** Show on the credit side
- **Profit & Loss Account:** No effect
- **Balance Sheet:** Show on the assets side (usually under the head **current assets**)

For example

In the books of Mr. Kamal showed the following items: The value of closing stock as on 31.3.2023 was Rs.10, 000.

The accounting treatment of closing stock in the financial statements of Mr. Kamal., will be as follows;

1. The following adjustment entry will be passed at the end of the year :

<i>Date</i>	<i>Particulars</i>		<i>LF No.</i>	<i>Debit Amount (Rs.)</i>	<i>Credit Amount (Rs.)</i>
31-3-2023	Closing Stock A/c	Dr.	1	10,000	
	To Trading A/c	Cr.			10,000

2. Trading A/c of Mr. Kamal for the year ending March 2023

Dr.

Cr.

<i>Particulars</i>	<i>Amount</i>	<i>Particulars</i>	<i>Amount</i>
		By Closing Stock	10,000

3. Balance Sheet of Mr. Kamal as on 31-3-2023

<i>Liabilities</i>	<i>Amount</i>	<i>Assets</i>	<i>Amount</i>
		Closing Stock	10,000

Note : If Closing stock is given inside the Trial balance, the above mentioned adjustment entry will not be passed and the closing stock will not be shown on the credit side of Trading A/c. The closing stock will be shown on the assets side of Balance Sheet only

2. Adjustment of Outstanding Expenses

Outstanding expenses are those expenses which incurred during the current year but has not been paid till the end of the accounting year such as Salaries & wages, Factory & office rent, Telephone charges etc.

Treatment of Outstanding Expenses Adjustment in Financial Statements

- **Trading Account:** Show on the debit side (add to respective direct expense)
- **Profit & Loss Account:** Show the debit side (add to respective indirect expense)
- **Balance Sheet:** Show on the liability side (usually under the head **current liabilities**).

For example

In the books of accounts of Mr. Kamal showed that, Wages paid during the year 2022-2023 ₹ 50,000. Wages outstanding for the year 2022-2023 ₹ 5,000. The accounting treatment of wages outstanding in the books of Mr. Kamal will be as follows

Journal Entry for Adjustment of Outstanding Expenses in Final Accounts

<i>Date</i>	<i>Particulars</i>	<i>LF No.</i>	<i>Debit Amount (Rs.)</i>	<i>Credit Amount (Rs.)</i>
31-3-2023	Wages A/c	Dr.		5,000
	To Wages Outstanding A/c (For wages outstanding for the year 2022-23)	Cr.		5,000

3. Trading A/c of Mr. Kamal for the year ending

Dr.

Cr.

<i>Particulars</i>	<i>Amount</i>	<i>Particulars</i>	<i>Amount</i>
Wages	50,000		
(+) Wages O/s	5,000		
	55,000		

3. Balance Sheet of Mr. Kamal as on 31-3-2012

<i>Liabilities</i>	<i>Amount</i>	<i>Assets</i>	<i>Amount</i>
Wages Outstanding	5,000		

3. Adjustment of Prepaid Expenses or Unexpired expenses

Prepaid expenses are expenses that are paid in advance for a benefit that is not received yet and these expenses are part of trial balance which may related to future. In order to avoid understating profits, it is crucial to record them towards the end of an accounting year. 'Expense paid in Advance' such as, out of the salaries paid during the current year, a part may relate to next accounting year. Similarly factory rent, wages, office rent, insurance premium, taxes, etc. may be prepaid in some cases. Such expenses are also called **expense paid in advance**. Examples: Prepaid rent, prepaid interest, prepaid insurance, etc.

Treatment of Prepaid Expenses Adjustment in Financial Statements

- **Trading Account** : Show on the debit side (subtract from the respective direct expense)
- **Profit & Loss Account** : Show the debit side (subtract from the respective indirect expense)

- **Balance Sheet** : Show on the assets side (usually under the head current assets)

For example

In the books of accounts of Mr. Kamal showed the following: Total salaries paid during the accounting year 2022-2023 is Rs. 1,00,000 out of which ‘ 25,000 relates to the next accounting year, i.e, 2023-24. The accounting treatment, of prepaid salaries in the books of Mr. Kamal will be as follows:

<i>Date</i>	<i>Particulars</i>	<i>LF No.</i>	<i>Debit Amount (Rs.)</i>	<i>Credit Amount (Rs.)</i>
31-3-2023	Prepaid Salaries A/c Dr. To Salaries A/c Cr. (For Salaries paid in advance for next year 2023-24)		25,000	25,000

2. Profit and Loss A/c of Mr. Kamal for the year ending 31st March 2023

Dr.

Cr.

<i>Particulars</i>	<i>Amount</i>	<i>Particulars</i>	<i>Amount</i>
To Salaries : 1,00,000			
(-) Prepaid Salaries : <u>25,000</u>	75,000		

3. Balance Sheet of Mr. Kamal as on 31-3-2023

<i>Liabilities</i>	<i>Amount</i>	<i>Assets</i>	<i>Amount</i>
		Prepaid Salaries	25,000

4. Adjustment of Depreciation

Depreciation is a **non-cash expense** i.e. it is not paid in form of cash or a cash equivalent. **Depreciation** is the allocation of the cost of a fixed asset over its estimated useful life. Since fixed assets are utilized to earn revenue, a decrease in their value is treated as an expense incurred to earn the said revenue .The value of fixed assets such as Plant and Machinery, Building, Furniture, Computers, Motor Vehicles, etc. goes on decreasing or

reducing every year due to their use, wear and tear. This decrease in the value of assets is called depreciation. Depreciation is an expense like any other expense of the business.

Treatment of Depreciation in Financial Statements (No Provision)

- **Trading Account:** No effect
- **Profit & Loss Account:** Show on the debit side (calculate as per % & method given)
- **Balance Sheet:** Show on the asset side (subtract depreciation from the fixed asset)

For example

In the books of accounts of Mr. Kamal showed the following: The value of Plant and Machinery is ‘ Rs.8, 00,000 as on 31-3-2023 and value of Furniture is Rs.80, 000 as on 31-3-2023. Depreciation is to be charged on these assets @10% p.a. The accounting treatment of depreciation in the financial statements of Mr. Kamal, will be as follows:

Journal Entry in the books of Kamal for the year ending 31st March 2023

<i>Date</i>	<i>Particulars</i>	<i>LF No.</i>	<i>Debit</i>	<i>Credit Amount (Rs.)</i>
31-3-2023	Depreciation A/c Dr.	5	88,000	
	To Plant & Machinery A/c			
80,000	To Furniture A/c			8,000
	(For depreciation charged on Plant and Machinery and Furniture @ 10% for one year)			

2. Profit and Loss A/c of Mr. Kamal for the year ending 31st March 2023

Dr.

Cr.

<i>Particulars</i>	<i>Amount</i>	<i>Particulars</i>	<i>Amount</i>
To Depreciation on Plant & Machinery	80,000		
Furniture	8,000		
	<u>88,000</u>		

Balance Sheet

Dr. **Cr.**

<i>Liabilities</i>	<i>Amount</i>	<i>Assets</i>	<i>Amount</i>
	₹		₹
Capital			
Add : Interest on Capital			

Note: In case amount of depreciation has been calculated before closing of accounts, it will appear in the debit column of the Trial Balance. It will be shown only on the debit of profit & Loss A/c and further adjustment is not required in the Balance Sheet.

8. Further Bad Debts

When the goods are sold on credit basis some of the debtors partly pay the due amount or do not pay at all. If this amount cannot be recovered it is called bad debts and is a loss to the firm. This is entered on the debit side of the Profit & loss A/c. But then there may be amount of bad debt which was not recorded in the books of accounts and hence did not appear in the Trial Balance. But the same was discovered before preparing the financial

Profit & Loss A/c

Dr. **Cr.**

<i>Particulars</i>	<i>Amount</i>	<i>Particulars</i>	<i>Amount</i>
	₹		₹
		Interest on Drawing	

Balance Sheet

Dr. **Cr.**

<i>Liabilities</i>	<i>Amount</i>	<i>Assets</i>	<i>Amount</i>
	₹		₹
Capital			
Less : Interest on Drawings			

Profit & Loss A/c

Dr. **Cr.**

<i>Particulars</i>	<i>Amount</i> ₹	<i>Particulars</i>	<i>Amount</i> ₹
Bad Debts Add : Provision for Doubtful debts			

Balance Sheet

Dr. **Cr.**

<i>Liabilities</i>	<i>Amount</i> ₹	<i>Assets</i>	<i>Amount</i> ₹
		Debtors Less : Provision for bad Debts	

Such Provision is created on Debtors at a given rate say 5%. In case there is further bad debts, provision for bad and doubtful Debts will be calculated on the amount of debtors after deducting from it the amount of further Bad Debts.

Over the years businessman might have experienced that a certain percentage of the debts created due to credit sales go bad every year. So a provision for bad and doubtful debt is made on the debtors of a year at a fixed percentage say 5%. This percentage may change if the circumstances have changed. For example, it may be reduced if the businessman has become selective in selling goods on credit.

Provision for bad and doubtful debt is maintained at every year at a fixed percentage of the debtors. Last year balance is carried forward in the current year. This may be called old provision for bad and doubtful debts. Current years bad debts or/and further bad debts is adjusted towards this provision and more provision is created, which may be called new provision for bad debts.

Arithmatically it is shown in the Profit and Loss A/c as follows:

Dr.**Profit & Loss A/c****Cr.**

<i>Particulars</i>	<i>Amount</i> ₹	<i>Particulars</i>	<i>Amount</i> ₹
Bad Debts			
Add : Further Bad Debts			
Add new provision for Bad and Doubtful Debts			
Less : Old provision for Bad and Doubtful Debts			

In case the balance amount of provision for bad and doubtful debts carried forward from last year is more than the amount of bad debts, amount of further Bad Debts and the amount of new provision for bad debts combined together, the excess balance will be credited to Profit and Loss A/c.

The amount of provision for Bad and Doubtful Debts is an item of liability. But usual practice is to show it as deducted from the amount of book debts/sundry debtors on the assets side of the Balance Sheet.

The above can best be explained by the following example :

Items appearing in the Trial Balance of a sole trader on 31st Dec. 2022

<i>Particulars</i>	<i>Dr</i> <i>Balance</i> ₹	<i>Cr</i> <i>Balance</i> ₹
Sundry Debtors	24600	
Provision for Bad and Doubtful Debts		1000
Bad Debts	700	

Additional Information

Further bad debts amounted to 600. Make a provision for Bad and Doubtful debts on Debtors @ 5%.

Show the above items and related adjustments in the financial statements as on that date.

11. Provision for Discount on Debtors

Debtors outstanding at the end of year make payment in the next year and they may be entitled to cash discount if they make the payment by the due date. Because, the debt has arisen during the year, the discount is to be taken as expense for the year.

Profit & Loss A/c
for the year ended 31st Dec., 2022

Dr.

Cr.

<i>Particulars</i>	<i>Amount</i> ₹	<i>Particulars</i>	<i>Amount</i> ₹
Bad Debts	700		
Add : Further Bad Debts	600		
Add new provision for Bad and Doubtful Debts	1200		
	2500		
Less : Old provision for Bad and Doubtful Debts (1000)			

Balance Sheet

for the year ended 31st Dec., 2022

Dr.

Cr.

<i>Liabilities</i>	<i>Amount</i> ₹	<i>Assets</i>	<i>Amount</i> ₹
		Sundry Debtors	24600
		Less : Further Bad Debts	600
			24000
		Less : Provision for bad Debts @ 5%	1200
			22800

Thus a Provision for Discount on Debtors is made.

The process is same as for the provision for doubtful debt. The likely amount of the discount to be allowed is debited to the Profit and Loss Account and credited to the Provision for Discount Account. This amount is deducted from book debts (debtors) in the balance sheet and is carried forward to the next year. Discount allowed to the existing debtors in the next year are debited to the Provision for Discount Account and not to the Profit and Loss Account. The debit reduces the balance in the provision account, it is made up to the required figure by a debit to the Profit & Loss Account and credit to the provisions account just like the Provision for Doubtful Debts Account.

An important point to note is that discount is not allowed on debts that became bad. Therefore, the provision for discount is made for good debts only. In other words, the amount of the Provision for Discount is calculated after deducting bad debts and the provision for doubtful debts from sundry debtors. Suppose, sundry debtors total ₹1,00,000,

provision for doubtful debts is required at 5% and provision for discounts at 2.5%. So first we have to calculate provision for doubtful debts i.e. ₹1,00,000 x 5% = ₹5,000, the remaining amount is ₹95,000. Now we calculate Provision for Discount on Debtors i.e. ₹95,000 x 2.5% it will be ₹2,375.

Accounting Treatment

(i) For Discount Allowed :

Discount Allowed A/c	Dr.
To Debtors A/c	

(Being discount allowed to debtors)

(ii) For transferring the amount of discount to profit & loss Account.

Profit & Loss A/c	Dr.
To Discount Allowed	

(Being discount allowed transferred to Profit & Loss A/c)

(iii) If the existing provision appears in the books, then the discount allowed would be transferred to the Provision and Discount on Debtors Account instead of the Profit Loss Account. The entry would be :-

Provision for Discount on Debtors A/c	Dr.
To Discount Allowed	

(Being discount transferred to Provision for Discount on Debtors A/c)

(iv) For creating Provision for Discount on Debtors :

Profit and Loss A/c	Dr.
To Provision for Discount on Debtors A/c	

(Being balance of provision for discount account

being charged to Profit & Loss A/c)

Illustration : 1

The Sundry Debts of a firm on 31st December, 2021 were ₹8,00,000. On that date, it was decided to create a Provision for Discount at 2% on Sundry Debtors. During 2022 the actual amount of discount allowed was ₹8000. The debtors on 31st December, 2022 were ₹3,00,000 and it was again decided to create a Provision for Discount over Debtor at 2%. Pass the Journal entries and prepare Discount Account and Provision for Discount Account for both the years.

Solution :

12. Manager's Commission

Sometimes, the manager is entitled to a commission on profits which is usually calculated

Journal

<i>Date</i>	<i>Particulars</i>	<i>LF</i>	<i>Debit (₹)</i>	<i>Credit (₹)</i>
2012 Dec.31	Profit and Loss A/c ...Dr. To Provision for Discount on Debtors A/c (Being provision for discount on debtor credited)		16000	16000
2013 Dec.31	Discount Allowed A/c ...Dr. To Sundry Debtors A/c (Being discount allowed on payment received)		8000	8000
Dec.31	Provision for Discount on Debtors A/c ...Dr. To Discount Allowed A/c (Being discount transferred to Provision Account)		8000	8000
Dec.31	Profit and Loss A/c ...Dr. To Discount Allowed A/c (Being discount transferred to Provision Account)		4000	4000

Provision for Discount on Debtors Account

<i>Date</i>	<i>Particulars</i>	<i>L.F.</i>	<i>(₹)</i>	<i>Date</i>	<i>Particulars</i>	<i>L.F.</i>	<i>(₹)</i>
2021				2021			
Dec. 31	To Balance c/d		16000	Dec.31	By Profit and Loss A/c		16000
2022				2022			
Dec. 31	To Discount Allowed A/c		8000	Jan. 1	By Balance b/d		8000
Dec. 31	To Balance c/d		12000	Dec. 31	By Profit and Loss A/c		12000
				2023			
				Jan. 1	By Balance c/d		12000

Discount Allowed Account

<i>Date</i>	<i>Particulars</i>	<i>L.F.</i>	<i>(₹)</i>	<i>Date</i>	<i>Particulars</i>	<i>L.F.</i>	<i>(₹)</i>
2022				2022			
Dec.31	To Sundry Debtors A/c		8000	Dec. 31	By Provision for Discount A/d		8000

as a fixed percentage of the profits. Suppose, the profit earned by the firm is ₹80,000 without considering the commission which is at 5%. The commission will be then ₹4,000. The profit will be reduced to ₹76,000. As the amount of commission ₹4,000 is still to be paid, it should be treated as an outstanding expense. Accordingly, the entry is

Profit and Loss A/c ...Dr.

To Commission Payable or Outstanding Commission A/c

Commission Payable is a current liability and is shown in the Balance Sheet.

Sometimes, however, the commission is calculated on profits remaining finally after the commission. If the rate of the commission is 5%, and the profit remaining after the commission is ₹100; then the profit before the commission will be ₹105. That is in this case the commission of ₹5 should be out of every ₹105 of profit before the commission. The formula to calculate the commission in such a case is:

If the profit before commission is ₹8,00,000 and the manager is entitled to a commission of 5% after deducting the commission, the amount will be ₹38,095, ₹8,00,000 of 5/105.

$$\frac{\text{Percentage of the commission}}{100 + \text{Percentage of the commission}} \times \text{Net Profit before charging the Commission}$$

This commission amount can be verified too. The profit after the commission is ₹7,61,905 and ₹38,095 is 5% of this figure. One can see that if we calculate it at 5% of 8,00,000 will be wrong since ₹40,000 is not 5% of ₹7,60,000.

Illustration : 2

The net profit of a firm amount to ₹1,05,000 before charging commission. The manager of the firm is entitled to a commission of Rs. 5% on the net profit. Calculate the commission payable to the manager under the following alternative cases-

- I. If the manager is allowed commission on the net profit before charging such commission, and
- II. If the manager is allowed commission on the net profit after charging such commission. Also show the treatment in the final account ending on 31st March 2013.

Solution :

I Case

[Commission allowed on the net profit before charging such commission]

$$\begin{aligned} \text{Commission} &= \text{Net Profit before charging the Commission} \times \frac{\% \text{ of Commission}}{100} \\ &= 1,05,000 \times \frac{5}{100} = 5,250 \end{aligned}$$

Profit & Loss Account for the year ended 31st March 2022

<i>Particulars</i>	<i>Amount</i> ₹	<i>Particulars</i>	<i>Amount</i> ₹
To Managers Commission	5,250		

II Case

Balance Sheet
as at 31st March 2022

<i>Liabilities</i>	<i>Amount</i> ₹	<i>Assets</i>	<i>Amount</i> ₹
Current Liabilities Manager's Com. Outstanding	5,250		

[Commission allowed on the net profit before charging such commission]

$$\text{Commission} = \text{Net Profit before charging the Commission} \times \frac{5}{105}$$

Illustration : 3

Profit & Loss Account
for the year ended 31st March 2022

<i>Particulars</i>	<i>Amount</i> ₹	<i>Particulars</i>	<i>Amount</i> ₹
To Managers Commission	5,000		

Balance Sheet
as at 31st March 2022

<i>Liabilities</i>	<i>Amount</i> ₹	<i>Assets</i>	<i>Amount</i> ₹
Current Liabilities Manager's Com. Outstanding	5,000		

From the following Trial Balance of Krishna Garments as on 31st December, 2022, prepare Trading A/c and Profit & Loss A/c for the year ended 31st December, 2022 and Balance Sheet as on that date :

Following adjustments are to be accounted for :

<i>Name of the Account</i>	<i>Dr. Amount</i> ₹	<i>Cr. Amount</i> ₹
Capital		160,000
Cash in hand	1,140	
Cash at bank	11,200	
Purchases	86,400	
Sales		156,000
Wages	20,800	
Power	9,460	
Carriage inward	4,080	
Carriage outward	6,400	
Stock (1.1.2006)	11,320	
Land & Building	80,000	
Machinery	40,000	
Salaries	8,000	
Insurance	1,200	
Sundry Debtors	56,000	
Sundry Creditors		20,000

- (i) Stock on 31-12-2012 20,000
(ii) Machinery to be depreciated @10% p.a. and Buildings to be depreciated @ 2% p.a.
(iii) Salaries for the month of December outstanding were 2,400
(iv) Insurance Premium was paid for one year ending 30th June, 2013

Make journal entries for the adjustments and prepare Trading and Profit & Loss A/c and the Balance Sheet.

Solution :

<i>Date</i>	<i>Particulars</i>	<i>LF</i>	<i>Debit (₹)</i>	<i>Credit (₹)</i>
2012				
Dec. 31	Closing Stock A/c ...Dr. To Trading A/c (Closing stock taken to Trading A/c)		20,000	20,000
Dec.31	Depreciation A/c ...Dr. To Machinery A/c To Land & Building A/c (Depreciation on machinery @ 10% p.a. and on land & Building @ 2% p.a. charged)		5,600	4,000 1,600
Dec.31	Salaries A/c ...Dr. To Salary Outstanding A/c (Salary due but not paid for December 2013)		2,400	2,400
Dec.31	Prepaid Insurance A/c ...Dr. To Insurance A/c (Insurance paid in advance accounted for)		600	600

Trading A/c

Dr.

for the year ended 31st Dec. 2013

Cr.

<i>Particulars</i>	<i>Amount</i> ₹	<i>Particulars</i>	<i>Amount</i> ₹
Stock	11,320	Sale	1,56,000
Purchases	86,400	Closing Stock	20,000
Wages	20,800		
Power	9,460		
Carriage Inward	4,080		
Gross Profit transferred to Profit & Loss A/c	43,940		
	1,76,000		1,76,000

Illustration : 4

From the following Trial Balance of Saritha & Co., prepare Trading and Profit and loss A/c for the year ending on 31st Dec. 2022 and Balance Sheet as on that date after making necessary journal entries for adjustments.

<i>Liabilities</i>	<i>Amount</i> ₹	<i>Assets</i>	<i>Amount</i> ₹
Land and Building	1,20,000	Capital	3,00,000
Plant and Machinery	80,000	Sundry Creditors	60,000
Bill Receivables	16,000	Sales	2,40,000
Stock on 1-1-2013	80,000	Reserve for Bad and Doubtful Debts	9,000
Purchases	1,01,000	Loan (12% p.a.)	20,000
Wages	40,000	Commission Received	4,000
Coal, Gas & Coke	11,600		
Salaries	10,000		
Rent	5,600		
Cash at bank	50,000		
Sundry Debtors	90,000		
Repairs	3,200		
Bad Debts	11,000		
Sales Returns	4,000		
Furniture and Fixture	8,000		
Interes on Loan	1,200		
	6,33,000		6,33,000

Adjustments

1. Closing stock was valued at ₹60,000.
2. Depreciate Plant & Machinery @5% and Furniture & Fixture @ 10%.
3. Provide for Bad and Doubtful Debts @5%.
4. Outstanding Wages ₹2,000, Rent ₹1,000 and interest on loan outstanding ₹1,200.
5. Commission accrued ₹2,000

Solution :

<i>Date</i>	<i>Particulars</i>	<i>Amount</i> ₹	<i>Amount</i> ₹
2012 Dec. 31	Closing Stock A/c To Trading A/c (Closing stock taken into account)	Dr. 60,000	 60,000
	Depreciation A/c To Plant & Machinery To Furniture & Fixture (Depreciation charged @5% on Plant & Machinery & @10% on Furniture)	Dr. 4,800	 4,000 800
	Profit & loss A/c To Reserve for Doubtful Debt (Reserve for Doubtful Debts created)	Dr. 4,500	 4,500
	Wages A/c Rent A/c To Outstanding Expenses A/c (Outstanding accrued taken into consideration)	Dr. Dr. 2,000 1,000	 3,000
	Commission Accrued A/c To commission received (Commission accrued taken into consideration)	Dr. 2,000	 2,000
	Interest on loan A/c To Interest on loan Outstanding A/c (Inteest on loan due but not paid)	Dr. 1,200 1,200	 1,200

Trading and Profit & Loss A/c of M/s. Saritha & Co.

Dr.

for the year ended on 31-12-2022

Cr.

<i>Particulars</i>	<i>Amount</i> ₹	<i>Particulars</i>	<i>Amount</i> ₹
Opening Stock	80,000	Sales	2,40,000
Purchases	12,000	Less : Sales Returns	4,000
Wages	40,000	Closing Stock	60,000
Add : Outstanding	2,000		
Coal, Gas & Coke	11,600		
Gross Profit c/d	60,400		
	2,96,000		2,96,000
Salaries	10,000	Gross Profit b/d	
Rent	5,600	Commission Received	
Add : Outstanding	1,000	Received	4,000
Repairs	3,200	Add : Accrued	
Bad Debts	11,000	Commission	2,000
Add : New Reserve	4,500		
	15,500		
Less : Old Reserve	9,000		
Interest on Loan	1,200		
Add : Interest Oustanding	1,200		
Depreciation			
Plant & Machinery	4,000		
Furniture & Fixture	800		
Net Profit Transferred to Capital A/c	32,500		
	66,400		66,400

Balance Sheet of M/s Saritha & Co.
as at 31-12-2022

<i>Liabilities</i>	<i>Amount</i> ₹	<i>Assets</i>	<i>Amount</i> ₹
Sundry creditors	60,000	Cash in Bank	50,000
Loan	20,000	Bill Receivable	16,000
Interest outstanding	1,200	Sundry Debtors	90,000
Outstanding Expenses :		Less : Reserve for	
Wages	2,000	Doubtful Debts	4,500
Rent	1,000	Closing Stock	60,000
Capital	3,00,000	Furniture & Fixture	8,000
Add : Net Profit	32,500	Less : Dep.	800
	3,32,500	Plant & Machinery	80,000
		Less : Dep.	4,000
		Land & Building	1,20,000
		Commission Accrued	2,000
	4,16,700		4,16,703

Illustration : 5

From the following balances of the year ending 31st December, 2022 and additional information prepare the Trading and Profit and Loss Account and the Balance Sheet of M/s Rajkamal and Sons.

	₹		₹
Capital	1,60,000	Insurance	1,200
Purchases	1,64,000	Salaries	25,000
Sales	2,20,000	Bad Debts	400
Return Outwards	2,000	Carriage on Purchase	400
Buildings	90,000	Commission (Cr.)	3,000
Opening Stock	30,000	Cash in Hand	10,000
Debtors	40,200	Cash at Bank	50,000
Creditors	56,000	Sales Tax Paid	10,000
Furniture	14,000	Sales Tax Collected	7,000
Wages	3,200	Interest on Investments	1,000
Rent	10,200		

Adjustments

- Closing Stock was valued at ₹40,000
- Provide Depreciation on building @5% and on furniture @10%
- Outstanding salaries ₹2,000.
- Unexpired insurance ₹100.
- Accrued commission ₹600
- Provide for Manager's Commission at 5% on net profit after charging such commission

Trading and Profit & Loss Account

for the ended 31st December, 2022

Dr.

Cr.

<i>Particulars</i>	<i>Amount</i> ₹	<i>Particulars</i>	<i>Amount</i> ₹
To Opening Stock	30,000	By Sales	2,20,000
To Purchases 1,64,000		By Closing Stock	40,000
Less : Return Outward 2,000	1,62,000		
To Wages	3,200		
To Carriage on Purchases	400		
To Gross Profit c/d	64,000		
	<u>2,60,000</u>		<u>2,60,000</u>
To Rent	10,200	By Gross Profit b/d	64,000
To Insurance 1,200		By Interest on Investment	1,000
Less : Unexpired Insurance 100	1100	By Commission 3,000	
To Salaries 25,000		Add : Accrued	
Add : Outstanding		Commission 600	3,200
Salaries 2,000	27,000		
To Bad Debts	400		
To Depreciation on :			
Building 4,500			
Furniture 1,400	5,900		

To Net Profit before Manager's Commission	2,400		
	68,600		68,600
To Manager's Commission (5/105 x 12,000)	1,142	By Net Profit before Manager's Commission	24,000
To Net Profit after Manager Commission	22,858		
	24,000		24,000

Balance Sheet of M/s Saritha & Co.
as at 31st December, 2022

<i>Liabilities</i>	<i>Amount</i> ₹	<i>Assets</i>	<i>Amount</i> ₹
Creditors	28,000	Cash in Hand	5,000
Outstanding Salary	1,000	Cash at Bank	25,000
Manager's Commission	571	Closing Bank	20,000
Capital	1,60,000	Debtors	40,200
Add : Net Profit	<u>22,858</u>	Advance Sales Tax Paid	3,000
	1,82,858	(Sales Tax Paid - Sales Tax Collected)	
		Accrued Commission	600
		Prepaid Insurance	100
		Building	90,000
		Less : Depreciation	<u>4,500</u>
		Furniture	14,000
		Less : Depreciation	<u>1,400</u>
			12,600
	<u>1,42,000</u>		<u>1,42,000</u>

13. *Abnormal Losses*

Such loss over because of fire, earthquakes or accidents. These may destroy some Bexed assets of the tion, In such case an Asset Account is credited and the Profit and toss Account is debited. The debit may be spread over two or three years.

Stock of goods may also be destroyed or damaged by fire, or other causes. It is obvious that because of this, the value of the stock will be lower than otherwise. This will reduce the amount of gross and net profit. It is, however, better to ascertain the geoss poollt which would have been earned without the loss since this enables the firm wudge to trading operations property. To nullify the effect of loss of stock, the Trading Account is credited with the cost of the goods destroyed. If the goods destroyed are got insured then the cost price of the goods destroyed is debited to Profit and Loss Account to the goods are insured, then the claim admitted by the insurance company is Jeducted and the claim not admitted is debited to the Profit and Loss Account. The adjusting cutrios are as follows:

(i) Accidental Loss of Stock A/c

or Loss by Fire	...Dr.	[Total Value of Abnormal Loss]
To Trading A/c		

(ii) Insurance Claim or Insurance Co. ...Dr. [Amount of Insurance Claim]

Profit and Loss A/c	...Dr.	[Value of Irrecovered Loss]
---------------------	--------	-----------------------------

To Accidental Loss of Stock A/c		[Total Value of Abnormal Loss]
---------------------------------	--	--------------------------------

Insurance Company's Account will be shown as an asset in Balance Sheet

Note : If stock is not insured, following entry will be passed.

Profit and Loss A/c	...Dr.	[Total Value of Abnormal Loss]
To Trading A/c		

Illustration : 5

On 31st Dec. 2012 stocks worth ₹8,00,000 were destroyed by fire. The stock was insured and the insurance company admitted the claim of ₹6,00,000 only. Give the necessary journal entries and show how it will be treated in the Final Accounts.

Solution :

<i>Date</i>	<i>Particulars</i>	<i>LF</i>	<i>Debit (₹)</i>	<i>Credit (₹)</i>
2013				
Dec. 31	Loss by Fire A/c To Trading A/c (Being loss of stock by fire)	Dr.	8,00,000	8,00,000
Mar.31	Insurance Co. P & L A/c To Loss by fire A/c (Being insurance co. admitted a partial claim only)	Dr. Dr.	6,00,000 2,00,000	8,00,000

Trading and Profit & Loss Account

Dr. *for the ended 31st December, 2022* **Cr.**

<i>Particulars</i>	<i>₹</i>	<i>Particulars</i>	<i>₹</i>
		By Loss by Fire A/c	8,00,000

Profit and Loss Account

Dr. *for the ended 31st December, 2022* **Cr.**

<i>Particulars</i>	<i>₹</i>	<i>Particulars</i>	<i>₹</i>
To Loss by fire	8,00,000		
Less : Ins. Claim	6,00,000		

Balance Sheet
as at 31st Dec. 2022

Dr.

Cr.

<i>Particulars</i>	₹	<i>Particulars</i>	₹
		Current Assets	
		Claim due from Insurance Co.	6,00,000

Illustration : 6

From the following Ledger balances of Mr. Ghanshyam, prepare the Trading and Profit and Loss Account for the year ended 31st March 2022 and the Balance Sheet as on that

<i>Particulars</i>	<i>Amount</i> ₹	<i>Particulars</i>	<i>Amount</i> ₹
Trade Expenses	8,000	Purchases	8,20,000
Freight and Duty	20,000	Stock on (1-4-2012)	1,50,000
Carriage Outwards	5,000	Plant and Machiner (1-4-2012)	2,00,000
Sundry Debtors	2,06,000	Plant and Machinery (additions on 1-10-2012)	50,000
Furniture and Fixtures	50,000	Drawings	60,000
Return Inwards	20,000	Capital	8,00,000
Printing and Stationery	4,000	Reserve for Doubtful Debts	8,000
Rent, Rates and Taxes	46,000	Rent for Premises Sublet	16,000
Sundry Creditors	1,00,000	Insurance Charges	7,000
Sales	12,00,000	Salaries and Wages	2,13,000
Return Outwards	10,000	Cash in Hand	62,000
Postage and Telegraphs	8,000	Cash at Bank	2,05,000

Adjustments

- (i) Stock on 31st March 2013 was ₹1,40,000
- (ii) Write off ₹6,000 as Bad Debts.
- (iii) Provision for Doubtful Debts is to be maintained @5%
- (iv) Provide Depreciation on furniture and fixtures at 5% p.a. and on plant and machinery at 20% p.a.
- (v) Insurance prepaid was ₹1,000

- (vi) A fire occurred in the godown and stock of the value of 50,000 was destroyed. It was insured and the insurance company admitted full claim.

14. Drawings of Goods by the Proprietor

When the proprietor draws some goods or cash from the business for his/her personal use, it is a drawing

Trading and Profit & Loss Account

Dr.

for the ended 31st December, 2022

Cr.

<i>Particulars</i>	<i>Amount</i> ₹	<i>Particulars</i>	<i>Amount</i> ₹
To Opening Stock	1,50,000	By Sales	12,00,000
To Purchases	8,20,000	Less : Return Inwards	20,000
Less : Return Outwards	10,000	By Loss of Stock by Fire A/c	50,000
To Freight and Duty	20,000	By Closing Stock	1,40,000
To Gross Profit c/d	3,90,000		
	<u>13,70,000</u>		<u>13,70,000</u>
To Trade Expenses	8,000	By Gross Profit b/d	3,90,000
To Carriage Outwards	5,000	By Rent for Premises	16,000
To Depreciation on Furniture and Fixtures	2,500		
To Dep. on Plant and Machinery			
2,00,000 x 20/100	40,000		
5,000 x 20/100 x 6/12	5,000		
	<u>45,000</u>		
To Printing & Stationery	4,000		
To Rent, Rates and Taxes	46,000		
To Insurance	7,000		
Less : Prepaid	1,000		
	<u>6,000</u>		
To Salaries and Wages	2,13,000		
To Postage and Telegraphs	8,000		

To Provision for Doubtful Debts (Closing)			
(2,00,000 x 5/100)	10,000		
Add : Bad Debts	<u>6,000</u>		
	16,000		
Less : Provision for Doubtful Debts (Opening)	<u>8,000</u>	8,000	
To Net Profit transferred to Capital A/c		60,500	
		<u>4,06,000</u>	<u>4,06,000</u>

Balance Sheet of M/s Saritha & Co.
as at 31st March, 2022

<i>Liabilities</i>	<i>Amount</i> ₹	<i>Assets</i>	<i>Amount</i> ₹
Current Liabilities		Current Assets	
Sundry Creditors	1,00,000	Cash in Hand	62,000
Capital		Cash at Bank	2,05,000
Opening Balance	8,00,000	Sundry Debtors	2,06,000
Add : Net Profit	<u>60,500</u>	Less : Further Bad Debts	<u>6,000</u>
	8,60,500		2,00,000
Less : Drawings	<u>60,000</u>	Less : Provision for Doubtful Debts	<u>10,000</u>
	8,00,500		1,90,000
		Closing Stock	1,40,000
		Insurance Claim	50,000
		Prepaid Insurance	1,000
		Fixed Assets	
		Furniture and Fixture	50,000
		Less : Depreciation	<u>2,500</u>
			47,500
		Plant and Machinery	2,50,000
		Less : Depreciation	<u>45,000</u>
			2,05,000
	<u>9,00,500</u>		<u>9,00,500</u>

Adjustments

- (i) Closing Stock - ₹6,000.
- (ii) Goods costing ₹1,000 were distributed as free samples while goods costing ₹500 were taken by the proprietor for personal use.
- (iii) A credit sale of ₹2,000 was not recorded in the sales book.
- (iv) Closing Stock included goods costing ₹1,000 which were sold and recorded as sales but not delivered to the customer.
- (v) Maintain provision for Doubtful Debts @5%
- (vi) Only one-third advertising expenses are to be written off.

Solution

Trading and Profit & Loss Account

for the ended 31st March, 2022

Dr.

Cr.

<i>Particulars</i>	<i>Amount</i> ₹	<i>Particulars</i>	<i>Amount</i> ₹
To Opening Stock	4,500	By Sales	66,420
To Purchases	30,000	Add : Credit Sales	2,000
Less : Free Samples	1,000		68,420
	<u>29,000</u>	By Closing Stock	6,000
Less : Drawing of Goods	500	Less : Cost of Goods Sold	
	28,500	but not delivered	1,000
To Wages	4,600		5,000
To Gross Profit c/d	35,820		
	73,420		73,420
To Salaries	10,600	By Gross Profit b/d	35,820
To Interest on Loan	400	By Old Pro.	
Add : Outstanding Interest		for Bad debts	2,500
on Loan	100	Less : Bad Debts	1,200
	500		1,300
To Insurance Premium	900	Less : New Provision	1,100
To Rent	1,520	By Discount Received	400
To Carriage Outwards	600	By Bad Debts Recovered	200
To Depreciation of Furniture	2,500	By Interest on Investment	2,000
To Advertisement	2,500	By Trading Commission	7,000
To Free Samples	1,000		
To Net Profit transferred to Capital A/c	25,500		
	<u>45,620</u>		<u>45,620</u>

Balance Sheet of M/s Saritha & Co.
as at 31st March, 2022

<i>Liabilities</i>	<i>Amount</i> ₹	<i>Assets</i>	<i>Amount</i> ₹
Capital	50,000	Bill Receivable	6,000
Add : Net Profit	25,500	Investment	40,000
	<u>75,500</u>	Furniture	12,000
Less : Drawings	<u>500</u>	Debtors	20,000
10% Loan	10,000	Add : Credit Sales Not Recorded	<u>2,000</u>
Outstanding Interest on Loan	100		22,000
Creditors	9,300	Less : New Provision	<u>1,100</u>
Bills Payable	5,000	Accrued Commission	1,000
Outstanding Salaries	500	Closing Stock	5,000
		Bank	10,000
		Unexpired Advertisement Exp.	5,000
	<u>99,900</u>		<u>99,900</u>

Summarised view of Adjustment Entries

<i>Adjustment</i>	<i>Adjustment entry</i>	<i>Treatment in Trading and Profit & Loss A/c</i>	<i>Treatment in Balance Sheet</i>
1. Closing Stock	Closing stock A/c Dr. To Trading A/c	Shown on the credit side of Trading A/c	Shown on the Assets side
2. Outstanding expenses	Expenses A/c Dr. To Outstanding expenses A/c	Added to respective expenses on the debit side	Shown on the liabilities side
3. Prepaid expenses	Prepaid Expenses A/c Dr. To Expenses A/c	Deducted from the respective expenses on the debit side	Shown on the Assets side
4. Accrued income	Accrued income A/c Dr. To Income A/c	Added to the respective income on the credit side	Shown on the Assets side
5. Income received in advance	Income A/c Dr. To income received in advance A/c	Deducted from the respective income on the credit side	Shown on the liabilities side

6. Interest on capital	Interest on capital A/c To capital A/c	Dr.	Shown on the debit side of P&L A/c	Shown as addition to capital on liabilities side
7. Interest on drawings	Capital A/c To interest on drawing A/c	Dr.	Shown on the credit side P&L A/c	Shown as deduction to capital on liabilities side
8. Depreciation	Depreciation A/c To Assets A/c	Dr.	Shown on the debit side P&L A/c	Deducted from the value of Assets
9. Further bad debts	Bad Debts A/c To Debtors A/c	Dr.	Shown on the debit side P&L A/c	Deducted from debtors, shown on Assets side
10. Provision for bad and doubtful debts	Profit & Loss A/c To Provision for bad and doubtful debts	Dr.	Shown on the debit side P&L A/c	Shown as deduction from debtors on Assets side.
11. Provision for Discount on Debtors	Profit & Loss A/c To Provision for Discount	Dr.	Shown on the debit side P&L A/c	Shown in liability side
12. Commission to Manager	Profit & Loss A/c To Manager's Commission	Dr.	Shown on the debit side P&L A/c	Shown as deduction from concerned Asset on Assets side.
13. Extra Ordinary Loss	Profit & Loss A/c To Extra Ordinary Loss	Dr.	Shown on the debit side P&L A/c	Shown as deduction from concerned Asset on Assets side.
14. Drawings of goods by the Owner	Drawing A/c To Purchases A/c	Dr.	To be deducted from purchases.	Shown as deduction from Capital on Liabilities side.
15. Distribution of goods as free samples	Advertisement A/c To Purchases A/c	Dr.	To be deducted from purchases.	Shown on debit side of P & L A/c

What you have Learnt

- Financial statements are of two types namely Income Statement (Trading and Profit & Loss Account) and Balance Sheet or Position Statement
- Trading Account is prepared to ascertain the results of the trading activities of the business.
- Trading Account may show profit (i.e. the excess of sales to cost of goods sold excess of credit side over debit side), which is termed as Gross Profit.
- Trading Account may show loss (i.e. Cost of goods sold exceeds sales or total of debit side exceeds total of credit side). This is called Gross Loss.
- Profit and Loss Account is prepared to find out Net Profit/Net Loss.

$\text{Net Profit} = \text{Gross Profit} + \text{other incomes} - \text{Indirect expenses.}$

may also show a net loss.

All indirect expenses are shown on the debit side of Profit & Loss Account.

All incomes and gains are shown on the credit side of Profit & Loss Account.

- Balance Sheet is prepared to ascertain the financial position of a firm on a particular date.
- Adjustments are needed to be accounted for so that Income Statement and Position Statement show the correct profit or loss and financial position.
- There can be items of income and expenditure which do not pertain to the accounting year for which financial statements are being prepared. These are to be excluded. These are called prepaid items.
- There can be items of expenses and income which are left out and are to be accounted, which are called outstanding expenses or accrued incomes
- Other important adjustments to be carried out are Closing Stock, Depreciation on fixed assets, interest on capital and interest on Drawings.
- There may be further bad debts and provision for bad and doubtful debts need to be made on debtors.
- Further bad debts are irrecoverable debts in addition to what has been shown in the Trial Balance as bad debts
- Provision for bad and doubtful debts is created for future payments due from debtors but seems to be irrecoverable. It is created on the basis of past experiences.
- The Process of creating provision for discount on debtors is same as provision for doubtful debts. The likely amount of the discount to be allowed is debited to the P&L A/c and the same will be deducted from debtors in the balance sheet.

- If the manager is allowed commission on the net profit before charging such commission then the following formula should be used:

$$\text{Net Profit} \times \frac{\% \text{ of commission}}{100}$$

and if the manager is entitled for commission. On the net profit after charging such commission then the following formula should be used :

$$\text{Net Profit} \times \frac{\% \text{ of commission}}{100 + \% \text{ of commission}}$$

- Abnormal losses occur because of fire, earthquakes or accidents. These may destroy some fixed assets of the firm. In such case an Asset Account is credited to trading A/c and debited to profit and loss A/c debited.
- Drawings of goods by the proprietor is deducted from purchases on the debit side of Trading A/c., and deducted from capital in Balance Sheet.
- Goods distributed as free sample is deducted from purchases and shown in the debit side of P&L A/c as advertisement.

Terminal Exercise

Section - A

1. Meaning of financial statements.
2. Trading Account
3. Profit & Loss Account
4. Balance Sheet
5. Revenue Expenditure
6. Revenue Receipt
7. Capital Expenditure
8. Capital Receipt
9. Cost of Goods Sold
10. Gross Profit
11. Net Profit
12. Direct Expenses
13. Intangible Assets
14. Fictitious Assets

Section - B

1. Explain the objectives of preparation of financial statements.
2. Write any differences between capital and revenue expenditure.
3. How is cost of goods sold calculated
4. What is meant profit and loss account ? Why is it prepared ?
5. What is meant by balance sheet ?
6. Write the proforma of trading account ?
7. Write the proforma of profit and loss account ?
8. Write the proforma of balance sheet ?
9. What are owner's funds ?
10. Answer the following questions in brief.
 - (a) Why are adjustments needed ?
 - (b) Why are outstanding expenses treated as liabilities?
 - (c) What is the difference between accrued income and unearned income?
11. Pass necessary journal entries for following adjustments:
 - i. Wages outstanding ii. Depreciation on Furniture
 - iii. Interest on Investment accrued but not received
 - iv. Insurance Premium paid in advance
12. Why reserve is created for doubtful debts?
13. Pass necessary journal entries for the following adjustments :
 - i. $\frac{1}{3}$ rd of the total commission received during the year of ₹12000 relates to the next year
 - ii. Insurance premium of Rs. 8000 is paid for the year ending 30th June. Accounts are closed on 31st March every year.
 - iii. Interest on drawing is charged for the year amounting to ₹450.
14. Explain the following adjustment with examples :
 - i. Provision for discount on debtors. ii. Manager's Commission
15. What do you mean by Abnormal loss ? Also explain its accounting treatment with the help of an example.
16. Explain the accounting treatment of drawing of goods by the proprietor and goods distributed as free samples.

17. The following are the balances extracted from the books of Suresh on 31st March 2023. Prepare Trading Account.

	₹		₹
Opening Stock	6,500	Fuel & Power	3,200
Purchases	40,000	Cash	4,500
Sales	70,000	Office Expenses	3,200
Return Inward	1,500	Office Rent	6,800
Return Outward	500		
Carriage on Purchases	1,200		
Wages	4,800		

Closing stock as on 31st March 2023 was Rs. 8,600

18. The following are the balances extracted from the books of Praveen on 31st March 2023. Prepare Profit & Loss A/c

	₹		₹
Gross Profit	64,800	Discount Received	600
Bad debts	1,500	Commission Received	2,100
Depreciation	2,500	Prepaid Insurance	600
Office rent	4,800	Salary	6,400
Insurance	3,200	Stationery	700
Telephone charges	1,700		
Interest on loan	2,400		

Closing stock as on 31st March 2023 was Rs. 30,000

18. From the balances given below prepare Balance Sheet of M/s Raju & Bros as on 31st December, 2023.

Particulars	₹	Particulars	₹
Capital	5,000	Sundry debtors	2,400
Loan from bank	2,000	Bills payable	800
Cash in hand	250	Drawings	600
Cash at bank	1,280	Building	2,500
Closing stock	2,470	Furniture	450
Sundry creditor	1,500	Investments	1,500
		Net Profit	320

Section - C

1. From the following trial balance of M/s V.B. Fertilizers prepare Trading & Profit and Loss Account for the year ending 31 December, 2023 and Balance Sheet as on that date. Also pass Journal entries for the adjustments :

Particulars	Dr. ₹	Particulars	Cr. ₹
Stock (1-1-2023)	13,800	Capital	65,000
Purchases	52,000	Bills payable	18,000
Wages	4,000	Sales	74,400
Return inward	2,400	Return outward	1,500
Land & Building	40,000	Discount	450
Plant & Machinery	24,500	Creditor	6,500
Bills receivable	12,000	Interest	600
Debtors	5,500	Bad debts Reserve	250
Cash in hand & at Bank	8,750	Loan	8,000
Rent (office)	2,200	Commission	700
Bad Debts	400		
Insurance	1,500		
Freight inward	1,400		
Fuel & Power	2,450		
Furniture	4,500		
	1,75,400		1,75,400

Adjustments

- (i) Stock on 31-12-2023 ₹25,000.
- (ii) Write off depreciation on furniture 10% and on plant & machinery 20%.
- (iii) Provide for wages outstanding ₹650 and rent outstanding ₹200. Prepaid insurance amounted to ₹300.
- (iv) Further bad debts amounted to ₹100. Make a provision for bad & doubtful debts @5% on debtors.
- (v) Interest on capital to be allowed @ 6%.

2. On 1st April, 2023 reserve for Bad Debts shows a balance of ₹3,200 Bad debts during the year as per ledger were ₹2,100. Debtors amounted to ₹7,000. After closing of the ledger, it was found that there were bad debts of ₹800. It was decided to create a reserve for doubtful debts on creditors @6%.

Pass necessary journal entries and show the items in Profit & Loss account and Balance Sheet.

3. From the following trial balance of Pranaya as at 31st December, 2022, prepare Trading and Profit & loss account for the year ended 31st December, 2022 and a Balance Sheet as on that date after making necessary adjustments. Also Give journal entries for these adjustments.

<i>Name of the Account</i>	<i>Dr. Balances</i> ₹	<i>Cr. Balances</i> ₹
Pranaya's Capital Account		1,00,000
Drawings	24,000	-
Plant and Machinery	45,000	-
Stock (1st Jan. 2022)	15,000	-
Purchases	85,000	-
Return inwards	5,000	-
Sundry Debtors	24,600	-
Freight and duty	2,000	-
Carrige outwards	1,600	-
Rent Rates & Taxes	3,800	-
Sundry Creditors	-	22,000
Postage & Courier Expenses	1,800	-
Sales	-	1,35,000
Provision for Bad Debts	-	600
Discount	-	800
Insurance Premium	900	-
Wages	23,000	-
Cash in Hand	6,200	-
Cash at Bank	20,500	-
	2,58,400	2,58,400

Adjustments

- (i) Stock on 31st December, 2022 was valued at ₹24,000.
 - (ii) Write off ₹600 as bad debts.
 - (iii) Provision for doubtful debts is to be maintained at 5% on sundry debtors.
 - (iv) Provide depreciation on plant and machinery at 20%. A machine costing ₹1,500 was purchased on 1st July, 2022
 - (v) Wages outstanding amounted to ₹1,500, and Insurance Prepaid was ₹250.
4. The following are the balances extracted from the books of Chinmay Aggarwal on 31st March 2022.

	₹		₹
Chinmay's Capital	60,000	Stock (1-4-2021)	44,200
Furniture & Fixtures	5,000	Debtors	36,000
Bank Overdraft	8,400	Rent received	2,000
Creditors	27,600	Purchases	2,20,000
Business Premises	50,000	Sales	3,00,000
Discount (Dr)	3,200	Sales Returns	4,000
Tax & Insurance	4,000	Bills Payable	10,000
Salaries	20,000		
Commission (Cr.)	2,000		
Carriage inward	3,600		
Bad Debts	1,600		
Motor Vehicle	14,400		
Investments	4,000		

Following adjustments are to be made :

- (i) Stock on 31 March, 2022 ₹ 35,000
- (ii) Write off depreciation on : Business Premises ₹800
Furniture & Fixture ₹500, Motor Vehicle 10% p.a.
- (iii) Interest on bank overdraft 150.
- (iv) Interest on capital was to be allowed 6% p.a.
- (v) Make a provision of 5% on debtors for doubtful debts.
- (vi) Carry forward ₹500 for unexpired insurance.

You have already learnt about preparation of accounts of sole proprietary form of business organisation. But, when a business expands, it goes beyond the capacity of one person to provide the capital and manage the affairs of the expanded business. A need is felt to combine his/her efforts and capital with those of another person/persons. This gives rise to the partnership form of business organisation.

As far as recording of business transactions in the books of original entry, their posting to ledger and preparing financial statements are concerned there is no difference between a sole proprietor or a partnership firm. But there are certain issues which are specific to partnership firm and require separate accounting treatment. These issues are appropriation of profits of the firm, treatment of goodwill on various occasions and so on. This lesson discusses on such issues related to partnership firms.

Objectives

After studying this lesson, you will be able to:

- Understand the meaning and characteristics of partnership, partnership deed;
- Describe accounting treatment of specific issues regarding partnership in the absence of partnership deed;
- State the meaning and preparation of capital account - fluctuating and fixed capital account;
- Prepare the Profit and Loss Appropriation account;
- Accounting aspects of admission of partner;
- Accounting aspects of retirement of partner;
- Accounting aspects of Death of partner;
- Accounting aspects of Dissolution of partnership firm;

9.1.1 Partnership Meaning

Partnership is a form of business organisation, where two or more persons join hands to run a business. They share the profits and losses according to the agreement amongst them.

According to the Indian Partnership Act 1932,

“Partnership is relation between persons who have agreed to share profits of a business carried on by all or any one of them acting for all”.

For example, one of your friends has passed class XII from Telangana Open School Society (TOSS) and wants to start a business. He/she approaches you to join in this venture. He/she wants you to contribute some money and participate in the business operations. Both of you if join hands, constitute a partnership.

Following are the characteristics of partnership :

- **Agreement:** A partnership is formed by an agreement. The agreement may be either oral or in writing. It defines the relationship between the partners and their roles in the business, who agrees to carry on business. The partnership agreement may contain the terms of sharing profit and the capital to be contributed by each partner, etc. such written agreement is known as partnership deed.
- **Number of persons:** According to section 464 of the Indian Companies Act, 2013 there must be minimum two persons to form a partnership and the maximum number of partners in a partnership firm can be 50.
- **Business:** The Partnership is formed to carry on business with a purpose of earning profits. Mere co ownership of a property does not result in partnership. For example, if X and Y jointly purchases of piece of land, they become the joint owners of the property and not the partners. But if they are in the business of purchase and sale of land for the purpose of earning profit, they will called partners. The business should be lawful. Thus, if two or more persons agree to carry on unlawful activities, it will not be termed as partnership.
- **Sharing Profits:** The partners agree to share profits in the agreed ratio. In case of loss, all the partners have to bear it in the same agreed profit sharing ratio.
- **Mutual Agency :** Every partner is an agent of the other partners. Every partner can bind the firm and all other partners by his/her acts. Each partner will be responsible and liable for the acts of all other partners.
- **Unlimited liability:** The liability of each partner, except that of a minor, is unlimited.

Their liability extends to their personal assets also. If the assets of the firm are insufficient to pay off its debts, the partners' personal property can be used to satisfy the claim of the creditors of the partnership firm.

- **Management :** All the partners have a right to manage the business. However, they may authorize one or more partners to manage the affairs of the business on their behalf.
- **Transferability of Share :** No partner can transfer his/her share to anyone including his/her family member without the consent of all other partners.

9.1.2 Partnership Deed

- **Partnership Deed:** Agreement forms the basis of partnership. The written form of the agreement is which a document of partnership is. It contains terms and conditions regarding the conduct of the business. It also explains relationship between the partners. This document is called partnership deed.

Every firm can frame its own partnership deed in which the rights, duties and liabilities of the partners are stated in detail. It helps in settling the disputes arising among the partners during the general conduct of business.

- **Contents of Partnership Deed :** The partnership deed generally contains the following :
 - (i) Name and address of the partnership firm;
 - (ii) Nature and objectives of the business;
 - (iii) Name and address of each partner;
 - (iv) Ratio in which profits is to be shared;
 - (v) Capital contribution by each partner;
 - (vi) Rate of Interest on capital if allowed;
 - (vii) Salary or any other remuneration to partners, if allowed;
 - (viii) Rate of interest on loans and advances by a partner to the firm;
 - (ix) Drawings of partners and interest thereon, if any
 - (x) Method of valuation of goodwill and revaluation of assets and liabilities on the reconstitution of the partnership i.e. on the admission, retirement or death of a partner;

- (xi) Settlement of disputes by arbitration;
- (xii) Settlement of accounts at the time of retirement or death of a partner;
- (xiii) Circumstances in which the firm can be dissolved;
- (xiv) Settlement of accounts at the time of dissolution of a firm.

- **In the Absence of the Partnership Deed:** In the absence of partnership deed, the following issues may arise: profit sharing ratio; interest on capital; interest on drawings; interest on loan and salary of the partners. In such cases, the provisions of the Indian Partnership Act, 1932 becomes applicable:

According to Partnership Act, in the absence of partnership deed the following rules are applicable:

- (i) **Distribution of Profit:** Partners are entitled to share profits equally.
- (ii) **Interest on Capital:** Interest on capital is not allowed.
- (iii) **Interest on Drawings:** No interest on drawing of the partners is to be charged.
- (iv) **Interest on Partner's Loan:** A Partner is allowed interest @ 6% per annum on the amount of loan given to the firm by him/her.
- (v) **Salary and Commission to Partner:** A partner is not entitled to any salary or commission or any other remuneration for managing the business operations.

9.1.3 Capital Account : Meaning and Preparation

Partners contribute their share of capital in business. These are recorded in their respective accounts named as capital accounts. Suppose there are two partners X and Y, there will be X's capital account and Y's capital account. These accounts may be maintained in two ways as mentioned hereunder:

(a) Fixed Capital Account

In fixed capital account, the closing balance of the capital account is same as that of opening balance except when additional capital is introduced or there is permanent withdrawal during the current accounting year. Items relating to capital account such as interest on capital, interest on drawings and share of profit etc., are recorded in capital account. But in this case a separate account is opened for each partner to record these items. This account is known as 'current account'. A current account may show a debit or a credit balance. Format of the fixed capital account and the current account is as under:

Dr.**Partner's Capital Account****Cr.**

<i>Date</i>	<i>Particulars</i>	<i>J.F.</i>	<i>Amount (Rs.)</i>	<i>Date</i>	<i>Particulars</i>	<i>J.F.</i>	<i>Amount (Rs.)</i>
	Bank (Permanent withdrawal of Capital)		xxx		Balance b/d (Capital contribution opening balance)		xxx
	Balance c/d (Closing balance)		xxx		Bank (Additional Capital introduced)		xxx

Dr.**Partner's Current Account****Cr.**

<i>Date</i>	<i>Particulars</i>	<i>J.F.</i>	<i>Amount (Rs.)</i>	<i>Date</i>	<i>Particulars</i>	<i>J.F.</i>	<i>Amount (Rs.)</i>
	Bank b/d (in case of debit opening Balance)		xxx		Bank b/d (in case of credit opening Balance)		xxx
	Drawing A/c				Salary Interest on capital		xxx
	Interest on Drawings A/c		xxx		Profit and Loss Appropriation (for share of profit)		xxx
	Profit and Loss Appropriation (for share of loss)		xxx		Balance c/d (in case of debit closing balance)		
	Balance c/d (in case of credit closing balance)						
			xxx				xxx

(a) Fluctuating Capital Account

When capital account for each partner is so maintained that in addition to the capital amount other items related to capital account such as interest on capital, drawings, net profit or net loss etc., are written in this account, it is called as fluctuating capital. In this case there is no need to maintain a separate account for recording of these adjustments.

In the absence of any information, the capital account should be prepared by this method. The format of fluctuating capital account is as follows:

Partner's Capital Account

Dr.

Cr.

Date	Particulars	J.F.	Amount (Rs.)	Date	Particulars	J.F.	Amount (Rs.)
	Balance b/d (in case of Debit Opening balance)				Balance b/d (in case of Credit Opening Balance)		xxx
	Drawings		xxx		Bank		
	Interest on Drawings				(Additional Capital		
	Profit and Loss Appropriation (for share of loss)		xxx		Introduced) A/c		xxx
	Balance c/d (in case of credit closing balance)		xxx		Salaries A/c		
					Interest on Capital		xxx
					Profit and Loss Appropriation (for share of profit)		
					Balance c/d (in case of debit closing balance)		xxx
			xxx				xxx

Illustration 1

Roja and Madhu are partners in a firm. Following information is provided as on 31st December, 2022:

	Roja (Rs.)	Madhu (Rs.)
Capital (as on 01.01.2022)	50,000	40,000
Drawings	5,000	4,000
Interest on Capital	4,000	2,500
Interest on Drawings	960	480
Share of Profit	6,000	4,500

Prepare capital account of each partner if capital is : (a) fixed, (b) fluctuating.

Solution :

(a) Fixed capital account

Dr. Capital Account Cr.

<i>Date 2022</i>	<i>Particulars</i>	<i>J.F.</i>	<i>Roja (Rs.)</i>	<i>Madhu (Rs.)</i>	<i>Date 2022</i>	<i>Particulars</i>	<i>J.F.</i>	<i>Roja (Rs.)</i>	<i>Madhu (Rs.)</i>
Dec. 31	Balance c/d		50,000	40,000	Jan. 1	Balance b/d		50,000	40,000
			50,000	40,000				50,000	40,000

Dr. Current Account Cr.

<i>Date 2022</i>	<i>Particulars</i>	<i>J.F.</i>	<i>Roja (Rs.)</i>	<i>Madhu (Rs.)</i>	<i>Date 2022</i>	<i>Particulars</i>	<i>J.F.</i>	<i>Roja (Rs.)</i>	<i>Madhu (Rs.)</i>
Dec.31	Drawings		5,000	4,000	Dec.31	Interest on Capital		4,000	2,500
Dec.31	Interest on drawings		960	480	Dec.31	Profit and Loss Appropriation A/c		6,000	4,500
Dec.31	Balance c/d		4,040	2,520				10,000	7,000
			10,000	7,000	Jan. 1	Balance b/d		4,040	2,520

(b) Fluctuating Capital Account

Dr. Capital Account Cr.

<i>Date 2022</i>	<i>Particulars</i>	<i>J.F.</i>	<i>Roja (Rs.)</i>	<i>Madhu (Rs.)</i>	<i>Date 2022</i>	<i>Particulars</i>	<i>J.F.</i>	<i>Roja (Rs.)</i>	<i>Madhu (Rs.)</i>
Dec.31	Drawings		5,000	4,000	Dec.31	Balance b/d		50,000	40,000
	Interest on drawings		960	480		Interest on Capital		4,000	2,500
Dec.31	Balance c/d		54,040	42,520	Dec.31	Profit and Loss Appropriation A/c		6,000	4,500
			60,000	47,000				60,000	47,000
						Balance b/d		54,040	42,520

2. For Interest on Capital

For transferring on Interest on Capital :

Profit and Loss Appropriation A/c Dr.

 To Interest on Capital A/c

(Interest on capital transferred to Profit & Loss Appropriation A/c)

3. For Interest on Drawings

For transferring Interest on Drawings :

Interest on Drawings A/c Dr.

 To Profit and Loss Appropriation A/c

(Interest on drawing transferred to Profit & Loss Appropriation A/c)

4. For Partner's Salary

For transfer of partner's Salary

Profit and Loss Appropriation A/c Dr.

 To Salary A/c

(Salary transferred to profit & Loss Appropriation A/c)

5. For Partner's Commission

For transferring commission

Profit and Loss Appropriation A/c Dr.

 To Commission A/c

(Commission transferred to Profit and Loss Appropriation A/c)

6. For Transfer of agreed amount to General Reserve

Profit and Loss Appropriation A/c Dr.

 To General Reserve A/c

(Transfer to General Reserve)

7. For share of Profit or Loss appropriation

(a) If Profit

Profit and Loss Appropriation A/c Dr.

 To Partner's Capital/Current A/c

(Profit transferred to capital/current A/c)

(b) If Loss

Partner's Capital/ Current A/c Dr.
 To Profit and Loss Appropriation A/c
(Loss transferred to capital/current A/c)

The format of Profit and Loss Appropriation Account is given as follows.

Profit and Loss Appropriation Account

for the year ended on

Illustration 1

Ravi and Krishna are partners with a capital of Rs. 8,00,000 and Rs. 10,00,000 respectively. They agree on the following terms:

- (a) To share profit equally.
- (b) Interest allowed on capital @ 9% p.a.
- (c) Interest charged on drawings @ 6% p.a.
- (d) Salary to be paid to Krishna @ Rs. 6,000 per month.
- (e) Ravi withdrew Rs. 8,000 and Krishna Rs. 6,000 during the year.

Profit for the year ending December 31, 2022 was Rs. 5,60,000. You are required to prepare Profit and Loss Appropriation account.

Solution :

Working Notes:

First you should calculate the interest on capital and the interest on drawings

Interest on Capital

Ravi = ' 8,00,000 × 9/100 ' 72,000
Krishna = ' 10,00,000 × 9/100 ' 90,000

Interest on Drawings

Ravi Drawings = Rs. 8,000
Interest = ' 8,000 × 6/100 ' Rs. 480
Krishna's Drawings = Rs. 6,000
Interest = 6,000 × 6/100 ' Rs. 360

9.1.7 Guarantee of Profit

Sometimes, a partner is admitted in the firm on guarantee in respect of his minimum share of profit from the business. Such a guarantee can be given even to an existing partner also. Such a guarantee to the incoming partner is given either by :

- (a) the firm *i.e.* by all the old partners in an agreed ratio, or
- (b) some of the old partners or any one of the old partners

When all the partners guarantee that one of the partners shall be given a minimum amount of profit, we should calculate the following two amounts separately:

- i. Share of profit of the guaranteed partner as per profit sharing ratio, and
- ii. Minimum guaranteed amount of profit of the guaranteed partner.

The higher of the above two is to be given to that partner. The balance of profit (total profit minus profit given to the guaranteed partner) is to be shared by the remaining partners in their respective profit -sharing ratio.

When the new partner's share of profit is more than the guaranteed amount, his actual share of profit is given to him instead of the guaranteed amount of profit.

WHAT YOU HAVE LEARNT

- Characteristics of partnership are : (i) Agreement; (ii) Number of persons; (iii) Business; (iv) Sharing of Profits; (v) Unlimited liability; (vi) Management; (vii) Mutual Agency; (viii) Transferability of share
- **Partnership Deed:** The written form of the agreement. It is a document in which the terms and conditions regarding the conduct of the business and the relationship between the partners are laid down. If there is no partnership deed or it is silent on certain issues, the Partnership Act becomes applicable. These issues are : (i) Distribution of Profit; (ii) Interest on capital; (iii) Interest on drawings; (iv) Interest on partner's loan; (v) Salary and commission to partners
- **Capital Account:** The contribution made by the partner's in a business is called capital. This capital may be fixed or fluctuating.
 - (a) Fixed Capital Account- Two separate accounts are kept for each partner *i.e.* 'capital account' and 'current account'.
 - (b) Fluctuating Capital Account – Only one account for each partner is kept *i.e.* capital account,

- **Profit and Loss Appropriation Account:** All adjustments such as partner's salary, partner's commission, interest on capital, interest on drawings etc. are made through this account.
- **Guarantee of Profit:** In this case a minimum amount of profit is guaranteed to a partner. This amount shall be given to him if his share of profit is lower than the guaranteed amount. The deficit shall be borne either by one of the old partners or by all the old partners in a particular agreed ratio. If nothing has been agreed, then in their old profit sharing ratio of the remaining partners. If his actual share of profit is more than the guaranteed amount, then, he will be given his actual share of profit.
- **Past Adjustments:** If after closing the accounts for the year it is discovered that some errors have been committed or some omissions have been made then these errors have to be rectified. An adjustment entry has to be passed to rectify the error. The entries are made without disturbing the signed balance sheet only through the capital account. These entries are to rectify the errors committed in past, therefore they are known as 'Past Adjustments'.

Terminal Exercise

Section - A

1. Partnership
2. Partnership Deed
3. Fixed Capital
4. Fluctuating Capital
5. Profit & Loss Appropriation A/c

Section - B

1. Describe any four characteristics of a partnership.
2. What are the provisions that become applicable in the absence of any partnership deed,?
3. Distinguish between fixed and fluctuating capital accounts.
4. Why the Profit and Loss Appropriation Account is prepared?

5. Anil and Banu are partners in a firm. On January 1, 2023 their capital is Rs. 3,00,000 and 2,00,000 respectively. Their drawings during the year were Rs. 3,000 per month each. They allowed 6% interest on capital. The profit for the year is Rs. 4,00,000. Calculate interest on capital for the year 2020 when capitals are fixed.
6. Xing and Yang are equal partners. They withdrew Rs. 5,000 each per month. Calculate interest 4% p.a. on drawing in the following cases:
 - (i) if they withdrew in the beginning of each month:
 - (ii) if they withdrew at the end of each month:
 - (iii) if they withdrew in the middle of each month:
7. Nag and Arohi started business with capital of Rs. 1,00,000 each on January 1, 2021. Their drawings during the year were Rs. 1,000 and 500 per month respectively. The interest on drawing was Rs. 200 and 100 respectively. They are allowed interest on capital at 8% p.a. Nag is allowed a salary of Rs. 2,000 per month. They earned a profit of Rs. 94,000 before interest and salary. They share profit in the ratio of 2:1. Prepare Profit and Loss Appropriation Account for the year ended March 31, 2023 and Capital accounts of partners.
8. What do you mean by guarantee of profits? Explain in brief.
9. Explain Past Adjustments.

Section - C

1. Raghu and Shanu were partners in a firm and their balances on April 1, 2022 are as under:

	<i>Rohan</i> (Rs.)	<i>Bhanu</i> (Rs.)
Capital accounts	90,000	1,20,000
Current account	8,000 (Cr)	4,000 (Dr.)
Drawings	5,000	6,000

Net profit for the year 2022 before charging interest on capital and partners salary was Rs. 25,600. They agree on the following:

- (i) Profit and losses to be shared equally.
- (ii) 6% interest is to be allowed on capital.
- (iii) Shanu will be paid a monthly salary Rs. 9,000.

Prepare Profit and Loss Appropriation Account for the year ended on March 31, 2023 and partners' capital accounts.

2. The partnership agreement of X and Y provides that:

- (i) Profit will be shared in the ratio of 3 : 2.
- (ii) X will be allowed a salary of ₹ 500 p.m.
- (iii) 8% interest will be allowed on partner's fixed capital accounts.
- (iv) 6 % interest to be charged on partners drawings.
- (v) The fixed capital of M and R is Rs. 2,00,000 and 1,50,000 respectively. Their drawings were Rs. 10,000 and 12,000 respectively. The net profit for the year ending December 2021 amounted to Rs. 62,000.

Prepare Profit and Loss Appropriation Account.

ADMISSION OF PARTNER

Anil and Krishna are running a partnership firm dealing in toys. They are one of the most successful businessmen in the locality. They now decide to start manufacturing toys that are electronically operated to diversify their business. For this they need more capital and also technical expertise. Arun their friend is an electronic engineer and has capital also. They have persuaded him to join their firm. In case, he joins the partnership firm, this will be a case of admission of a partner. As a result, he may need to bring in capital and share of goodwill. In this lesson, you will learn about goodwill and other adjustments at the time of admission of a partner. Arun will bring in capital and share of goodwill. Some changes in the value of some assets and liabilities of the existing firm are needed to bring them at their realistic value, on his admission. There may be other issues involving finance on his admission. All this need accounting treatment. In this lesson you will learn accounting treatment and adjustments to be made on the admission of a new partner.

Objectives

After studying this lesson, you will be able to :

- Understand the meaning of admission of a partner;
- Find out new profit sharing ratio and sacrificing ratio;
- List out the factors affecting goodwill;
- Explain the methods of valuation of goodwill;
- Understand accounting treatment of goodwill;
- Explain the need for revaluation of assets and reassessment of liabilities;
- Illustrate the accounting treatment of changes arising from revaluation of assets and reassessment of liabilities;
- Explain accounting treatment of undistributed profits and reserves;
- Explain the treatment of various adjustments in partners' capitals; and
- Prepare Revaluation Account, Partners' Capital Accounts and balance sheet of the reconstituted firm.

9.2.1 Admission of Partner

Meaning, New Profit Sharing Ratio and Sacrificing Ratio

Meaning

An existing partnership firm may take up expansion/diversification of the business. In that case it may need managerial help or additional capital. An option before the partnership firm is to admit partner/partners. When a partner is admitted to the existing partnership firm, it is called admission of a partner.

According to the Partnership Act 1932, a person can be admitted into partnership only with the consent of all the existing partners unless otherwise agreed upon.

On admission of a new partner, the partnership firm is reconstituted with a new agreement. For example, Ramu and Neha are partners sharing profit in the ratio of 5:3. On April 1, 2023 they admitted Sinu as a new partner with 1/4th share in the profit of the firm. In this case, with the admission of Sinu as partner, the firm stands reconstituted.

On the admission of a new partner, the following adjustments are necessary:

- (i) Adjustment in profit sharing ratio;
- (ii) Adjustment of Goodwill;
- (iii) Adjustment for revaluation of assets and reassessment of liabilities;
- (iv) Distribution of accumulated profits and reserves; and
- (v) Adjustment of partners' capitals.

Admission of a Partner Adjustment in Profit sharing Ratio

When a new partner is admitted he/she acquires his/her share in profit from the existing partners. As a result, the profit sharing ratio in the new firm is decided mutually between the existing partners and the new partner. The incoming partner acquires his/ her share of future profits either from one or more existing partner. The existing partners sacrifice a share of their profit in the favour of new partner. Hence, the calculation of new profit sharing ratio becomes necessary.

Sacrificing Ratio

At the time of admission of a partner, existing partners have to surrender some of their share in favour of the newly admitted partner. The ratio in which they agree to sacrifice their share of profits in favour of incoming partner is called sacrificing ratio. Some amount is paid to the existing partners for their sacrifice. The amount of compensation is paid by

the new partner to the existing partners for acquiring the share of profit which they have surrendered in favour of the new partner.

Sacrificing Ratio is calculated as follows:

$$\text{Sacrificing Ratio} = \text{Existing Ratio} - \text{New Ratio}$$

Following cases may arise for the calculation of new profit sharing ratio and sacrificing ratio:

(i) Only the new partner's share is given

In this case, it is presumed that the existing partners continue to share the remaining profit in the same ratio in which they were sharing before the admission of the new partner. Then, existing partner's new ratio is calculated by dividing remaining share of the profit in their existing ratio. Sacrificing ratio is calculated by deducting new ratio from the existing ratio.

Illustration 1

Deepa and Tina are partners sharing profit in the ratio of 4 : 2. They admit Sita a new partner for $\frac{1}{4}$ share in profit. Calculate the new profit sharing ratio and sacrificing ratio.

Solution :

Calculation of new profit sharing ratio :

Let total Profit = 1

New partner's share	= $\frac{1}{4}$
Remaining share	= $1 - \frac{1}{4} = \frac{3}{4}$
Deepa's new share	= $\frac{4}{6}$ of $\frac{3}{4}$ i.e. $\frac{1}{2}$
Tina's new share	= $\frac{2}{6}$ of $\frac{3}{4}$ i.e. $\frac{1}{4}$
Sita's Share	= $\frac{1}{4}$

The new profit sharing ratio of Deepa, Tina and Sita is : $\frac{1}{2} : \frac{1}{4} : \frac{1}{4} = 4 : 2 : 2$

So Deepa Sacrificed	= $\frac{4}{6} - \frac{4}{8} = \frac{1}{6}$
Tina Sacrificed	= $\frac{2}{6} - \frac{2}{8} = \frac{1}{12}$
Sacrificing Ratio	= 2 : 1

(ii) The new partner purchases his/her share of the profit from the Existing partner in a particular ratio.

In this case : the new profit sharing ratio of the existing partners is to be ascertained after deducting the sacrifice of share agreed from his share. It means the incoming partner has purchased some share of profit in a particular ratio from the existing partners.

Illustration 2

Hari and Giri are partners, sharing profit in the ratio of 5 : 3. They admit Siri as a new partner for 1/6 share in profit. She acquires this share as 1/8 from Hari and 1/24 share from Giri. Calculate the new profit sharing ratio and sacrificing ratio.

Solution :

Hari's and Giri's existing ratio is 5 : 3

$$\text{Hari's new share} = 5/8 - 1/8 = 4/8 \text{ or } 12/24$$

$$\text{Giri's new share} = 3/8 - 1/24 = 8/24$$

$$\text{Siri's share} = 1/8 + 1/24 = 4/24$$

The new profit sharing ratio of Hari, Giri and Siri is

$$\begin{aligned} & 12/24 : 8/24 : 4/24 \\ & = 12 : 8 : 4 = 3 : 2 : 1 \end{aligned}$$

$$\text{(ii) Sacrificing ratio} = 1/8 : 1/24 \text{ or } 3 : 1$$

(iii) Existing partners surrender a particular portion of their share in favour of a new partner.

In this case, sacrificed share of the each partner is to be ascertained. This is ascertained by multiplying the existing partner's share in the ratio of their sacrifice. The share sacrificed by the existing partners should be deducted from their existing share. Therefore, the new share of the existing partners is determined. The share of the incoming partner is the sum of sacrifice by the existing partners.

Illustration 3

Rani and Ramu shared profits in the ratio of 10:6. Raghu was admitted as a partner. Rani surrendered 1/5 of her share and Ramu 1/3 of his share in favour of Raghu. Calculate the new profit sharing ratio.

Solution :

Rani surrenders $\frac{1}{5}$ of her share, i.e., $= \frac{1}{5}$ of $\frac{10}{16} = \frac{1}{8}$

Ramu surrenders $\frac{1}{3}$ of his share, i.e., $= \frac{1}{3}$ of $\frac{6}{16} = \frac{1}{8}$

So, sacrificing ratio of Rani and Ramu is $\frac{1}{8} : \frac{1}{8}$ or equal.

Rani's new share $= \frac{10}{16} - \frac{1}{8} = \frac{8}{16} = \frac{8}{16} = \frac{2}{8}$

and Ramu's new share $= \frac{6}{16} - \frac{1}{8} = \frac{4}{16} = \frac{2}{8}$

Raghu's share $= \frac{1}{8} + \frac{1}{8} = \frac{2}{8}$

New profit sharing ratio of Rani, Ramu and Raghu is

$$= \frac{4}{8} : \frac{2}{8} : \frac{2}{8} \text{ or } 4 : 2 : 2 \text{ or } 2 : 1 : 1.$$

II. If Tarun and Nisha are partners sharing profits in the ratio of 5:3. What will be their sacrificing ratio if Rahul is admitted for $\frac{1}{8}$ share of profit in the firm?

9.2.2 Goodwill : Meaning, Factors Affecting Goodwill and Valuation

Meaning of Goodwill

Over a period of time, a business firm develops a good name and reputation among the customers. This help the business earn some extra profits as compared to a newly set up business. In accounting, capitalised value of this extra profit is known as goodwill. For example, your firm earns say Rs.1,200 and the normal rate of profit expected to be earned by other similar firms in this industry is 10% say at this rate normal profit of your firm is Rs. 700 goodwill is ascertained as under :

Step 1 : Excess profit = Actual profit – Desired normal profit

$$1200 - 700 = 500$$

Step 2 : Goodwill = $500 \times \frac{100}{10} = \text{Rs.}5000$

In other words, goodwill is the value of the reputation of a firm in respect of the profit earned in future over and above the normal profit. It may also be defined as the present value of the capacity to earn future profits. This means that a firm can be said to have goodwill only if it has capacity to earn profit in future. A firm earning only normal profits like similar firms cannot claim to have any goodwill.

Factors affecting the Goodwill

The factors affecting goodwill are as follows:

1. **Location :** If the firm is located at a central place, resulting in good sale, the goodwill tends to be high.
2. **Nature of Business :** A firm that produces high value products or having a stable demand is able to earn more profits and therefore has more goodwill.
3. **Management efficiency :** A well-managed firm always earns higher profit and so the value of goodwill will also be high.
4. **Quality :** If a firm is known for the quality of its products the value of goodwill will be high.
5. **Market Situation :** The monopoly condition leads to earn high profits which leads to higher value of goodwill.
6. **Special Advantages :** The firms which have special advantages like importing licenses, long term contracts for supply of material, patents, trademarks, etc. enjoy higher value of goodwill.

Goodwill valuation methods

The methods of valuation of goodwill are generally decided by the partners among themselves while preparing partnership deed. The following are the important methods of valuing the goodwill of a firm:

- (i) Average Profit Method
- (ii) Super Profit Method
- (iii) Capitalisation Method

Let us discuss in detail about these methods.

1. **Simple Average Profit Method:** Under this method, average of the profits of certain given years is calculated. The value of the goodwill is calculated at an agreed number of years purchase of the average profit. Thus the goodwill is calculated as follows:

Value of goodwill = Average Profit × Number of year of purchase

For example, the average profits of a firm of say 3 years is Rs. 15,000 and the goodwill is to be calculated at 3 years purchase of the average profit. The value of

the goodwill will be Rs. 45,000[Rs. 15,000 × 3]. Thus goodwill = average profits × Number of years purchase.

Illustration : 4

The profit for the last four years of a firm were as follows Year 2018 Rs.1,00,000: Year 2019 Rs.1,10,000: Year 2020 Rs.1,50,000: Year 2021 Rs.1,60,000: Calculate goodwill of the firm on the basis of 2 years purchases of 4 years average profits.

Solution :

<i>Year</i>	<i>Profit (Rs.)</i>
2018	1,00,000
2019	1,10,000
2020	1,50,000
2021	1,60,000
Total	5,20,000

$$\begin{aligned}\text{Average Profit} &= \text{Total Profit/No. of Years} \\ &= \text{Rs.5,20,000/4} = \text{Rs.1,30,000}\end{aligned}$$

$$\begin{aligned}\text{Goodwill} &= \text{Average Profits} \times \text{No. of years purchased} \\ &= \text{Rs.1,30,000} \times 2 = \text{Rs.2,60,000}\end{aligned}$$

2. **Super Profit Method** : Super profit is the excess of actual profit over the normal profit. If a new business earns certain percentage of the capital employed, it is called 'normal profit'. The value of the goodwill is calculated at an agreed number of years purchase of super profit by multiplying the Super Profit by the certain number of years. Normal profit is that profit which is, earned by other business unit of the same business. Normal profit will be calculated as follows:

$$\text{Normal profit} = \text{Capital employed} \times \text{normal rate of return}/100$$

Actual Profit : These are the profit earned during the year or it is also taken as the average of the last few years profit.

$$\text{Super Profit} = \text{Actual Profit} - \text{Normal Profit}$$

For example, A firm earns profit of Rs. 75,000 on a capital of Rs. 5,00,000 and the normal rate of return in similar business is 10%. Then the normal profit is Rs.50,000[10% of the Rs.5,00,000]. The actual profit is Rs.75,000. Thus,

$$\begin{aligned}
\text{Super profit} &= \text{Actual profit} - \text{Normal profit} \\
&= \text{Rs.75,000} - \text{Rs.50,000} \\
&= \text{Rs.25,000}
\end{aligned}$$

If value of Goodwill is calculated by 4 years' purchase of super profit then goodwill is equal to Rs. 1,00,000 [Rs.25,000 × 4].

Weighted average method : This method is a modified version of average profit method. In this method each year profit is assigned a weight i.e. 1, 2, 3, 4 etc. Thereafter each year profit is multiplied by the weight and find product. The total of products is divided by the total of weight. As a result we find the weighted average profit. After this, the value of goodwill is calculated by multiplying the weighted average profit by the agreed number of year's purchase. Thus the goodwill is calculated as follows :

$$\text{Weighted average profit} = \frac{\text{Total product of profit}}{\text{Total of weights}}$$

$$\text{Value of goodwill} = \text{Weighted average profit} \times \text{number of year of purchase}$$

(**Note :** This method is used when we observe that there is a tendency to increase the annual profits. Latest year profit is assigned the highest weight.

Illustration : 5

The profit of firm for past years were as follow :

<i>Year</i>	<i>Profit (Rs.)</i>
2018	75,000
2019	80,000
2020	85,000
2021	90,000
2022	1,00,000

The weight to be used are 1, 2, 3, 4, and 5 for the years from 2018 -2022

Calculate the value of goodwill on the basis of three year's purchase of weighted average profit.

Solution :

<i>Year</i>	<i>Profit</i>	<i>Weight</i>	<i>Products</i>
2018	75,000	1	75,000
2019	80,000	2	1,60,000
2020	85,000	3	2,55,000
2021	90,000	4	3,60,000
2022	1,00,000	5	5,00,000
		15	13,50,000

Weighted Average Profit = $13,50,000/15 = \text{Rs. } 90,000$

Goodwill = $\text{Rs.}98000 \times 3 = \text{Rs. } 2,70,000$

Illustration : 6

A firm earned the following net profits during the last 4 years

2016	80,000
2017	1,20,000
2018	1,50,000
2019	1,75,000

Capital employed in the firm is Rs. 7,50,000. The normal rate of profit is 10%. Calculate the value of the goodwill on the basis of 3 year purchase of super profit.

Solution :

Total profit of 4 years = $\text{Rs.}80,000 + \text{Rs.}1,20,000 + \text{Rs.}1,50,000 + \text{Rs.}1,75,000$
= $\text{Rs.}5,25,000$

Average annual profit = $\text{Rs.}5,25,000/4$
= $\text{Rs.}1,31,250$

Normal Profit = $10\% \text{ of Rs.}7,50,000 = \text{Rs.}7,50,000 \times 10/100$
= $\text{Rs. } 75,000$

Super profit = $\text{Rs.}1,31,250 - \text{Rs. } 75,000$
= $\text{Rs.}56,250$

Value of goodwill at 4 years' purchase = Rs.56,250 × 3 = Rs.1,68,750

- 3. Capitalisation Method :** In this method, goodwill is the amount of capital saved. Normally businessmen invest capital to operate business activities, and earn profit with the efficient utilisation of capital. If the business earns more profit by investing lesser amount of capital as compared to other business, who earned same amount of profit with more amount of capital, the saved amount is assumed to be goodwill.

Under this method, the Goodwill is calculated in two ways:

- i.* Capitalisation of Average profit
- ii.* Capitalisation of Super profit

- i. Capitalisation of Average Profit :* In this method, the value of goodwill is assumed to be excess of the capital value of average profit over the actual capital employed.

Following formula is applied for Calculation of capital employed:

$$\text{Capital employed} = \text{Total Assets} - \text{Outsider Liabilities}$$

Following formula is applied for calculation of capitalised value of profit

$$\text{Capitalised Value of Profit} = \text{Average Profit} \times 100 / \text{Normal Rate of Profit}$$

$$\text{Goodwill} = \text{Capitalised Value of Profits} - \text{Capital Employed}$$

Illustration : 7

A firm earned average profit during the last few years is Rs.50,000 and the normal rate of return in similar business is 10%. The total assets is Rs.4,00,000 and outside liabilities is Rs.40,000. Calculate the value of goodwill with the help of Capitalisation of Average profit method.

Solution :

$$\begin{aligned} \text{Capital employed} &= \text{Total assets} - \text{Outside liabilities} \\ &= \text{Rs.4,00,000} - \text{Rs.40,000} \\ &= \text{Rs.3,60,000} \end{aligned}$$

$$\begin{aligned} \text{Capitalised value of average profit} &= \text{Average Profit} \times 100 / \text{Normal rate of profit} \\ &= \text{Rs.50,000} \times 100 / 10 \\ &= \text{Rs.5,00,000} \end{aligned}$$

$$\begin{aligned}
\text{Goodwill} &= \text{Capitalised value} - \text{Capital employed} \\
&= \text{Rs.5,00,000} - \text{Rs.3,60,000} \\
&= \text{Rs.1,40,000}
\end{aligned}$$

Illustration : 8

The capital invested in a firm is Rs. 5,60,000 and the rate of return in the similar business is 10%. The firm earns the following profit in the last 4 years:

2015	Rs. 80,000	2017	Rs. 90,000
2016	Rs. 1,00,000	2018	Rs. 1,10,000

Calculate the value of goodwill by Capitalisation method.

Solution :

$$\begin{aligned}
\text{Total Profit} &= \text{Rs. 80,000} + \text{Rs.1,00,000} + \text{Rs. 90,000} + \text{Rs. 1,10,000} \\
\text{Average Profit} &= \text{Rs. 3,80,000}/4 \\
&= \text{Rs. 95,000} \\
\text{Capitalised Value} &= \text{Average profit} \times 100/10 \\
&= \text{Rs. 95,000} \times 100/10 \\
&= \text{Rs. 9,50,000} \\
\text{Goodwill} &= \text{Capitalised value} - \text{Capital employed} \\
&= \text{Rs. 9,50,000} - \text{Rs. 5,60,000} \\
&= \text{Rs. 3,90,000}
\end{aligned}$$

- i. Capitalisation of Super Profit :* In this method, the value of goodwill is calculated on the basis of super profit method. Goodwill is the capitalised value of super profit. Following formula is applied for Calculation of capitalised value *i.e.*, goodwill.

$$\text{Goodwill} = \text{Super Profit} \times 100/\text{Normal Rate of Profit}$$

Illustration : 9

A firm earns a profit of Rs. 25,000 and has invested capital amounting to Rs. 2,00,000. In the same business normal rate of earning profit is 8%. Calculate the value of goodwill with the help of Capitalisation of super profit method.

Solution :

Actual Profit	=	Rs. 25,000
Normal Profit	=	Rs. 2,00,000 x 8/100 = Rs. 16,000
Super Profit	=	Actual Profit - Normal Profit
	=	Rs. 25,000 - Rs. 16,000
	=	Rs. 9,000
Goodwill	=	Super Profit x 100/normal rate of profit
	=	Rs. 9,000 x 100/8
	=	Rs. 1,12,500

9.2.3 Treatment of Goodwill

The new partner acquires his/her share of profit from the existing partners. This will result in the reduction of the share of existing partners. Therefore, he/she compensates the existing partners for the sacrifices. He/she compensates them by making payment in cash or in kind. The payment is equal to his/her share in the goodwill.

As per Accounting Standard 10(AS-10) that goodwill should be recorded in the books only when some consideration in money has been paid for it. Thus, if a new partner does not bring necessary cash for goodwill, no goodwill account can be raised in the books. He/she should pay for goodwill in addition to his/ her contribution for capital.

If, he/she does not pay for goodwill, then amount equal to his/her share of goodwill will be deducted from the capital. The amount brought in by him/her as goodwill or amount of goodwill deducted from his/her capital is divided between the existing partners in their sacrificing ratio. At the time of admission of a new partner any goodwill appearing in the books, will be written off in existing ratio among the existing partners.

There are different situations relating to treatment of goodwill at the time of admission of a new partner. These are discussed as under:

1. When the amount of goodwill is paid privately by the new partner.
 2. When the new partner brings his/her share of goodwill in cash.
 3. When the new partner does not bring his/her share of goodwill in cash.
1. **The amount of goodwill is paid privately by the new partner:** If the amount of goodwill is paid by the new partner to the existing partner privately, no journal entries are made in the books of the firm.
 2. **The new partner brings his/her share of goodwill in cash and the amount of goodwill is retained in the Business:** When, the new partner brings his/ her share of goodwill in cash. The amount brought in by the new partner is transferred to the existing partners in the sacrificing ratio. If there is any goodwill account in the balance sheet of existing partners, it will be written off immediately in existing ratio among the partners. The journal entries are as follows:

(i) The existing goodwill in the books of the firm will be written off in existing profit ratio as;

Existing Partners Capital A/c Dr. [individually]
 To Goodwill A/c
(Existing goodwill written off)

(ii) For bringing cash for Capital and goodwill

Cash/Bank A/c Dr.
 To Goodwill Premium A/c
 To New partner's Capital A/c
(Cash brought in for capital and goodwill)

(iii) For amount of goodwill transferred to existing partner capital account:

Goodwill A/c Dr.
 To Existing Partner's Capital/current A/c [individually]
(The amount of goodwill credited to existing partner's capitals in sacrificing ratio)

Illustration : 10

Tara and Sara are partners in a firm sharing profit in the ratio 5 : 3. They admitted Meera as a new partner for $\frac{1}{4}$ th share in the profit. Meera brings Rs.30,000 for her share of

goodwill and Rs. 1,20,000 for capital. Make journal entries in the books of the firm after the admission of Meera. The new profit sharing ratio will be 2 : 1 : 1.

Solution :

Books of Tanaya, Sumit and Gauri

<i>Date</i>	<i>Particulars</i>	<i>LF No.</i>	<i>Debit Amount (Rs.)</i>	<i>Credit Amount (Rs.)</i>
1.	Bank A/c Dr. To Goodwill Premium A/c To Meera's Capital A/c (cash brought by Meera for her share of goodwill and capital)		1,50,000	30,000 1,20,000
	Goodwill Premium A/c Dr. To Tara's Capital A/c To Sara's Capital A/c (Goodwill transferred to existing partners capital account in their sacrificing ratio)		30,000	15,000 15,000

Working Note :

Calculation of sacrificing ratio (existing ratio - new ratio)

<i>Partners</i>	<i>Existing Ratio</i>	<i>New Ratio</i>	<i>Sacrifice</i>	<i>Sacrificing Ratio</i>
Tara	5/8	2/4	$5/8 - 2/4 = 1/8$	Tara : Sara
Sara	3/8	1/4	$3/8 - 1/4 = 1/8$	1 : 1

The amount of goodwill is withdrawn by the existing partners:

- (i) Existing Partners Capital/current A/c Dr. [individually]
 To Cash/Bank A/c

(The amount of goodwill withdrawn by the existing partners)

It is to be noted that sometimes partner's withdraw only 50% or 25% amount of goodwill. In such a case, entry will be made for the withdrawn amount only.

bring her share of goodwill in cash, the goodwill of the firm to be valued at Rs. 1,80,000. At the time of admission goodwill existed in the books of the firm at Rs. 80,000. Make necessary journal entries in the books of the firm.

Solution :

Books of Ashmita, Sahil and Charu

<i>Date</i>	<i>Particulars</i>	<i>LF No.</i>	<i>Debit Amount (Rs.)</i>	<i>Credit Amount (Rs.)</i>
	Bank A/c Dr. To Krutika's Capital A/c [Cash brought by Krutika for her capital)		2,50,000	2,50,000
	Aswini's Capital A/c Dr. Bharani's Capital A/c Dr. To Goodwill A/c [Goodwill written off before Krutika's admission]		48,000 32,000	80,000
	Krutika's Capital A/c Dr. To Aswini's Capital A/c To Bharani's Capital A/c [Existing partners capital a/c credited for goodwill on's admission in sacrificing ratio]		36,000	21,600

Krutika

Working Note :

Aswini and Bharani sacrifice their profit in favour of Krutika in their existing profit sharing ratio i.e. 3 : 2. Therefore, the sacrificing ratio is 3 : 2.

Value of Goodwill = Rs. 1,80,000

Krutika's share in Profit = 1/5

Krutika's share of Goodwill = Rs. 1,80,000 × 1/5 = Rs. 36,000

New partner brings in only a part of his share of goodwill

When new partner is not able to bring the full amount of his/her share of goodwill in cash and brings only a part of cash. In this case, the amount of goodwill brought by him is credited to goodwill account. At the time of goodwill transferred to capital account of existing partner's, new partner's capital account is debited with his unpaid share of goodwill besides debiting goodwill account with the amount of goodwill is paid by him. The journal entries is as

Bank A/c	Dr.	
		To Goodwill Premium A/c
[Part Amount of goodwill brought by new partner]		
Goodwill Premium A/c	Dr.	
New Partner's Capital A/c	Dr.	
To Existing Partner's Capital A/c		[individually in sacrificing ratio]
[Credit given to sacrificing partner by new partner's in full share of goodwill]		

Illustration 13

Manu and Sonu are partners sharing profit in the ratio of 5 : 3. They admit Janu into the firm for 1/6 share in profit which she takes 1/ 18 from Manu and 2/ 18 from Sonu. Janu brings Rs. 9,00 as goodwill out of her share of Rs. 12,00. No goodwill account appears in the books of the firm. Make necessary journal entries in the books of the firm.

Solution :

Journal

Date	Particulars	LF No.	Debit Amount (Rs.)	Credit Amount (Rs.)
	Bank A/c Dr.		9000	
	To Goodwill Premium A/c			9000
	[A part of her share of goodwill brought in by Janu]			
	Goodwill Premium A/c Dr.		9000	
	Janu Capital A/c Dr.		3000	
	To Manu's Capital A/c			4000
	To Sonu's Capital A/c			8000
	[Goodwill credited to Manu and Sonu in their sacrificing ratio i.e. 1:2]			

ACCOUNTING TREATMENT OF RESERVES AND ACCUMULATED PROFITS/LOSSES

When There is Change in Profit Sharing Ratio of Existing Partner's

Case (i) When Reserves and Accumulated Profits/Losses are to be transferred to Capital Accounts :

(a) If, at the time of change in the profit sharing ratio, there are Reserves or Accumulated profits/losses existing in the books of the firm, these should be transferred to the Partner's Capital Accounts (if capitals are fluctuating) or to partners Current Account (if capitals are fixed) in their old profit sharing ratio. The reason for such transfer is that these reserves and accumulated profits/losses have come into existence before the change in profit sharing ratio and hence belong to the partners in their old profit sharing ratio. Following entries are passed for this purpose :

i. For Transfer of Reserves and Accumulated Profits :

Reserve A/c	Dr.	
Profit & Loss A/c	Dr.	
Workmen's Compensation Reserve A/c	Dr.	(Excess of Reserve over Actual Liability)
Investment Fluctuation Reserve A/c	Dr.	(Excess of Reserve Over difference between Book value and Market value)
To Old Partner's Capital or Current A/cs	Dr.	(in Old Profit Sharing Ratio)
(Being the undivided Profit/Reserves transferred to Partners Capital Current A/c)		

ii. For Transfer of Accumulated Losses :

Old Partner's Capital or Current A/cs.	Dr.	(in Old Profit Sharing Ratio)
To Profit & Loss A/c		
To Deferred Revenue Expenditure A/c		(for example Advertisement Suspense A/c)
(Being the Losses/..... on assets transferred to partner capitals/.....)		

Illustration 14

Smita and Rita are partners sharing profits and losses in the ratio of 2 : 1. From April 1st,

2022, they decided to share the profits in the ratio of 3 : 2. On that date, profit and loss account showed a debit balance of Rs. 9,00,000. Record the necessary journal entry for the distribution of the balance in the Profit and Loss Account.

Solution :

Journal

<i>Date</i>	<i>Particulars</i>	<i>LF No.</i>	<i>Debit Amount (Rs.)</i>	<i>Credit Amount (Rs.)</i>
2013 Apr. 1	Smita's Capital A/c (2/3) Dr. Rita's Capital A/c (1/3) Dr. To Profit and Loss A/c (Transfer of undistributed loss on change in profit sharing ratio)		6,00,000 3,00,000	9,00,000

Illustration 15

Anu, Balu and Chitra are partners sharing profits in the ratio of 2 : 3 : 4. From April 1st, 2023 they decided to share the profits equally. On that date their books showed a credit balance of Rs. 18,00,000 in the Profit and Loss Account and a balance of Rs.4,50,000 in the General Reserve. Record the necessary journal entry for the distribution of profits and the general reserve.

Solution

Journal

<i>Date</i>	<i>Particulars</i>	<i>LF No.</i>	<i>Debit Amount (Rs.)</i>	<i>Credit Amount (Rs.)</i>
2023 Apr. 11	Profit & Loss A/c Dr. General Reserve A/c Dr. To Anu's Capital A/c (4/9) To Balu's Capital A/c (3/9) To Chitra's Capital A/c (2/9) [Transfer of undistributed profit and general reserve on change in profit sharing ratio]		18,00,000 4,50,000	10,00,000 7,50,000 5,00,000

Illustration 16

Shoba, Sai and Shiva sharing profits and losses in the ratio of 4 : 5 : 6, decide to share future profits and losses in the ratio of 3 : 4 : 5 with effect from 1st April, 2020. Following an extract of their Balance Sheet as on 31st March, 2021 :

<i>Liabilities</i>	<i>Amount</i>	<i>Assets</i>	<i>Amount</i>
Workmen Compensation Reserve	6,00,000		

Show the accounting treatment under the following alternative cases:

Case (i) If there is no other information.

Case (ii) If a claim on account of workmen's compensation is estimated at Rs.1,50,000

Solution :

Journal

<i>Date</i>	<i>Particulars</i>	<i>LF No.</i>	<i>Debit Amount (Rs.)</i>	<i>Credit Amount (Rs.)</i>
2014 Apr. 1	Case (i) Workmen Compensation Reserve A/c Dr. To Shoba's Capital A/c To Sai's Capital A/c To Shiva's Capital A/c [Transfer of Workmen Compensation Reserve to partner's capital accounts in their old profit sharing ratio]		6,00,000	1,60,000 2,00,000 2,40,000
	Case (ii) Workmen Compensation Reserve A/c Dr. To Provision for Workmen		6,00,000	

Compensation Claim A/c			1,50,000
To Shoba's Capital A/c			1,20,000
To Sai's Capital A/c			1,50,000
To Shiva's Capital A/c			1,80,000
[Transfer of excess Compensation Reserve to partner's capital accounts in their old profit sharing ratio]			

Case (ii) When Reserves and Accumulated Profit/Loss are not to be transferred to Capital Accounts or to be continued in future Balance Sheet:

If, in case of change in profit sharing ratio, there are reserves and accumulated profits appearing in the old Balance Sheet and the partners decide to leave the reserves and accumulated profits undistributed, it will be necessary to pass an adjusting entry for the same. This is, because, at present the partners are entitled to share such reserves and profits in the old profit sharing ratio whereas in future they will be entitled to share such reserves and profits in the new profit sharing ratio. Hence, the gaining partner must compensate the sacrificing partner that share of reserves and profits which is proportionate to the share gained by him/her. For example, suppose M and N sharing profits in the ratio of 2 : 1 decide to share future profits in equal proportion. Reserves appearing in the Balance Sheet amount to Rs.6,00,000 and the partners do not want to distribute them. In such a case at present M is entitled to Rs.4,00,000 and N Rs. 2,00,000 of such reserves but in future, after the change in the profit sharing ratio, each would be entitled to Rs. 3,00,000. Hence, N must compensate M to the extent of Rs. 1,00,000. This amount is proportionate to the share (*i.e.* $1/2 - 1/3$) gained by him.

The adjustment for this amount is usually made by passing the following adjustment entry :

	Particulars	LF No.	Debit Amount (Rs.)	Credit Amount (Rs.)
	N's Capital Dr. To M's Capital A/c (Being adjustment made in the capital A/cs of the partner for Reserves)		1,00,000	1,00,000

Illustration 17

Mani and Nani are partners in a firm sharing profits in the ratio of 2 : 4. On March 31st, 2019 their Balance Sheet showed a General Reserve of Rs.6,00,000. On that date they decided to change their profit sharing ratio which will be 5 : 3. Record necessary journal entries in the books of the firm under the following circumstances:

- i. When they decided to transfer the general reserve to their capital accounts.
- ii. When they don't want to transfer general reserve in their capital A/c but prefer to record an adjustment entry for the same.

Solution :

Alternative (i) When General Reserve is transferred to Capital Accounts :

Journal

<i>Date</i>	<i>Particulars</i>	<i>LF No.</i>	<i>Debit Amount (Rs.)</i>	<i>Credit Amount (Rs.)</i>
2019 Mar. 31	General Reserve A/c Dr. To Mani's Capital A/c To Nani's Capital A/c (General reserve transferred to the Capital A/c of partners on the reconstitution of the firm)		6,00,000	2,00,000 4,00,000

Alternative (ii) When General Reserve is not transferred to Capital Accounts:

Old Profit Sharing Ratio of Mani and Nani = 2 : 4 New Profit Sharing Ratio of Mani and Nani = 5 : 3 Sacrifice or Gain :

$$\text{Mani} = \frac{2}{6} - \frac{5}{8} = \frac{(16-30)}{48} = \frac{14}{48} \text{ gain}$$

$$\text{Nani} = \frac{4}{6} - \frac{3}{8} = \frac{(32-18)}{48} = \frac{14}{48} \text{ sacrifice}$$

Therefore, Mani's Capital A/c will be debited & Nani's capital A/c will be credited with (14/48)th proportions.

Journal

<i>Date</i>	<i>Particulars</i>	<i>Debit Amount (Rs.)</i>	<i>Credit Amount (Rs.)</i>
2019 Mar. 31	Mani's Capital A/c Dr. To Nani's Capital A/c (Adjustment to General Reserve A/c when it is not to be closed)	1,75,000	1,75,000

Illustration 18

Shyam and Sundar were partners in a firm sharing profits in the ratio of 5 : 2. With effect from 1st January 2022 they agreed to share profits in the ratio of 4 : 1. For this purpose the goodwill of the firm was valued at Rs.4,00,000. General reserves appear in the books at Rs. 3,00,000. Partners neither want to show goodwill in the books nor want to distribute the reserves. You are required to record the change by passing a single journal entry.

Solution :

Value of goodwill 4,00,000

General Reserve 3,00,000

7,00,000

Old Ratio of Shyam and Sundar 5 : 2

New Ratio of Shyam and Sundar 4 : 1

Sacrifice or Gain :

$$\text{Shyam} = \frac{5}{7} - \frac{4}{5} = \frac{25-28}{35} = \frac{3}{35} \text{ (Gain)}$$

$$\text{Sundar} = \frac{2}{7} - \frac{1}{5} = \frac{10-7}{35} = \frac{3}{35} \text{ (Sacrifice)}$$

Shyam will be compensated by Sundar to the extent of $\frac{3}{35}$ of Rs.7,00,000 = Rs.60,000

Journal

<i>Date</i>	<i>Particulars</i>	<i>Debit Amount (Rs.)</i>	<i>Credit Amount (Rs.)</i>
2022 Jan. 31	Shyam's Capital A/c Dr. To Sundar's Capital A/c (Adjustment for good will and reserves on change in profit sharing ratio)	60,000	60,000

Illustration 19

Parta, Kriti and Renu are partner sharing profits and losses in the ratio of 4 : 3 : 2. They decided to share future profits and losses in the ratio of 2 : 3 : 4 They also decided to record the effect of the following without affecting their book values:

General Reserve	8,00,000
Profit & Loss A/c	4,00,000
Advertisement Suspense A/c	3,00,000

You are required to give the necessary single adjustment entry for the same.

Solution :

Calculation of Net Effect of Accumulated Profit/Losses :

General Reserve	8,00,000
(+) Profit & Loss A/c	4,00,000
(-) Advertisement Suspense A/c	3,00,000

Net Amount *Calculation of Sacrifice or Gain* : 9,00,000

Old Ratio of Parta, Kriti and Renu 4/9 : 3/9 : 2/9

New Ratio of Parta, Kriti and Renu 2/9 : 3/9 : 4/9

Sacrifice or Gain :

Parta $4/9 - 2/9 = 2/9$ (Sacrifice)

Kriti $3/9 - 3/9 = 0$ (No Profit no loss)

Renu $2/9 - 4/9 = 2/9$ (Gain)

Journal

<i>Date</i>	<i>Particulars</i>	<i>LF No.</i>	<i>Debit (Rs.)</i>	<i>Credit (Rs.)</i>
	Renu's Capital A/c (2/9 of 4,50,000 Dr. To Parta's Capital A/c (2/9 of 4,50,000) (Adjustment for general reserve, profit & loss account balane and advertisement suspense account on change in profit sharing ratio)		2,00,000	2,00,000

Illustration 20

Akila, Bumi and Chinna sharing profits and losses in the ratio of 1 : 2 : 2, decided to share future profits equally with effect from 1st April, 2020. On that date, Profit & Loss Account showed a credit balance of Rs. 1,20,000. Partners do not want to distribute the profit but prefer to record the change in the profit sharing ratio by passing an adjustment entry. You are required to give the adjusting entry.

Solution :

Old Ratio of A, B and C 1/5 : 2/5 : 2/5

New Ratio of A, B and C 1/3 : 1/3 : 1/3

Sacrifice or Gain :

Akila = $1/5 - 1/3 = 3-5 / 15 = 2/15$ (Gain)

Bumi = $2/5 - 1/3 = 6-5 / 15 = 1/15$ (Sacrifice)

Chinna = $2/5 - 1/3 = 6-5 / 15 = 1/15$ (Sacrifice)

Journal

<i>Date</i>	<i>Particulars</i>	<i>LF No.</i>	<i>Debit (Rs.)</i>	<i>Credit (Rs.)</i>
2014 Apr. 1	A's Capital A/c (2/15 of 2,40,000 Dr. To B's Capital A/c (1/15 of 2,40,000) To C's Capital (1/15 of 2,40,000) (Adjustment for Profit and Loss Account balance on change in profit sharing ratio)		16,000	8,000 8,000

9.2.4 Accounting Treatment of Goodwill when there is change in the Profit Sharing Ratio of Existing Partners

A change in profit sharing ratio basically denotes that one partner is purchasing from another partner, a share of profits previously belonging to the latter. The purchasing or gaining partner must compensate the sacrificing partner by paying the proportionate amount of goodwill. In other words, the gaining partner should pay the sacrificing partner that share of goodwill which is equal to the share gained by him. For example, suppose D and E are sharing profits in the proportion of $4/5 : 1/5$. If it is decided that in future they will share profits in the proportion of $3/5 : 2/5$, it implies that D is selling $1/5$ th ($4/5 - 3/5$) of his share to E. If the profits of the firm are Rs. 1,00,000 p.a. D will lose Rs. 20,000 and E will gain Rs.20,000 annually. This must be compensated by E by paying to D an amount equal to $1/5$ th of total present value of goodwill of the firm. If the goodwill is valued at Rs. 5,00,000 E must pay to D $1/5$ th of Rs.5,00,000 i.e., Rs.1,00,000.

Such an adjustment is made by passing an adjustment entry wherein E's Capital Account will be debited and D's Capital Account will be Credited by Rs.1,00,000.

Illustration 21

Mohan and Nayak were partners in a firm sharing profits in the ratio of 5: 4. With effect from 31st March, 2022 they agreed to share profits equally. For this purpose the goodwill of the firm was valued at Rs. 2,25,000. Pass the necessary adjustment entry:

Solution :

Old Ratio of Mohan and Nayak = 5: 4

New Ratio of Mohan and Nayak = 1 : 1

Sacrifice or Gain :

Mohan = $5/9 - 1/2 = 10-9 /18 = 1/18$ (Sacrifice)

Nayak = $4/9 - 1/2 = 8-9 /18 = 1/18$ (Gain)

Since Mohan has sacrificed, he will be credited by $1/18$ of Rs.2,25,000 i.e., Rs.12,500

Since Nayak has gained, he will be debited by $1/18$ of Rs.2,25,000 i.e. Rs.12,500

Journal

<i>Date</i>	<i>Particulars</i>	<i>Debit (Rs.)</i>	<i>Credit (Rs.)</i>
2022 Mar.31	Nayak's Capital A/c Dr. To Mohan' Capital A/c (Adjustment for goodwill due to change in profit sharing ratio)	12,500	12,500

Illustration 22

J, K and L are partners sharing profits equally. They decided that in future C will get 1/5th share in profits. On the day of change, firm's goodwill has been valued at Rs.6,00,000. Make the necessary adjustment entry for the treatment of goodwill.

Solution :

Old Ratio of J, K and L = 1/3 : 1/3 : 1/3

New Ratio of J, K and L = 2/5 : 2/5 : 1/5

Sacrifice or Gain :

J = $1/3 - 2/5 = 5-6 / 15 = 1/15$ (Gain)

K = $1/3 - 2/5 = 5-6 / 15 = 1/15$ (Gain)

L = $1/3 - 1/5 = 5-3 / 15 = 2/15$ (Sacrifice)

Calculation of share of Loss or gain of Goodwill

Total Goodwill Rs.6,00,000

J's Share of loss = 1/15 of Rs. 6,00,000 = Rs. 40,000

K's Share of loss = 1/15 of Rs.6,00,000 = Rs.40,000

Journal

<i>Date</i>	<i>Particulars</i>	<i>Debit (Rs.)</i>	<i>Credit (Rs.)</i>
	J's Capital A/c (1/15 of 6,00,000) Dr.	40,000	
	K's Capital A/c (1/15 of 6,00,000) Dr.	40,000	
	To L's Capital A/c (2/15 of 6,00,000) (L Compensated by J and K for the sacrifice made by him)		80,000

Illustration 23

P, Q and R are partners sharing profits and losses in the ratio of 5 : 4 : 1. It was decided that with effect from 1st January 2023 the profit sharing ratio will be 9 : 6 : 5. Goodwill is to be valued at 2 year's purchase of average of 3 year's profits. The profits for 2020, 2021 and 2022 were Rs. 66,000; Rs. 54,000 and Rs.90,000 respectively.

Pass the necessary journal entry for the treatment of goodwill without opening Goodwill Account.

Solution :

Average Profit = Rs.(66,000+54,000+90,000)/3 = Rs.70,000

Value of Goodwill at 2 year's purchase = Rs.70,000 x 2 = Rs. 1,40,000

Old Ratio of P, Q and R = 5 : 4 : 1

New Ratio of P, Q and R = 9 : 6 : 5

Sacrifice or Gain

$$P = 5/10 - 9/20 = 40-36/80 = 1/20(\text{Sacrifice})$$

$$Q = 4/10 - 6/20 = 8-6 /20 = 2/20 (\text{Sacrifice})$$

$$R = 1/10 - 5/20 = 2-5 /20 = 3/20 (\text{Gain})$$

Since P has sacrificed, he will be credited by 1/20 of Rs.1,40,000 = Rs.7,000

Since Q has sacrificed, he will be credited by 2/20 of Rs. 1,40,000 = Rs.14,000

Since R has gained, he will be debited by 3/20 of Rs. 1,40,000 = Rs.21,000

Journal

<i>Date</i>	<i>Particulars</i>	<i>Debit (Rs.)</i>	<i>Credit (Rs.)</i>
2014 Jan. 1	R's Capital A/c To P's Capital A/c To Q's Capital A/c (Treatment for goodwill due to change in profit sharing ratio)	Dr. 21,000	7,000 14,000

Illustration 25

Bheema and Arjun were partners sharing profits and losses in the ratio of 3 : 1. They decided that with effect from 1st January 2019, they would share profits and losses in the ratio of 5 : 3. The partnership deed provides that in the event of any change in profit sharing ratio, the goodwill should be valued at the total of two year's profits preceding the date the decision became effective. The profits for 2016, 2017 and 2018 were Rs. 5,00,000; Rs. 6,00,000 and Rs. 7,00,000 respectively. Pass the necessary Journal entry to give effect to the above arrangement.

Solution :

Value of goodwill = Rs. 6,00,000 + Rs. 9,00,000 = Rs. 13,00,000

Calculation of Sacrifice or Gain :

Old Ratio = 3 : 1

New Ratio = 5 : 3

$$\text{Bheema} = \frac{3}{4} - \frac{5}{8} = \frac{6-5}{8} = \frac{1}{8} \text{ (Sacrifice)}$$

$$\text{Arjun} = \frac{1}{4} - \frac{3}{8} = \frac{2-3}{8} = \frac{1}{8} \text{ (Gain)}$$

Since Bheema has sacrificed, he will be credited by $\frac{1}{8}$ of Rs.11,00,000 = Rs.1,62,500

Since Arjun has gained, he will be debited by $\frac{1}{8}$ of Rs.11,00,000 = Rs.1,62,500

Journal

<i>Date</i>	<i>Particulars</i>	<i>Debit (Rs.)</i>	<i>Credit (Rs.)</i>
2013 Jan. 1	Arjun's Capital A/c Dr. To Bheema's Capital A/c (Adjustment for goodwill due to change in profit sharing ratio)	1,62,500	1,62,500

9.2.5 Revaluation of Assets and Liabilities

On admission of a new partner, the firm stands reconstituted and consequently the assets are revalued and liabilities are reassessed. It is necessary to show the true position of the firm at the time of admission of a new partner. If the values of the assets are raised, gain will increase the capital of the existing partners. Similarly, any decrease in the value of assets, i.e. loss will decrease the capital of the existing partners. For this purpose a 'Revaluation Account' is prepared. This account is credited with all increases in the value of assets and decrease in the value of liabilities. It is debited with decrease on account of value of assets and increase in the value of liabilities. The balance of this account shows a gain or loss on revaluation which is transferred to the existing partner's capital account in existing profit sharing ratio.

Accounting for Revaluation of Assets and Liabilities when there is a Change in the Profit Sharing Ratio of Existing Partners

Assets and liabilities of a firm must also be revalued at the time of change in profit sharing ratio of existing partners. The reason is that the realisable or actual value of assets and liabilities may be different from those shown in the Balance Sheet. It is possible that with the passage of time some of the assets might have appreciated in value while the value of certain other assets might have decreased and no record has been made of such changes in the books of accounts. Similarly there may be some unrecorded assets & liabilities that may have to be accounted for. Revaluation of assets and reassessments of liabilities becomes necessary because the change in the value of assets and liabilities belongs to the period to change in profit sharing ratio and hence must be shared by the partners in their old profit sharing ratio.

Revaluation of assets and reassessment of liabilities may be given effect to in two different ways:

- (a) When revised values are to be recorded in the books, and
- (b) When revised values are not to be recorded in the books.

When revised values are to be recorded in the books

In such a case revaluation of assets and reassessment of liabilities is done with the help of a new account called '**Revaluation Account**'. Sometimes this account is also called as '**Profit & Loss Adjustment A/c**'. If there is a loss due to revaluation, revaluation account is debited and if the revaluation results in a profit, the revaluation account is credited.

(a) When revaluation account shows gain :

Revaluation A/c Dr.
 To Partner's Capital A/c (Old Profit Sharing Ratio)
 (Profit on revaluation credited to Partner's Capital A/c)

(b) Above entry is reversed when revaluation account shows loss :

Partners Capital A/cs (Old Profit Sharing Ratio) Dr.
 To Revaluation A/c
 (Loss on revaluation debited to Partner's Capital A/cs)

Proforma of Revaluation Account is given as under :

Revaluation Account

Dr.

Cr.

<i>Particulars</i>	<i>Amount (Rs.)</i>	<i>Particulars</i>	<i>Amount (Rs.)</i>
To Decrease in value of assets	By Increase in value of assets	.....
To Increase in value of liabilities	By Decrease in value of liabilities	.....
To Unrecorded liabilities	By Unrecorded assets	.....
To Gain on Revaluation transferred to Partner's Capital Accounts (in old ratio)	By Loss on Revaluation transferred to Partner's Capital accounts (in old ratio)	.....

Illustration 26

E, F and G are partners sharing profits and losses in the ratio of 3 : 3 : 2. Their balance sheet as on 31st March 2021 was as follows :

<i>Liabilities</i>	<i>Amount (Rs.)</i>	<i>Assets</i>	<i>Amount (Rs.)</i>
Sundry creditors	2,40,000	Cash at Bank	3,70,000
General Reserve	3,60,000	Sundry Debtors	4,40,000
Capital Accounts :		Stock	12,00,000
P 20,00,000		Machinery	15,90,000
Q 15,00,000		Building	20,00,000
R 15,00,000	50,00,000		
	56,00,000		56,00,000

Partners decided that with effect from 1st April 2022, they would share profits and losses in the ratio of 4 : 3 : 2. It was agreed that :

- i. Stock be valued at ₹ 11,00,000
- ii. Machinery is to be depreciated by 10%.
- iii. A provision for doubtful debts is to be made on debtors @5%.
- iv. Building to be appreciated by 20%.
- v. A liability for ₹ 25,000 included in sundry creditors is not likely to arise.

Partners agreed that the revised values are to be recorded in the books. They do not, however want to distribute the general reserve. You are required to pass journal entries, prepare capital accounts of the partners and the revised balance sheet.

Solution :

Journal

<i>Date</i>	<i>Particulars</i>	<i>Debit Amount (Rs.)</i>	<i>Credit Amount (Rs.)</i>
	Revaluation A/c Dr. To Stock A/c To Machinery A/c To Provision for Doubtful Debts A/c (Decrease in the value of assets and provision made for doubtful debts)	2,81,000	
	Building A/c Dr. Sundry Creditors Dr. To Revaluation A/c (Increase in the value of building and decrease in creditors)	4,00,000 25,000	4,25,000
	Revaluation A/c Dr.⁽¹⁾ To E's Capital A/c To F's Capital A/c To G's Capital A/c (The transfer of gain on revaluation to the capital accounts of partners in old ratio)	1,44,000	54,000 54,000 36,000
	E's Capital A/c Dr. ⁽²⁾ To F's Capital A/c To G's Capital A/c (The adjustment for general reserve on change in profit sharing ratio)	25,000	15,000 10,000

Working Note :

Revaluation Account

Dr.

Cr.

<i>Particulars</i>	<i>Amount (Rs.)</i>	<i>Particulars</i>	<i>Amount (Rs.)</i>
To Stock A/c	1,00,000	By Building A/c	4,00,000
To Machinery A/c	1,59,000	By Sundry Creditors A/c	25,000
To Provision for doubtful debts A/c	22,000		
To Gain on Revaluation transferred to :			
E's Capital A/c (3/8)	54,000		
F's Capital A/c (3/8)	54,000		
G's Capital A/c (2/8)	36,000		
	4,25,000		4,25,000

(1) Adjustment for General Reserve :

Old Ratio of E, F and G 3 : 3 : 2

New Ratio of E, F and G 4 : 3 : 2

Sacrifice or Gain :

$E = 3/8 - 4/9 = 5/72$ (Gain)

$F = 3/8 - 3/9 = 3/72$ (Sacrifice)

$G = 2/8 - 2/9 = 2/72$ (Sacrifice)

Since E has gained, he will be debited for $5/72$ of General reserve

or Rs.3,60,000 = Rs.25,000

Since F has Sacrificed, he will be credited for $3/72$ of General reserve

or Rs. 3,60,000 = Rs. 15,000

Since G has sacrificed, he will be credited for $2/72$ of General reserve

or Rs. 3,60,000 = Rs. 10,000

Capital Accounts

<i>Particulars</i>	<i>E</i> <i>(Rs.)</i>	<i>F</i> <i>(Rs.)</i>	<i>G</i> <i>(Rs.)</i>	<i>Particulars</i>	<i>E</i> <i>(Rs.)</i>	<i>F</i> <i>(Rs.)</i>	<i>G</i> <i>(Rs.)</i>
To F's Capital A/c	15,000			To Balance b/d	20,00,000	15,00,000	15,00,000
To G's Capital A/c	10,000			By Revaluation A/c	54,000	54,000	36,000
To Balance C/d	20,29,000	15,69,000	15,46,000	By E's Capital A/c		15,000	10,000
	20,54,000	15,69,000	15,46,000		20,54,000	15,69,000	15,46,000

Balance Sheet as at 1st April 2022

<i>Liabilities</i>	<i>Amount</i> <i>(Rs.)</i>	<i>Assets</i>	<i>Amount</i> <i>(Rs.)</i>
Sundry creditors	2,15,000	Cash at Bank	3,70,000
General Reserve	3,60,000	Debtors <i>Less</i> :	4,40,000
Capital Accounts :		Provision for	
E	20,29,000	doubtful debts	22,000
F	15,69,000	Stock	11,00,000
G	15,46,000	Machinery	14,31,000
	51,44,000	Building	24,00,000
	57,19,000		57,19,000

Illustration 27

Tomi, Soni and Jani are partners sharing profits and losses in the ratio of 1 : 2 : 3. Their balance sheet as at 31st December 2022 was as follows :

<i>Liabilities</i>	<i>Amount</i> <i>(Rs.)</i>	<i>Assets</i>	<i>Amount</i> <i>(Rs.)</i>
Creditors	8,700	Cash	3,000
Reserves	4,200	Debtors	6,200
Profit & Loss A/c (Profits)	2,100	Less : Provision for	
Capital Accounts :		doubtful debts	200
Tomi	30,000	Stock	18,000
Soni	30,000	Furniture	3,000
Jani	5,000	Plant	20,000
	65,000	Building	30,000
	80,000		80,000

The partners agreed that from 1st January 2023 they will share profits and losses in the ratio of 1 : 4 : 4. They agreed the following:

- i. Stock is to be valued at 20% less.
- ii. Provision for doubtful debts to be increased by Rs. 150.
- iii. Furniture is to be depreciated by 20% and plant by 15%.
- iv. Rs. 350 are outstanding for salaries.
- v. Building is to be valued at Rs. 35,000.
- vi. Goodwill is valued at Rs. 4,500.

Partners do not want to record the altered values of assets and liabilities in the books and want to leave the reserves and profits undistributed. They also decided not to show goodwill in the books.

You are required to pass a single journal entry to give effect to the above. Also prepare the revised balance sheet.

Solution :

Workings :

Loss due to decrease in the value of Stock	3,600
Loss due to provision for doubtful debts	150
Loss due to decrease in the value of Furniture	600
Loss due to decrease in the value of Plant	3,000
Loss due to unrecorded liability (<i>i.e.</i> Outstanding salary)	350
	7,700
Gain due to increase in the value of Building	5,000
Loss on Revaluation	(-) 2,700
Adjustment for Reserves	(+) 4,200
Adjustment for Profit & Loss A/c (Profit)	(+) 2,100
Adjustment for Goodwill	(+) 4,500

Net Gain (+) 8,100

Old Ratio of Tomi, Soni and Jani 1 : 2 : 3

New Ratio of Ram, Mohan and Sohan 1 : 4 : 4

Sacrifice or Gain :

Tomi = $1/6 - 1/9 = 1/18$ (Sacrifice) $8,100 \times 1/18 = 450$ (Cr.)

Soni = $2/6 - 4/9 = 2/18$ (Gain) $8,100 \times 2/18 = 900$ (Dr.)

Jani = $3/6 - 4/9 = 1/18$ (Sacrifice) $8,100 \times 1/18 = 450$ (Cr.)

Journal

<i>Date</i>	<i>Particulars</i>	<i>Debit Amount (Rs.)</i>	<i>Credit Amount (Rs.)</i>
2013 Jan. 1	Soni's Capital A/c Dr. To Tomi's Capital A/c To Jani Capital A/c (The adjustment for revaluation of assets and liabilities and for reserves, profits and goodwill on change in profit sharing ratio)	900	450 450

Illustration 28

Manoj, Hari and Krishna are partners in a firm in the ratio of 3: 4 : 2. On 1st April, 2022 they decided to share profits in future in the ratio of 4 : 2: 3. On this date general reserve was Rs.7,29,000 and loss on revaluation of assets and liabilities was Rs. 1,80,000. It was decided that adjustment should be made without altering the figures of assets and liabilities in the Balance Sheet. Make adjustment by a single journal entry.

Solution :

General Reserve	7,29,000
(-) Loss on Revaluation	1,80,000
Net amount of gain	5,49,000

Old Ratio of Manoj, Hari and Krishna 3: 4 : 2.

New Ratio of Manoj, Hari and Krishna 4 : 2 : 3

Sacrifice or Gain :

Manoj = $3/9 - 4/9 = 1/9$ (Gain) $5,49,000 \times 1/9 = 61,000$ (Dr.)

Hari = $4/9 - 2/9 = 2/9$ (Sacrifice) $5,49,000 \times 2/9 = 1,22,000$ (Cr.)

Krishna = $2/9 - 3/9 = 1/9$ (Gain) $5,49,000 \times 1/9 = 61,000$ (Dr.)

Journal

<i>Date</i>	<i>Particulars</i>	<i>Debit Amount (Rs.)</i>	<i>Credit Amount (Rs.)</i>
2022 Apr 1	Krishna's Capital A/c Dr. Manoj's Capital A/c To Hari Capital A/c (The adjustment for general reserve and loss on revaluation of assets and liabilities on change in profit sharing ratio)	61,000 61,000	1,22,000

Illustration 29

Adi, Suri and Giri are partners sharing profits and losses in the ratio of 3 : 3 : 2. Their Balance Sheet as on 31st March, 2022 is as follows:

Partners decided that with effect from 1st April, 2014 they would share profits and losses in the ratio of 4 : 3 : 2. It was agreed that :

- i. Stock be valued at Rs. 11,000.
- ii. Machinery is to be depreciated by 10%.
- iii. A provision for doubtful debts is to be made on Debtors @5%.
- iv. Building to be appreciated by 20%.
- v. A liability for Rs.250 included in Sundry Creditors is not likely to arise.

Partners agreed that the revised values are not to be recorded in the books. They also do not want to distribute the general reserve. You are required to pass Journal Entries, prepare Capital Account of the partners and the Balance Sheet.

Solution :

Journal

<i>Date</i>	<i>Particulars</i>	<i>Debit Amount (Rs.)</i>	<i>Credit Amount (Rs.)</i>
2022 Apr 1	Adi's Capital A/c Dr. To Suri's Capital A/c To Giri's Capital A/c (Being adjustment for revaluation of assets and liabilities and for general reserve made on change in profit-sharing ratio)	350	210 140

Partner's Capital Accounts

<i>Particulars</i>	<i>Adi (Rs.)</i>	<i>Suri (Rs.)</i>	<i>Giri (Rs.)</i>	<i>Particulars</i>	<i>Adi (Rs.)</i>	<i>Suri (Rs.)</i>	<i>Giri (Rs.)</i>
To Suri's Capital A/c	210	.....	.....	By Balance b/d	20,000	15,000	15,000
To Giri's Capital A/c	140	15,210	15,140	By Adi's Capital A/c	.....	210	140
To Balance c/d	19,650						
	20,000	15,210	15,140		20,000	15,210	15,140

Balance Sheet as at 1st April 2022

<i>Liabilities</i>	<i>Amount (Rs.)</i>	<i>Assets</i>	<i>Amount (Rs.)</i>
Sundry creditors	2,400	Cash at Bank	3,700
General Reserve	3,600	Sundry Debtors	4,400
Capital Accounts :		Stock	12,000
Adi	19,650	Machinery	15,900
Suri	15,210	Building	20,000
Giri	15,140		
	50,000		
	56,000		56,000

Working Notes :

Journal

<i>Particulars</i>	<i>(Rs.)</i>	<i>(Rs.)</i>
Loss due to decrease in the value of Stock	1,000	
Loss due to decrease in the value of Machinery	1,590	
Loss due to Provision for Doubtful Debts	220	2,810
Gain due to increase in the value of Building	4,000	
Gain due to decrease in Sundry Creditors	250	4,250
Gain on Revaluation	1,440	
+General Reserve	3,600	5,040

(2) Old Ratio of Adi, Suri and Giri 3 : 3 : 2

New Ratio of Adi, Suri and Giri 4 : 3 : 2

Sacrificing Ratio = Old Share - New Share

Adi = $\frac{3}{8} - \frac{4}{9} = \frac{5}{72}$ (Gain) $5,040 \times \frac{5}{72} = \text{Rs.}350$ (Dr.)

Suri = $\frac{3}{8} - \frac{3}{9} = \frac{3}{72}$ (Sacrifice) $5,040 \times \frac{3}{72} = 210$ (Cr.)

Giri = $\frac{2}{8} - \frac{2}{9} = \frac{2}{72}$ (Sacrifice) $5,040 \times \frac{2}{72} = 140$ (Cr.)

Illustration 30

Basha and David are partners sharing profit and losses in the ratio of 4 : 2. Their Balance Sheet was as follows:

Balance Sheet of Karan and Traun as at December 31st, 2014

<i>Liabilities</i>	<i>Amount (Rs.)</i>	<i>Assets</i>	<i>Amount (Rs.)</i>
Creditors	10,000	Cash in hand	7,000
Bills Payable	7,000	Debtors	26,000
Capitals :		Building	20,000
Basha 40,000		Investment	15,000
David <u>30,000</u>	70,000	Machinery	13,000
		Stock	6,000
	<u>87,000</u>		<u>87,000</u>

John is admitted as a partner and assets are revalued and liabilities reassessed as follows:

- (i) Create a Provision for doubtful debt on debtors at Rs. 800.
- (ii) Building and investment are appreciated by 10%.
- (iii) Machinery is depreciated at 5%
- (iv) Creditors were overestimated by Rs. 500.

Make journal entries and Prepare revaluation account before the admission of John.

Solution :

Journal

<i>Date</i>	<i>Particulars</i>	<i>Debit Amount (Rs.)</i>	<i>Credit Amount (Rs.)</i>
	Revaluation A/c Dr. To Provision for Doubtful Debts (Provision made for doubtful debts)	800	800
	Building A/c Dr. Investment A/c Dr. To Revaluation A/c (Increase in the value of Building & Investment)	2,000 1,500	3,500
	Revaluation A/c Dr. To Machinery A/c (Decrease in the value of Machinery)	650	650
	Creditors A/c Dr. To Revaluation A/c (Value of Creditors reduced by Rs. 500)	500	500

Illustration 31

Shoba and Reshma are partners sharing profit in the ratio of 5:2. On 1st April 2021 they admit Jansi as a new partner for 1/3 share in profits. On that date the balance sheet of the firm shows a balance of Rs.1,05,000 in general reserve and debit balance of Profit and Loss A/c of Rs.28,000. make the necessary journal entries.

Solution :

Journal

<i>Date</i>	<i>Particulars</i>	<i>LF No.</i>	<i>Debit (Rs.)</i>	<i>Credit (Rs.)</i>
	General Reserve Dr.		1,05,000	
	To Shoba's Capital A/c			75,000
	To Reshma's Capital A/c			30,000
	(Transfer of general reserve to the existing partner's capital accounts)			
	Shoba's Capital A/c Dr.		20,000	
	Reshma's Capital A/c Dr.		8,000	
	To Profit & Loss A/d			28,000
	(Transfer of accumulated Loss to existing partner's capital A/c)			

Illustration 32

Suma and Mina are partners sharing profit and losses in the ratio of 6:4 respectively. Their Balance Sheet as on March 31, 2022 is as under :

Balance Sheet of Suma and Mina as on March 31st, 2022

<i>Particulars</i>	<i>(Rs.)</i>	<i>Particulars</i>	<i>(Rs.)</i>
Creditors	28,000	Cash in hand	3,000
Capitals :		Cash at bank	23,000
Suma 70,000		Debtors	19,000
Mina 70,000	1,40,000	Buildings	65,000
		Furniture	15,000
		Machinery	13,000
		Stock	30,000
	1,68,000		1,68,000

On that date, they admit Swathi into partnership for 1/3 share in future profit on the following terms:

- (i) Furniture and stock are to be depreciated by 10%.
- (ii) Building is appreciated by Rs. 20,000.
- (iii) 5% provision is to be created on Debtors for doubtful debts.

Swathi is to bring in Rs. 50,000 as his capital and Rs. 30,000 as goodwill. Make necessary ledger accounts and balance sheet of the new firm.

Solution :

Revaluation Account

Dr.		Cr.	
<i>Particulars</i>	<i>Amount (Rs.)</i>	<i>Particulars</i>	<i>Amount (Rs.)</i>
Provision for Doubtful Debts	950	Building	20,000
Furniture	1,500		
Stock	3,000		
Profit transferred to			
Suma's Capital A/c	8,730		
Mna's Capital A/c	<u>5,820</u>		
	14,550		
	<u>20,000</u>		<u>20,000</u>

Capital Account

<i>Particulars</i>	<i>Suma (Rs.)</i>	<i>Mina (Rs.)</i>	<i>Swathi (Rs.)</i>	<i>Particulars</i>	<i>Suma (Rs.)</i>	<i>Mina (Rs.)</i>	<i>Swathi (Rs.)</i>
Balance c/d (Closing)	96,730	87,820	50,000	Balance b/d (Closing)	70,000	70,000	....
				Revaluation (Profit)	8,730	5,820	....
				Bank A/c	....	....	50,000
				Goodwill Premium A/c	18,000	12,000	....
	<u>96,730</u>	<u>87,820</u>	<u>50,000</u>		<u>96,730</u>	<u>87,820</u>	<u>50,000</u>

Balance Sheet of Suma, Mina and Swathi as on December 31st, 2022

<i>Particulars</i>		<i>(Rs.)</i>	<i>Particulars</i>		<i>(Rs.)</i>
Creditors		28,000	Cash in hand		3,000
Capitals :			Cash at bank		1,03,000
Suma	96,730		Debtors	19,000	
Mina	87,820		Less : Provision	950	18,050
Swathi	<u>50,000</u>	2,34,550	Stock		27,000
			Furniture		13,500
			Machinery		13,000
			Building		85,000
		<u>2,62,550</u>			<u>2,62,550</u>

Illustration 33

Arjun and Nakul are partners sharing profit in the ratio of 3 : 2, their Balance sheet on March 31, 2022 was as follows:

Balance Sheet of Ashu and Pankaj as on March 31st, 2022

<i>Liabilities</i>		<i>Amount (Rs.)</i>	<i>Assets</i>		<i>Amount (Rs.)</i>
Creditors		38,000	Cash in Hand		15,000
Bills Payable		40,000	Cash at Bank		62,000
Salaries outstanding		5,000	Debtors		58,000
Profit & Loss		40,000	Stock		85,000
Capitals :			Machinery		1,45,000
Arjun	1,50,000		Goodwill		38,000
Nakul	<u>1,30,000</u>	2,80,000			
		<u>4,03,000</u>			<u>4,03,000</u>

They admitted Sahadev into partnership on the following terms on March 31, 2022.

- New profit sharing ratio is agreed as 3 : 2 : 1.
- He will bring in Rs. 1,00,000 as his share of capital and Rs.30,000 as his share of goodwill.

- (c) Machinery is appreciated by 10%
- (d) Stock is valued at Rs. 87,000.
- (e) Creditors are unrecorded to the extent of Rs. 6,000.
- (f) A provision for doubtful debts is to be created by 4% on debtors.

Prepare Revaluation account, Capital Accounts, Bank account and Balance Sheet of the new firm after admission of Sahadev.

Solution:

Revaluation Account

<i>Particulars</i>	<i>Amount (Rs.)</i>	<i>Particulars</i>	<i>Amount (Rs.)</i>
Provision for Doubtful Debts	2,320	Machinery	14,500
Creditors	6,000	Stock	2,000
Profit transferred to			
Arjun's Capital A/c	4,908		
Nakul's Capital A/c	3,272		
	8,180		
	16,500		16,500

Capital Account

<i>Particulars</i>	<i>Arjun (Rs.)</i>	<i>Nakul (Rs.)</i>	<i>Sahadev (Rs.)</i>	<i>Particulars</i>	<i>Arjun (Rs.)</i>	<i>Nakul (Rs.)</i>	<i>Sahadev (Rs.)</i>
Goodwill A/c	22,800	15,200	.....	Balance b/d	1,50,000	1,30,000	.....
Balance c/d	1,74,108	1,46,072	1,00,000	Profit & Loss A/c	24,000	16,000	
				Revaluation A/c (Profit)	4,908	3,272	
				Bank A/c	.....	.....	1,00,000
				Goodwill	18,000	12,000	.....
	1,96,908	1,61,272	1,00,000		1,96,908	1,61,272	1,00,000

Balance Sheet of Arjun, Nakul and Sahadev as on March 31st, 2022

<i>Liabilities</i>	<i>Amount (Rs.)</i>	<i>Assets</i>	<i>Amount (Rs.)</i>
Creditors	44,000	Cash in Hand	15,000
Bills Payable	40,000	Cash at Bank	1,92,000
Salaries outstanding	5,000	Debtors	58,000
Capitals :		Less : Prov. of	
Ashu	1,74,108	doubtful debts (-)	<u>2,320</u>
Pankaj	1,46,072	Stock	87,000
Gurdeep	1,00,000	Machinery	1,59,500
	4,20,180		5,09,180
	5,09,180		5,09,180

Bank Account

Dr.

Cr.

<i>Particulars</i>	<i>Amount (Rs.)</i>	<i>Particulars</i>	<i>Amount (Rs.)</i>
Balance b/d	62,000	Balance c/d	1,92,000
Sahadev's Capital A/c	1,00,000		
Goodwill A/c	30,000		
	1,92,000		1,92,000

Working Note :

Sacrificing Ratio = Existing Ratio – New Ratio

<i>Partners</i>	<i>Existing Ratio</i>	<i>New Ratio</i>	<i>Sacrifice</i>	<i>Sacrificing Ratio</i>
Arjun	3/5	3/6	$\frac{18-15}{30} = 3/30$	Arjun : Nakul
Nakul	2/5	2/6		3 : 2

9.2.7 Adjustment of Partner's Capital

Sometime, at the time of admission, the partners' agree that their capitals be adjusted in proportion to their profit sharing ratio. For this purpose, the capital accounts of the existing partners are prepared, making all adjustments, on account of goodwill, general-reserve, revaluation of assets and resettlement of liabilities. The actual capital so adjusted will be compared with the amount of capital that should be kept in the business after the admission of the new partner. The excess if any, of adjusted actual capital over the proportionate capital will either be withdrawn or transferred to current account and vice versa.

The partners may decide to calculate the capitals which are to be maintained in the new firm either on the basis of new Partner's Capital and his profit sharing ratio or on the basis of the existing partner's capital account balances.

1. Adjustment of existing partner's capital on the basis of the capital of the new partner:

If the capital of the new partner is given, the entire capital of the new firm will be determined on the basis of the new partner's capital and his profit sharing ratio. Therefore the capital of other partners is ascertained by dividing the total capital as per his profit sharing ratio.

If the existing capital of the partner after adjustment is in excess of his new capital, the excess amount is withdrawn by partner or transferred to the credit of his current account. If the existing capital of the partner is less than his new capital, the partner brings the short amount or makes transfer to the debit of his current account. The journal entries are made as under:

- (i) When excess amount is withdrawn by the partner or transferred to current account.

Existing Partner's Capital A/c	Dr.
To Bank A/c or Partner Current A/c	

(Excess amount is withdrawn by the partner or transferred to current account)

- (ii) For bringing in the Deficit amount or Balance transferred to current account.

Bank A/c or Partner Current A/c	Dr.
To Existing Partner's Capital A/c	

(Bringing the Deficit amount or Balance transferred to current account)

Illustration 34

Dipa and Saha are partners sharing profit in the ratio of 4:2 with capital of Rs.50,000 and Rs.40,000 respectively. They admit a new partner Nila. The new profit sharing ratio of Dipa, Saha and Nila is 4:3:2 respectively. Nila brings Rs.40,000 as capital. The profit on revaluation of assets and reassessment of liabilities is Rs.8,400. It is agreed that capitals of the partner's should be in the new profit sharing ratio. Calculate new capital of each partner.

Solution :

Actual Capital of Dipa and Saha

	Dipa (Rs.)	Saha (Rs.)
Balance in Capital A/c	50,000	40,000
Add Profit on Revaluation (4 : 2)	5,600	2,800
Capital after Adjustment	55,600	42,800

Calculation of new capital of the firm and existing partner's capital

Nilas Share in the firm = $\frac{2}{9}$

Nilas brings Rs.40,000 for $\frac{2}{9}$ Share

$$\begin{aligned} \text{Total capital of the new firm in terms of Nilas capital} &= \text{Rs.}40,000 \times \frac{9}{2} \\ &= \text{Rs.}1,80,000 \end{aligned}$$

$$\text{Dipas share in New Capital} = \text{Rs.}1,80,000 \times \frac{4}{9} = \text{Rs.}80,000$$

$$\text{Sahas share in New Capital} = \text{Rs.}1,80,000 \times \frac{3}{9} = \text{Rs.}60,000$$

On comparing Dipas adjusted capital with the new capital we find that the Dipa brings Rs.24,400 [Rs.80,000 - Rs.55,600] or the amount may be debited to her current account.

On comparing the Sahas adjusted capital with the new capital, we find that the Saha brings Rs.17,200 [Rs.60,000 - Rs.42,800] or the amount may be debited to his current account.

2. When the capital of the new partner is calculated in proportion to the total capital of the new firm.

Sometimes the capital of the new partner is not given. He/she is required to bring an amount proportionate to his/her share of profit. In such a case, new partner's capital will be calculated on the basis of adjusted capital of the existing partners.

For example, the capital accounts of Soni and Ami show the balance after all adjustments and revaluation as Rs.60,000 and Rs.45,000 respectively. They admit Sohil as a new partner for $\frac{1}{4}$ share in the profits. Sohils capital is calculated as follows:

Total share = 1
 Sohil's share in the profit = $1/4$
 Remaining share = $1 - 1/4 = 3/4$
 $3/4$ share of profit combined capital of Soni and Ami
 = Rs.60,000 + Rs.450,000 = Rs.1,05,000
 Total Capital of the firm = Rs.1,05,000 \times $4/3$
 = Rs.1,40,000
 Sohil's capital for $1/4$ share of profits = Rs.1,40,000 \times $1/4$ = Rs.35,000
 Sohil brings in Rs.35,000 as his Capital

Illustration 35

Ravi and Anu are partner sharing profit and losses in the ratio of 7 : 3. On March 31, 2022 their Balance Sheet was as follows:

Balance Sheet of Arjun, Nakul and Sahadev as on March 31st, 2022

<i>Liabilities</i>	<i>Amount (Rs.)</i>	<i>Assets</i>	<i>Amount (Rs.)</i>
Capital :		Bank	12,000
Ravi 88,000		Sundry Debtors	45,000
Anu 64,000	1,52,000	Bills Receivable	30,000
Sundry Creditors	32,000	Stock	35,000
Bills Payable	38,000	Investment	13,000
Reserve	18,000	Machinery	40,000
		Building	45,000
		Goodwill	20,000
	2,40,000		2,40,000

They admit Siri into partnership on the following terms:

- (i) Stock is revalued at Rs.40,000.
- (ii) Building, Machinery and Investment are depreciated by 12%.
- (iii) Prepaid Insurance is Rs.1,000.
- (iv) Siri brings Rs.40,000 as his capital and Rs.12,000 for goodwill for $1/6$ share of profit of the firm.
- (v) Capital of the partners shall be proportionate to their profit sharing ratio. Adjustment of Capitals to be made by Cash.

Prepare Revaluation Account, Partners' Capital Account, Cash Account and Balance Sheet of the new firm.

Solution :

Dr. Revaluation Account Cr.

<i>Particulars</i>	<i>Amount (Rs.)</i>	<i>Particulars</i>	<i>Amount (Rs.)</i>
Building	5,400	Stock	5,000
Machinery	4,800	Prepaid Insurance Loss	1,000
Investment	1,560	transferred to	
		Ravi's Capital	4,032
		Anu's Capital	<u>1,728</u>
			5,760
	<u>11,760</u>		<u>11,760</u>

Dr. Capital Account Cr.

<i>Particulars</i>	<i>Ravi (Rs.)</i>	<i>Anu (Rs.)</i>	<i>Soiri (Rs.)</i>	<i>Particulars</i>	<i>Ravi (Rs.)</i>	<i>Anu (Rs.)</i>	<i>Soiri (Rs.)</i>
Goodwill	14,000	6,000		Balance b/d	88,000	64,000	
Revaluation A/c (loss)	4,032	1,728		Reserve	12,600	5,400	
Bank A/c		5,272		Goodwill A/c	8,400	3,600	
Balance c/d	1,40,000	60,000	40,000	Bank A/c	49,032		40,000
	<u>1,58,032</u>	<u>73,000</u>	<u>90,000</u>		<u>1,58,032</u>	<u>73,000</u>	<u>90,000</u>

Balance Sheet of Ravi, Anu and Siri as on March 31st, 2022

<i>Liabilities</i>	<i>Amount (Rs.)</i>	<i>Assets</i>	<i>Amount (Rs.)</i>
Bills Payable	38,000	Bank	1,07,760
Sundry Creditors	32,000	Bills Receivable	30,000
Capitals A/c.		Sundry Debtors	45,000
Ravi	1,40,000	Stock	40,000
Anu	60,000	Investment	11,440
Siri	<u>40,000</u>	Prepaid Insurance	1,000
		Machinery	35,200
		Building	39,600
	<u>3,10,000</u>		<u>3,10,000</u>

Dr.		Bank Account		Cr.	
<i>Particulars</i>	<i>Amount (Rs.)</i>	<i>Particulars</i>	<i>Amount (Rs.)</i>		
Balance b/d	12,000	Anu's Capital A/c	5,272		
Ravi's Capital A/c	49,032	Balance c/d	1,07,760		
Goodwill A/c	12,000				
Siri's Capital A/c	40,000				
	1,13,032				
				1,13,032	

Working Note :

- (a) Calculation of New profit Sharing Ratio:

Total Profit = 1

Siri gets = $1/6$

Remaining Profit = $1 - 1/6 = 5/6$ shared by Ravi and Anu in their existing profit sharing ratio.

Ravi's new share = $5/6 \times 7/10 = 7/12$

Anu's new shares = $5/6 \times 3/10 = 3/12$

New profit sharing ratio of Ravi, Anu and Siri

= $7/12 : 3/12 : 1/6$ or $7 : 3 : 2$.

- (b) Adjustment of Capital:

Siri brought capital for $1/6$ share = Rs.40,000

Total Capital of the firm = Rs.40,000 $\times 6/1$ = Rs.2,40,000

Ravi's Capital = Rs.2,40,000 $\times 7/12$ = Rs.1,40,000

Anu's Capital = Rs.2,40,000 $\times 3/12$ = Rs.60,000

Siri's Capital = Rs.2,40,000 $\times 2/12$ = Rs.40,000

WHAT YOU HAVE LEARNT

- **Admission of a Partner – Meaning:** When a partner is admitted to the existing partnership firm, it is called admission of a partner.

On the admission of a new partner, the following adjustments become necessary:

- (i) Adjustment in profit sharing ratio;
- (ii) Adjustment of Goodwill;
- (iii) Adjustment for revaluation of assets and reassessment of liabilities;
- (iv) Distribution of accumulated profits and reserves; and
- (v) Adjustment of partners' capitals.

Adjustment in Profit sharing Ratio : When new partner is admitted he/she acquires his/her share in profit from the existing partners. As a result, the profit sharing ratio in the new firm is decided mutually between the existing partners and the new partner.

- **Sacrificing Ratio:** At the time of admission of an incoming partner, existing partners have to surrender some of their share in favour of the new partner. The ratio in which they surrender their profits is known as sacrificing ratio.
- **Meaning of Goodwill:** Any established firm develops wide business connections. This helps the firm to earn more profits as compared to a new firm. The monetary value of such advantage is known as “Goodwill”.
- **Methods of valuation of Goodwill :** (i) Average Profit Method (ii) Super Profit Method (iii) Capitalisation Method
- **Revaluation of Assets and Liabilities:** On admission of a new partner, the firm is reconstituted and the assets are revalued and liabilities are reassessed. It is necessary to show the true position of the firm at the time of admission of a new partner.
- **Adjustments of Reserves and Accumulated Profit or Losses:** Any accumulated profit or reserve appearing in the balance sheet at the time of admission of a new partner, are credited in the existing partner's capital account in existing profit sharing ratio. If there is any loss, the same will be debited to the existing partners in the existing ratio.
- **Adjustment of Partner's Capital :** Sometimes, at the time of admission, the partners' agreed that their capitals are adjusted in proportionate to their profit sharing

ratio. The partners may decide to calculate the capitals which are to be maintained in the new firm either on the basis of new Partner's Capital and his profit sharing ratio or on the basis of the existing partner's capital accounts.

- At the time of change in profit sharing ratio of the existing partners the Reserves and accumulated profits/losses existing in the books are transferred to the capital/current accounts of the partners in their old profit sharing ratio.
- In case the partners decide to leave the reserves and profits/losses undistributed then an adjustment entry passed to give effect to the change in the profit sharing ratio. This is done by debiting the capital accounts of the partner(s) who have gained and crediting the capital accounts of the partners who have sacrificed proportionately.
- A change in profit sharing ratio of the existing partners implies that one partner is purchasing from another partner, a share of profit previously belonging to the latter. Therefore, the purchasing or gaining partner must compensate the sacrificing partner by paying the proportionate amount of goodwill. The following journal entry is passed for treatment of goodwill on change in the profit sharing ratio of the existing partners.

Gaining Partners' Capital A/c Dr.

To Sacrificing partner's Capital A/c

(Treatment of goodwill on change in profit sharing ratio of existing partners)

- On change in profit sharing ratio of the existing partners it is desirable to revalue assets and reassess the liabilities. The reason is that the realisable value of assets may be different from the book value. Similarly the amount payable on account of third party liabilities may be different from the book value of the liabilities.
- Revaluation of assets and reassessment of liabilities may be given effect in two different ways : (a) When revised values are recorded in the books and; (b) When revised values are not recorded in the books.
- In the first case the revaluation is done by preparing Revaluation Account. Gain or Loss on revaluation is transferred to the capital accounts of the partners in their old profit sharing ratio.

Terminal Exercise

Section - A

1. Revaluation Account
2. Goodwill
3. Sacrificing Ratio

Section - B

1. What are the different methods of valuation of Goodwill?
2. Explain 'Revaluation Account'. Why assets and liabilities are revalued at the time of admission of a new partner?
3. Explain the treatment of accumulated profit or losses and reserves at the time of admission of a new partner.
4. Explain the calculation of the proportionate capital of the new partner in case of admission of a partner.
5. L and M are partners sharing profit in the ratio of 5 : 3 N is admitted to the partnership for 1/4 share of future profit . Calculate the new profit sharing ratio and sacrificing ratio.
6. Raja and Rana are partners sharing profits and losses in the ratio of 7 : 3. Raja surrenders 1/7 of his share and Rana surrenders 1/3 of her share in favour of Teena, a new partner. Calculate the new profit sharing ratio.
7. A firm has earned Rs. 3,00,000 as average profit for the last few years. Normal rate of return in the class of business is 15%. Find out goodwill according to Capitalisation of Super profit, if the value of net assets amounted to Rs. 16,00,000.

Section - C

1. The following is the Balance Sheet of Kotler and Khan sharing profit and losses in the ratio of 2 : 1.

<i>Liabilities</i>	<i>Amount (Rs.)</i>	<i>Assets</i>	<i>Amount (Rs.)</i>
Capitals :		Cash	12,000
Kotler 50,000		Sundry Debtors	60,000
Khan 40,000	90,000	Stock	12,000
Sundry Creditors	20,000	Furniture	6,000
		Building	20,000
	1,10,000		1,10,000

They agreed to admit Jain into partnership on the following terms:

- (i) Jain to pay Rs. 9,000 as Goodwill.
- (ii) Jain bring Rs. 11,000 as her Capital for 1/4 share of profit in the business.
- (iii) Building and furniture to be depreciated at 5%. Stock is reduced by Rs. 1,600 and Bad Debt Reserve Rs. 1,300 to be provided for.

Prepare necessary ledger accounts and balance sheet after admission.

2. J and K are partner in a firm sharing profit in the ratio 2 : 1. L is admitted into the firm with 1/4 share in profits. He will bring in Rs. 60,000 as capital and capital of J and K are to be adjusted in the profit sharing ratio. The Balance sheet of J and K as on March 31, 2022 was as under :

<i>Liabilities</i>		<i>Amount (Rs.)</i>	<i>Assets</i>		<i>Amount (Rs.)</i>
Sundry Creditors		16,000	Cash in Hand		4,000
Bills Payable		8,000	Cash at Bank		20,000
General Reserve		12,000	Sundry Debtors		16,000
Capitals :			Stock		20,000
J	1,00,000		Furniture		10,000
K	<u>64,000</u>	1,64,000	Machinery		50,000
			Building		80,000
		<u>2,00,000</u>			<u>2,00,000</u>

Other terms of agreement are as under :

- i. L will bring in Rs. 24,000 as his share of Goodwill.
- ii. Building was valued at Rs. 90,000 and Machinery at Rs. 46,000
- iii. A provision for bad debts is to be created @ 6% on Debtors.
- iv. The capital account of J and K are to be adjusted through cash.

Prepare necessary accounts and Balance Sheet after L's admission.

3. Giri and hari were partners in a firm sharing profits in 3 : 2 ratio. From 1.4.2021 they decided to share profits equally. For this purpose the goodwill of the firm was valued at Rs. 50,000. Pass necessary adjustment entry for the treatment of goodwill due to change in profit sharing ratio between Giri and Hari.

4. Karuna and Yamini were partners sharing profits in 5 : 3 ratio. From 1.1.2020 they decided to change the profit sharing ratio. The new ratio will be 3 : 5. For this purpose the goodwill of the firm was valued at Rs. 1,60,000. Pass necessary adjustment entry for treatment of goodwill on change in profit sharing of Karuna and Yamini.
5. Aruna, Jaya and Sobha were partners sharing profits in 3 : 2 : 1 ratio. They decided to share the profits in future equally. For this purpose the goodwill of the firm was valued at Rs. 1,20,000. Pass necessary adjustment entry in the books of Aruna, Jaya and Sobha for the treatment of goodwill due to change in profit sharing ratio.
6. Anil, Nikhil and Khaleel were partner in a firm sharing profits in 5:3:2 ratio. From 1.4.2022 they decided to share the profits in 3 : 5 : 2 ratio. For this purpose the goodwill of the firm was valued at Rs. 2,00,000.

Pass the necessary journal entry for the treatment of goodwill on change in profit sharing ratio of Anil, Nikhil and Khaleel.

7. Kiran and Jaya were partners in a firm sharing profits in 3 : 2 ratio. On 31.3.2022 their balance sheet showed general reserve of ‘ Rs. 30,000. On that date they decided to share future profits equally.

Pass necessary journal entry for the treatment of general reserve on the occasion of change in profit sharing ratio.

8. Ravi and Anu were partners sharing profits in 3 : 1 ratio. On 31.3.2020 their books showed a debit balance of Rs. 40,000 of profit and loss account. They decided to share the profits in 3 : 2 ratio.

Pass necessary journal entry for the treatment of the above balance.

9. Minnu and Kanha were partners in a firm sharing profits in 3 : 2 ratio. Their balance sheet showed a general reserve of Rs. 15,000. They decided to share future profit in 3 : 1 ratio.

Pass necessary journal entries for the treatment of general reserve on change in profit sharing ratio of Minnu and Kanha.

10. Madhu, Jagan and Ruma were partners in a firm sharing profits in 3 : 2 : 1 ratio. They decided to share the future profits equally. At the time of change in profit sharing ratio they had a debit balance of Rs. 60,000 in their profit and loss account. They decided not to distribute the loss among themselves and give effect to the same by passing an adjustment entry.

11. Pal and Lal were partners in a firm sharing profits in 3 : 4 ratio. They decided to share the profits equally from 1.4.2022. The following revaluation of assets and reassessment of liabilities was agreed upon between the partners on this occasion :
- i. Building was depreciated by Rs. 2,000.
 - ii. A provision of 5% on debtors which were Rs. 10,000 was created for bad and doubtful debts.
 - iii. Land was appreciated by Rs. 70,000.
 - iv. Stock was depreciated by Rs. 30,000.
- Pass necessary journal entries for the above and prepare revaluation account.
12. Pass necessary journal entries and prepare revaluation account for the revaluation of the following items on change in profit sharing ratio of Lata and Mithra from 2 : 3 to 4 : 5.
- i. There was an unrecorded Computer of Rs. 70,000 which was taken into account.
 - ii. A creditor of Rs. 5,000 was not likely to be paid.
 - iii. A piece of land purchased 5 years ago for Rs. 20,000 was valued at Rs. 2,00,000.

RETIREMENT AND DEATH OF A PARTNER

If you look around, you must have noticed people in your relation and in your neighbourhood running business in partnership. You must have seen people quitting partnership firm or a person dies while in partnership. These are the events that take place during the lifetime of a partnership firm. Some issues arise on the happening of these events involving finance. Some assets and liabilities may need revaluation, goodwill is to be treated and amount of joint life policy is distributed and some accounting adjustment have to be made. Whenever such events take place, the firm has to calculate the dues of a partner leaving the firm or that of the deceased. In this lesson you will learn the accounting treatment in the books of the firm in these two cases i.e. retirement of a partner and death of a partner.

Objectives

After studying this lesson, you will be able to:

- state the meaning of retirement/death of a partner;
- calculate new profit sharing ratio and gaining ratio;
- make adjustments relating to goodwill;
- explain the need for revaluation of assets and reassessment of liabilities at the time of retirement/death;
- describe treatment of accumulated reserves and undistributed profits at the time of retirement/death of a partner;
- prepare revaluation account on retirement/death of a partner;
- illustrate the various methods of settling the claim of retiring partner and the related accounting treatment;
- illustrate the accounting treatment of partners' capital and its adjustment;
- ascertain profit up to the date of death of a partner and
- prepare the account of the deceased partner's executor.

9.3.1 Retirement - Meaning, Calculation of New Profit Sharing Ratio and Gaining Ratio

When one or more partners leave the firm and the remaining partners continue to do the business of the firm, it is known as retirement of a partner. Amit, Sunil and Ashu are partners in a firm. Due to some family problems, Ashu wants to leave the firm. The other partners decide to allow him to withdraw from the partnership. Thus, due to some reasons like old age, poor health, strained relations etc., an existing partner may decide to retire from the partnership. Due to retirement, the existing partnership comes to an end and the remaining partners form a new agreement and the partnership firm is reconstituted with new terms and conditions. At the time of retirement the retiring partner's claim is settled.

A partner retires either :

- (i) with the consent of all partners, or
- (ii) as per terms of the agreement; or
- (iii) at his or her own will.

The terms and conditions of retirement of a partner are normally provided in the partnership deed. If not, they are agreed upon by the partners at the time of retirement. The old partnership comes to an end and a new partnership is formed among the remaining partners. At the time of retirement the following accounting issues are dealt with :

- (a) New profit sharing ratio and gaining ratio.
- (b) Goodwill.
- (c) Adjustment of changes in the value of Assets and liabilities.
- (d) Treatment of reserve and accumulated profits.
- (e) Settlement of retiring partners dues.
- (f) New capital of the continuing partners.

New Profit Sharing Ratio and Gaining Ratio

As soon as a partner retires the profit sharing ratio of the continuing partners get changed. The share of the retiring partner is distributed amongst the continuing partners. In the absence of information, the continuing partners take the retiring partner's share in their profit sharing ratio or in an agreed ratio. The ratio in which retiring partner's share is distributed amongst continuing partners is known as gaining ratio. Gain of a partner is

New Ratio – Existing Ratio

Gain of an existing partner = His New Share - His Existing (old) Share Various cases of new ratio and gaining ratio are illustrated as follows :

(i) Retiring Partner's Share Distributed in Existing Ratio

In this case, retiring partner's share is distributed in existing ratio amongst the remaining partners. The remaining partners continue to share profits and losses in the existing ratio. The following example illustrates this :

Tanu, Manu and Rena are partners sharing profits and losses in the ratio of 4 : 3 : 2. Tanu retires and remaining partners decide to take Tanu's share in the existing ratio i.e. 3 : 2. Calculate the new ratio of Manu and Rena.

Existing Ratio between Manu and Rena = $\frac{3}{9}$ and $\frac{2}{9}$

Tanu's Share (retiring partner) = $\frac{4}{9}$

Tanu's share taken by the Manu and Rena in the ratio of 3 : 2

Manu's Gain = $\frac{4}{9} \times \frac{3}{5} = \frac{12}{45}$

Manu's New Share = $\frac{3}{9} + \frac{12}{45} = \frac{27}{45}$

Rena's Gain = $\frac{4}{9} \times \frac{2}{5} = \frac{8}{45}$

Rena's New Share = $\frac{2}{9} + \frac{8}{45} = \frac{18}{45}$

New ratio of Manu and Rena is $\frac{27}{45} : \frac{18}{45} = 27 : 18 = 3 : 2$.

Gain of a Partner = New Share – Existing Share

Manu's Gain = $\frac{27}{45} - \frac{3}{9} = \frac{12}{45}$

Rena's Gain = $\frac{18}{45} - \frac{2}{9} = \frac{8}{45}$

Gaining Ratio = $\frac{12}{45} : \frac{8}{45}$ OR 3 : 2

You may note that the new ratio is similar to existing ratio that existed between Manu and Rena before Tanu's retirement.

Note : In absence of any information in the question, it will be presumed that retiring partner's share has been distributed among the remaining partners in existing (old) ratio.

(ii) Retiring partner's share distributed in Specified proportion

Sometimes the remaining partners purchase the share of the retiring partner in specified ratio. The share purchased by them is added to their old share and the new ratio is arrived at. The following example illustrates this:

A, B and C are partners in the firm sharing profits in the ratio of 3 : 2 : 1. B retired and his share was divided equally between A and C. Calculate the new profit sharing ratio of A and C.

$$\text{B's Share} = 2/6$$

B's share is divided between A and C in the ratio of 1 : 1.

$$\text{A's Gain } 1/2 \text{ of } 2/6 = 2/6 \times 1/2 = 1/6$$

$$\text{A's New Share} = 3/6 + 1/6 = 4/6$$

$$\text{C's Gain } 1/2 \text{ of } 2/6 = 2/6 \times 1/2 = 1/6$$

$$\text{C's New share} = 1/6 + 1/6 = 2/6$$

Thus new, ratio of A and C will be 2 : 1

(iii) Retiring Partner's share is taken by one of the partners

The retiring partner's share is taken up by one of the remaining partners. In this case, the retiring partner's share is added to that of existing partner's share. Only his/her share changes. The other partners continue to share profit in the existing ratio. An example illustrating this point is given below:

Anuj, Babu and Rani share profit in the ratio of 5 : 4 : 2. Babu retires and his share is taken by Rani, So Rani's share is $2/11 + 4/11 = 6/11$, Anuj share will remain unchanged i.e, $5/11$. Thus, the new profit sharing ratio of Anuj and Rani is 5 : 6.

Illustration 1

Nani, Mani and Phani are partners sharing profit in the ratio of 3 : 4 : 2. Phani retires. Find the new ratio of Nani and Mani if terms for retirement provide the following :

- (i) Ratio is not given
- (ii) Equal distribution of Phani's share
- (iii) Phani's share is taken by Nani and Mani in the ratio of 2 : 1
- (iv) Mani takes over the share of Phani.

Sol :

(i) New profit sharing ratio of Nani and Mani is 3 : 4.

$$\begin{aligned} \text{(ii) Phani's share} &= 2/9 \\ \text{Nani's Gain} &= 1/2 \text{ of } 2/9 = 2/9 \times 1/2 = 1/9 \\ \text{Nani's New share} &= 3/9 + 1/9 = 4/9 \\ \text{Mani's Gain} &= 1/2 \text{ of } 2/9 = 2/9 \times 1/2 = 1/9 \\ \text{Mani's New Share} &= 4/9 + 1/9 = 5/9 \end{aligned}$$

New profit sharing ratio of Nani and Mani is 4/9 : 5/9 or 4 : 5

Gaining ratio is equal $1/9 : 1/9 = 1 : 1$

$$\begin{aligned} \text{(iii) Phani's Share} &= 2/9 \\ \text{Nani's Gain} &= 2/3 \text{ of } 2/9 = 2/9 \times 2/3 = 4/27 \\ \text{Nani's new share} &= 3/9 + 4/27 = 13/27 \\ \text{Mani's Gain} &= 1/3 \text{ of } 2/9 = 2/9 \times 1/3 = 2/27 \\ \text{Mani's new share} &= 4/9 + 2/27 = 14/27 \end{aligned}$$

New profit sharing ratio of Nani and Mani is 13 : 14.

Gaining ratio is $4/27 : 2/27 = 4 : 2 = 2 : 1$

(i.e. $16/27 - 4/9 = 4/27$; $11/27 - 3/9 = 2/27$; $4 : 2 = 2 : 1$)

(iv) Mani takes over Phani share fully.

$$\begin{aligned} \text{Phani's share} &= 2/9 \\ \text{Mani's Gain} &= 2/9 \\ \text{Mani's new share} &= 4/9 + 2/9 = 6/9 \end{aligned}$$

New profit sharing ratio of Nani and Mani is 3 : 6 Only Mani gains.

Illustration 2

A, B, and C are partners sharing profits and losses in the ratio of 3 : 2 : 4 respectively. C retires and A and B decide to share the profits and losses equally in future. Calculate the gaining ratio.

Solution :

Gain of a Partner = New Share – Existing (old) Share

$$\text{Hence, A's Gain} = 1/2 - 3/9 = 3/18 = 1/6$$

$$\text{B's Gain} = 1/2 - 2/9 = 5/18 = 5/18$$

Gaining ratio between A and B is 3 : 5

9.3.2 Treatment of Goodwill

The retiring partner is entitled to his/her share of goodwill at the time of retirement because the goodwill is the result of the efforts of all partners including the retiring one in the past. The retiring partner is compensated for his/her share of goodwill. As per Accounting Standard 10 (AS-10), goodwill is recorded in the books only when some consideration in money is paid for it. Therefore, goodwill is recorded in the books only when it is purchased and the goodwill account cannot be raised on its own.

Therefore, in case of retirement of a partner, the goodwill is adjusted through partner's capital accounts. The retiring partner's capital account is credited with his/her share of goodwill and remaining partner's capital account is debited in their gaining ratio. The journal entry is made as under:

Remaining Partners' Capital A/c Dr. (individually)

To Retiring Partner's Capital A/c

(Retiring partner's share of goodwill adjusted

to remaining partners in the gaining ratio)

Illustration 3

Madhu, Uday and Sunil are partners sharing profit and losses equally. Sunil retires and the goodwill of the firm is valued at 75,000. No goodwill account appears in the books of the firm. Madhu and Uday share future profit in the ratio of 3 : 5. Make necessary journal entry for goodwill.

Solution :

Journal

<i>Date</i>	<i>Particulars</i>	<i>LF No.</i>	<i>Debit Amount (Rs.)</i>	<i>Credit Amount (Rs.)</i>
	Madhu's Capital A/c Dr.		3,125	
	Uday's Capital A/c Dr.		21,875	
	To Sunil's Capital A/c (Sunily's Share of goodwill adjusted to remaining partners in their gaining ratio 1:7)			25,000

Note : Sunil's share of goodwill = Rs. 75,000 \times 1/3 = Rs. 25,000

Gain of a Partner = New Share – Existing Share

Madhu Gains = $3/8 - 1/3 = 9/24 - 8/24 = 1/24$

Uday Gains = $5/8 - 1/3 = 15/24 - 8/24 = 7/24$

Gaining Ratio between Madhu and Uday = 1 : 7

When the Goodwill Account already appears in the Books

Normally the goodwill is not shown in the books of the firm. If at the time of retirement/death of a partner, goodwill appears in the Balance Sheet of the firm, it will be written off by debiting all the partners' capital accounts in their existing profit sharing ratio and crediting the goodwill account. In such a case, the following journal entry is made:

Partners' Capital A/c Dr (including retiring partner's capital A/c)

To Goodwill A/c

(Existing goodwill written-off)

Illustration 4

Tina, Pinky and Meena are partners' sharing profit in the ratio of 4 : 3 : 2. Pinky retires and on the date of Pinky's retirement goodwill is valued at 1,80,000. Goodwill already appears in the books at a value of 96,000. New ratio of Tina and Meena is 4 : 2. Make the necessary journal entries.

Solution :

Journal

<i>Date</i>	<i>Particulars</i>	<i>LF No.</i>	<i>Debit Amount (Rs.)</i>	<i>Credit Amount (Rs.)</i>
	Tina's Capital A/c Dr.		42,667	
	Pinky's Capital A/c Dr.		32,000	
	Meena's Capital A/c Dr.		21,333	
	To Goodwill A/c (Existing goodwill written-off from the books)			96,000
	Tina's Capital A/c Dr.		40,000	
	Meena's Capital A/c Dr.		20,000	
	To Pinky's Capital A/c (Pinky's share of goodwill adjusted to remaining partners in their gaining ratio 3 : 7)			60,000

Note : Pinky's share of goodwill = Rs. 1,80,000 \times 3/9 = Rs. 60,000

Gaining of a Partner's = New Share – Existing Share,

Tina's Gain = $4/6 - 4/9 = 12/18 - 8/18 = 4/18$

Meena's Gain = $2/6 - 2/9 = 6/18 - 4/18 = 2/18$

Gaining Ratio between Tina and Meena = 4 : 2

9.3.3 Revaluation of Assets and Reassessment of Liabilities

At the time of retirement of a partner the assets of the firm are revalued and liabilities are reassessed. Revaluation Account is prepared in the same way as in case of admission of a partner. This is done to adjust the changes in value of assets and liabilities at the time of retirement/death of a partner. Any gain or loss due to revaluation is divided amongst all the partners including retiring/deceased in their existing profit sharing ratio. Following journal entries are made for this purpose:

(i) For increase in value of assets:

Assets A/c Dr. (Individually)

 To Revaluation A/c

(Increase in the value of assets)

(ii) For decrease in value of assets:

Revaluation A/c Dr.

 To Assets A/c (Individually)

(Decrease in the value of asset)

(iii) For increase in value of Liabilities:

Revaluation A/c Dr.

 To Liabilities A/c (Individually)

(Increase in the value of liabilities)

(iv) For decrease in value of Liabilities:

Liabilities A/c Dr. (Individually)

 To Revaluation A/c

(Decrease in the value of liabilities)

Revaluation account is prepared to record the change in the value of assets or liabilities. It will reveal profit or loss on revaluation. This profit or loss is divided amongst all partners including the retiring/deceased partner in existing profit sharing ratio.

(v) For Profit on Revaluation :

Revaluation A/c Dr. (Individually)

 To Partner's Capital A/c

(Profit on revaluation divided amongst all partners
in their existing profit sharing ratio)

(vi) For loss on Revaluation :

Partner's Capital A/c Dr. (Individually)

To Revaluation A/c

(Loss on revaluation borne by all partners in their existing profit sharing ratio)

Illustration 5

Rani, Vani and Sony are partners sharing profit in the ratio 2 : 1 : 3. Rani retires from the partnership. In order to settle her claim, the following revaluation of assets and liabilities was agreed upon:

- (i) The value of Machinery is increased by Rs. 30,000.
- (ii) The value of Investment is increased by Rs. 3,000.
- (iii) A provision for outstanding bill standing in the books at Rs.2,000 is now not required. The value of Land and Building is decreased by Rs. 14,000.

Give journal entries and prepare Revaluation account.

Solution :

Journal

<i>Date</i>	<i>Particulars</i>	<i>LF No.</i>	<i>Debit Amount (Rs.)</i>	<i>Credit Amount (Rs.)</i>
	Machinery A/c Dr.		30,000	
	Investment A/c Dr.		3,000	
	Provision for Outstanding Bill Dr.		2,000	
	To Revaluation A/c			35,000
	(Increase in value of Assets i.e. Machinery and investment and reduction in provision)			
	Revaluation A/c Dr.		14,000	
	To Land and Building			14,000
	(Decrease in value of assets)			
	Revaluation A/c Dr.			21,000
	To Rani's Capital A/c			7,000
	To Vani's Capital A/c			3,500
	To Sony's Capital A/c			10,500
	(Gain on revaluation credited to all partners capital A/c in old Profit sharing ratio i.e. 2:1:3)			

Revaluation Account

<i>Particulars</i>	<i>Amount</i>	<i>Particulars</i>	<i>Amount</i>
Land and Building	14,000	Machinery	30,000
Profit transferred to :		Investments	3,000
Rani Capital 7,000		Provision for	2,000
Vani Capital 3,500		Outstanding Bill not required	
Sony Capital 10,500	21,000		
	35,000		35,000

9.3.4 Treatment of Accumulated Reserves and Undistributed Profit

All the balances of Accumulated Reserves, funds and undistributed amount of Profit or Loss appearing in the balance sheet of the firm on the date of retirement/death is distributed amongst all partners including retiring/deceased partner in their old profit sharing ratio, The following entries are made:

(i) *For distribution of undistributed profit and reserve.*

Reserves A/c	Dr	
Profit & Loss A/c (Profit)	Dr.	
To Partners' Capital A/c		(individually)

(Reserves and Profit & Loss (Profit) transferred to all partners capitals A/c in existing profit sharing ratio)

(ii) *For distribution of undistributed loss*

Partners' Capital A/c	Dr.	(individually)
To Profit & Loss A/c (Loss)		

(Profit & Loss (loss) transferred to all partners Capitals A/c in old profit sharing ratio)

9.3.5 Settlement of Retiring Partner's Claim

The amount due to the retiring partner is paid according to the terms of partnership agreement. The retiring partners' claim consists of

- (a) The credit balance of Capital Account;
- (b) His/her share in the Goodwill of the firm;
- (c) His/her share in the Gain/Profit on Revaluation;
- (d) His/her share in General Reserve and Accumulated Profit and
- (e) Interest on Capital

But, the following deductions are made from the balance in his/her Capital Account on account :

- (a) His/her share in the Loss on Revaluation;
- (b) His/her Drawings and Interest on Drawings up to the date of retirement;
- (c) His/her share of any accumulated losses and
- (d) Loan taken from the firm.

The total amount so calculated is the claim of the retiring partner. He/she is interested in receiving the amount at the earliest. Total payment may be made immediately after his/her retirement. However, the resources of the firm may not be adequate to make the payment to the retiring partner in lumpsum. The firm makes payment to retiring partner in installments.

Payment in Lump Sum

Retiring partners' claim is paid either out of the funds available with the firm or out of funds brought in by the remaining partners.

The following journal entry is made for disposal of-the amount payable to the retiring partner :

On payment of cash in lump sum.

Retiring Partner's Capital A/c	Dr.
To Cash/Bank A/c	
(Amount paid to the retiring partner)	

Illustration 6

Anil, Rosy and Mary are partners sharing profit in the ratio of 3 : 2 : 1. Their balance sheet as at December 31st 2022 is as follows:

Balance Sheet as on December 31, 2022

<i>Liabilities</i>	<i>Amount (Rs.)</i>	<i>Assets</i>	<i>Amount (Rs.)</i>
Creditors	80,000	Building	1,80,000
Bills Payable	26,000	Plant	1,40,000
General Reserve	24,000	Motor Car	40,000
Capital :		Stock	1,00,000
Anil	1,60,000	Debtors	63,000
Rosy	1,20,000	<i>Less : Provision</i>	
Mary	1,20,000	for Bad Debts	3,000
		Cash at Bank	10,000
	5,30,000		5,30,000

Rosy retires on that date on the following terms:

- The Goodwill of the firm is valued at Rs. 60,000.
- Stock and Building to be appreciated by 10%.
- Plant is depreciated by 10%
- Provision for Bad debts is increased upto Rs. 5,000.
- Rosy's share of goodwill was adjusted through remaining partners capital account,

The amount due to Rosy is paid out of the fund brought in by Anil and Mary in their new profit sharing ratio. Rosy is paid full amount.

Prepare Revaluation Account and Partner's Capital account.

Solution :

It is assumed that Anil and Mary gaining ratio remains 3 : 1.

Rosy' Share of goodwill

$$\text{Rs. } 60,000 \times \frac{2}{6} = \text{Rs. } 20,000$$

Adjusted through the remaining partners capital account in 3 : 1 ratio

Revaluation Account

<i>Particulars</i>	<i>Amount</i>	<i>Particulars</i>	<i>Amount</i>
Provision for Bad Debts	2,000	Stock	10,000
Plant	14,000	Building	18,000
Profit transferred to Capital Accounts :			
Anil	6,000		
Rosy	4,000		
Mary	2,000		
	12,000		
	28,000		28,000

Capital Account

Dr.

Cr.

<i>Particulars</i>	<i>Anil (Rs.)</i>	<i>Rosy (Rs.)</i>	<i>Mary (Rs.)</i>	<i>Particulars</i>	<i>Anil (Rs.)</i>	<i>Rosy (Rs.)</i>	<i>Mary (Rs.)</i>
Capital	15,000	-	5,000	Balance b/d	1,60,000	1,20,000	1,20,000
Bank		1,52,000		General			
Balance c/d	2,77,000	-	1,59,000	Reserve	12,000	8,000	4,000
				Revaluation (Profit)	6,000	4,000	2,000
				Anil Capital	-	15,000	-
				Mary Capital	-	5,000	
				Bank	1,14,000		38,000
	2,92,000	1,52,000	1,64,000		2,92,000	1,52,000	1,64,000

(ii) Payment in Installments

In this case the amount due to retiring partner is paid in installments. Usually, some amount is paid immediately on retirement and the balance is transferred to his loan account. This loan is paid in one or more installments. The loan amount carries some interest. In the absence of any agreement the rule under Section 37 of the Indian Partnership Act 1932 applies.

According to this rule, if the amount due to the retiring partner is not paid immediately on his retirement, he can claim interest @ 6% p.a. on the amount due.

An installment consists of two parts :

- (i) Principal Amount of installment due to retiring partner.
- (ii) Interest at an agreed rate,

Interest due on loan amount is credited to retiring partners' loan account. Installment inclusive of interest then is paid to the retiring partner as per schedule agreed upon.

(i) *On part payment in cash and balance transferred to his/her loan account.*

Retiring Partner's Capital A/c Dr.

 To Cash/Bank A/c

 To Retiring Partner's Loan A/c

(Part payment made and balance transferred to loan A/c)

(ii) *Total amount due transferred to loan A/c*

Retiring Partner's Capital A/c Dr.

 To Retiring Partner's Loan A/c

(Total amount due transferred to loan A/c)

(iii) *For interest due*

Interest on loan A/c Dr.

 To Retiring Partners' Loan A/c

(Interest due on loan)

(iv) *For payment of installment*

Retiring Partners' Loan A/c

 To Cash/Bank A/c

(Installment inclusive of interest paid)

Illustration 7

Taking the figures of the previous illustration, assuming that she is paid 50% of the amount due immediately and the balance in four equal yearly installments. The interest payable is 10% p.a.

Solution :

The amount due to Rosy	= Rs. 1,52,000
Amount paid immediately	= Rs. 1,52,000 \times 50/100 = Rs. 76,000
Amount of three equal installments	= Rs. 1,52,000 – Rs. 76,000
	= Rs. 76,000 \div 4 = Rs. 19,000
1 st Installment at the end of 1 st Year	= Rs. 19,000 + Rs. 7,600 (interest)
	= Rs. 26,600
Interest @ 10% pa.	= Rs. 76,000 \times 10/100 = Rs. 7,600
2 nd Installment at the end of 2 nd Year	= Rs. 19,000 + Rs. 5700 (interest)
	= Rs. 24,700
Interest @ 10% pa.	= Rs. 57000 \times 10/ 100 = Rs. 5700
3 rd Installment at the end of 3 rd Year	= Rs. 19000 + Rs. 3800
	= Rs. 22,800
Interest @ 10% pa.	= Rs. 38,000 \times 10/100 = Rs. 3,800
4 th Installment at the end of 4 th Year	= Rs. 19000 + Rs. 1,900
	= 20,900
Interest @10%	= 19,000 \times 10/100 = 1,900

9.3.6 Adjustment of Remaining Partner's Capital Account After Retirement

After retirement of a partner the remaining partners may decide to adjust their capital. Often the remaining partners determine the total amount of capital of the reconstituted firm and decide to keep their respective capital accounts in proportion to the new profit sharing ratio. The total capital of the firm may be more or less than the total of their capital at the time of retirement. The new capitals of the partners are compared with the balance standing to the credit of respective partner's capital account. If there is a surplus in the capital account, the amount is withdrawn by the concerned partner. The partner brings cash in case the balance in the capital account is less than the calculated amount.

Illustration 8

Reeta, Sunita and Sheetal are partners sharing profit in the ratio of 4 : 3 : 2. Reeta retired, when their capitals were: Rs. 40,000, Rs. 35,000 and Rs. 25,000 respectively after making all adjustments on retirement. Sunita and Sheetal decided to have a total capital of the firm at Rs. 81,000 in the proportion of 3: 6. Calculate actual cash to be paid or brought in by each partner and make necessary journal entries.

Solution :

Total Capital of the New firm = 81,000

Sunita's share in the new capital = $81,000 \times \frac{3}{9} = \text{Rs. } 27,000$

Sheetal's share in the new capital = $81,000 \times \frac{6}{9} = \text{Rs. } 54,000$

On comparing Sunita's share in the new capital of the firm with the amount standing to the debit of her capital, it is observed that she has to withdraw Rs.8,000 the excess amount (Rs.35,000 – Rs.27,000) in Cash.

Similarly, Sheetal's share in the new capital of the firm is Rs.54,000 while Rs. 25,000 stand credited to her capital account. So she has to bring Rs. 29,000, the deficit amount (Rs. 54,000 – Rs.25,000) to the firm so as to make her capital in proportion to their new profit share ratio.

Journal

<i>Date</i>	<i>Particulars</i>	<i>LF No.</i>	<i>Debit Amount (Rs.)</i>	<i>Credit Amount (Rs.)</i>
	Bank A/c Dr. To Sheetal's Capital A/c (The deficit amount brought in by the partner)		29,000	29,000
	Sunita's Capital A/c Dr. To Bank A/c (The surplus amount withdrawn by the partner)		8,000	8,000

Adjustment of remaining partner's capital in their profit sharing ratio, when the total capital of the new firm is not pre-determined.

In this case the total amount of adjusted capital of the remaining partners is rearranged as per agreed proportion in which they share profit of the reconstituted firm. The following steps may be adopted:

- (i) Add the balance standing to the credit of the remaining partners' capital accounts.
- (ii) The total so obtained is the total capital of the firm.
- (iii) This capital is divided according to the new profit sharing ratio.

Illustration 9

Shankar, Amar and Naren are partners sharing profit in the ratio of 5 : 2 : 1. when Amar retired, their adjusted capitals were Rs.80,000; Rs.50,000 and Rs.40,000 respectively. Shankar and Naren decided to have their total capital of the firm in the ratio of 4 : 2. The necessary adjustments were to be made in cash only. Calculate actual cash to be paid off or brought in by each partner.

Solution:

Total of the adjusted capitals of the remaining partners.

Shankar	=	Rs. 80,000
Naren	=	Rs. 40,000
Total	=	Rs. 1,20,000

Total capital of the firm which is divided in the new ratio of 3 : 2.

New capital of Shankar = Rs. 1,20,000 \times 4/6 = Rs. 80,000

New Capital of Naren = Rs. 1,20,000 \times 2/6 = Rs. 40,000

Shankar's share in the new capital of the firm is Rs. 80,000 while Rs. 80,000 stand credited to his capital account. So he no capital is to be withdrawn or to be brought in to make his capital in proportion to his new profit sharing ratio.

Similarly, Naren's share in the new capital of the firm is Rs. 40,000 while Rs. 40,000 stands credited to his capital account, no withdrawal is to be made or no additional capital is to be brought in to make his capital in proportion to his new profit sharing ratio.

Illustration 10

The Balance Sheet of Ravi, Neelu and Sana who are partners in a firm sharing profits according to their capitals as on 31st March 2022 was as under :

Balance Sheet as on March 31st, 2022

<i>Liabilities</i>	<i>Amount (Rs.)</i>	<i>Assets</i>	<i>Amount (Rs.)</i>
Creditors	25,000	Machinery	40,000
Bills Payable	13,000	Building	90,000
General Reserve	2,000	Debtors	30,000
Capital :		Less Provision for	
Ravi	60,000	Bad Debts	1,000
Neelu	40,000	Stocks	23,000
Sana	40,000	Cash at Bank	18,000
	2,00,000		2,00,000

On the date of Balance Sheet, Neelu retired from the firm, and following adjustments were made:

- (i) Building is appreciated by 10%.
- (ii) Provision for bad debts is increased to 10% on Debtors.
- (iii) Machinery is depreciated by 4%.
- (iv) Goodwill of the firm is valued at Rs. 70,000 and the retiring partner's share is adjusted.
- (v) The capital of the new firm is fixed at Rs. 1,50,000.

Prepare Revaluation Account, Capital Accounts of the partner and Balance Sheet of the new firm after Neelu's retirement.

Solution :

Revaluation Account

<i>Particulars</i>	<i>Amount</i>	<i>Particulars</i>	<i>Amount</i>
Provision for Bad Debts A/c	1,400	Building A/c	9,000
Machinery A/c	1,600		
Profit transferred to			
Capital Accounts (3 : 2 : 2)			
Ravi	3,000		
Neelu	2,000		
Sana	2,000		
	7,000		
	9,000		9,000

Capital Account

Dr. **Cr.**

<i>Particulars</i>	<i>Ravi (Rs.)</i>	<i>Neelu (Rs.)</i>	<i>Sana (Rs.)</i>	<i>Particulars</i>	<i>Ravi (Rs.)</i>	<i>Neelu (Rs.)</i>	<i>Sana (Rs.)</i>
Sunil's Capital A/c	12,000	-	8,000	Balance b/d General	60,000	40,000	40,000
Bank		68,286		Reserve	9,428	6,286	6,286
Balance c/d	90,000	-	60,000	Revaluation (Profit)	3,000	2,000	2,000
				Ravi's Capital A/c	-	12,000	-
				Sana's Capital A/c		8,000	
				Bank	29,572		19,714
	1,02,000	68,286	68,000		1,02,000	68,286	68,000

Balance Sheet as at 31st March 2022

<i>Liabilities</i>	<i>Amount (Rs.)</i>	<i>Assets</i>	<i>Amount (Rs.)</i>
Creditors	25,000	Building	1,08,000
Bank Overdraft	37,500	Machinery	36,000
Bills Payable	13,000	Debtors	30,000
Capital :		Less Provision for	
Rohit	72,000	Bad Debts	1,500
Sunil	48,000	Stock	23,000
	1,20,000		
	1,95,500		1,95,500

Working Notes:

(i) (a) Profit sharing ratio is 60,000 : 40,000 : 40,000 i.e. = 3 : 2 : 2

(b) Gaining Ratio: Ravi = $\frac{3}{5} - \frac{3}{7} = \frac{21}{35} - \frac{15}{35} = \frac{6}{35}$

Sana = $\frac{2}{5} - \frac{2}{7} = \frac{14}{35} - \frac{10}{35} = \frac{4}{35}$

= $\frac{6}{35} : \frac{4}{35}$

= 6 : 4 = 3 : 2

(c) Neelu Share of Goodwill = Rs. 70,000 × 2/7 = Rs. 20,000.

Share of Goodwill in the gaining ratio by the existing partner, i.e.

Ravi = Rs. 20,000 × 3/5 = Rs. 12,000

Sana = Rs. 20,000 × 2/5 = Rs. 8,000

The journal entry is

Ravi's Capital A/c	Dr.	12,000	
Sana's Capital A/c	Dr.	8,000	
To Neelu's Capital A/c			20,000

(Share of Goodwill divided into gaining ratio)

Bank Account

Dr.

Cr.

<i>Particulars</i>	<i>Amount</i>	<i>Particulars</i>	<i>Amount</i>
Balance b/d	18,000	Neelu's Capital A/c	68,286
Ravi's Capital A/c	29,572		
Sana's Capital A/c	19,714		
Balance c/d (Bank Overdraft)	68,286		
	68,286		68,286

(ii) Bank overdraft is taken to pay the retiring partners amount.

(iii) New Capital of the firm is fixed at Rs. 1,50,000

	<i>Ravi (Rs.)</i>	<i>Sana (Rs.)</i>
New Capital (Rs. 1,50,000 in the ratio of 3 : 2)	90,000	60,000
Existing Capital (After Adjustments) i.e. partner capitals	60,428	40,286
Cash to be brought by the remaining partners	29,572	19,714

Illustration 11

Chandra, Tillu and Guru are partners in a firm sharing profit and losses in the ratio of 1/2, 1/6 and 1/3 respectively. The Balance Sheet as on March 31, 2020 was as follows :

<i>Liabilities</i>		<i>Amount (Rs.)</i>	<i>Assets</i>		<i>Amount (Rs.)</i>
Sundry Creditors		36,000	Freehold Premises		80,000
Bills Payable		24,000	Machinery		60,000
General Reserve		24,000	Furniture		24,000
Capitals :			Debtors		40,000
Chandra	60,000		Less : Provision		
Tillu	60,000		for bad debts	<u>2,000</u>	38,000
Guru	<u>56,000</u>	1,76,000	Stock		44,000
			Cash		14,000
		<u>2,60,000</u>			<u>2,60,000</u>

Guru retires from the business and the partners agree to the following revaluation :

- Freehold premises and stock are to be appreciated by 20% and 15%. respectively
- Machinery and furniture are to be depreciated by 10% and 7% respectively
- Bad debts reserve is to be increased to Rs. 3,000.
- On Guru's retirement, the goodwill is valued at Rs. 42,000.
- The remaining partners have decided to adjust their capitals in their new profit sharing ratio after retirement of Guru. Surplus/deficit, if any in their capital account will be adjusted through cash.

Prepare necessary ledger accounts and Balance Sheet of reconstituted firm.

Solution :

Dr.

Cr.

<i>Particulars</i>	<i>Amount (Rs.)</i>	<i>Particulars</i>	<i>Amount (Rs.)</i>
Provision for Bad Debts	1,000	Freehold Premises	16,000
Machinery	6,000	Stock	
Furniture	1,680	6,600	
Profit transferred to			
Capital Accounts :			
Chandra	6,960		
Tillu	2,320		
Guru	4,640		
	<u>13,920</u>		
	<u>22,600</u>		<u>22,600</u>

Dr.**Capital Account****Cr.**

<i>Particulars</i>	<i>Chandra (Rs.)</i>	<i>Tillu (Rs.)</i>	<i>Guru (Rs.)</i>	<i>Particulars</i>	<i>Chandra (Rs.)</i>	<i>Tillu (Rs.)</i>	<i>Guru (Rs.)</i>
Guru Capital	10,500	3,500		Balance b/d	60,000	60,000	56,000
Guru Loan			82,640	General			
Cash		30,000		Reserve	12,000	4,000	8,000
Balance c/d	98,460	32,820		Revaluation (Profit)	6,960	2,320	4,640
				Chandra Capital A/c			10,500
				Tillu Capital	30,000		3,500
	1,08,960	66,320	82,640		1,08,960	66,320	82,640

Balance Sheet as on 31st March 2022

<i>Liabilities</i>	<i>Amount (Rs.)</i>	<i>Assets</i>	<i>Amount (Rs.)</i>
Creditors	36,000	Freehold Premises	96,000
Bills Payable	24,000	Machinery	54,000
Gupta's Loan	82,640	Furniture	22,320
Capital :		Debtors	40,000
Chandra	98,460	Less : Provision	
Tillu	<u>32,820</u>	for bad debts	<u>3,000</u>
	1,31,280	Stock	50,600
		Cash	14,000
	<u>2,73,920</u>		<u>2,73,920</u>

Working Note :

- In the absence of agreement, retiring partner's capital account is transferred to his loan account.
- In the absence of agreement, gaining ratio is equal to existing ratio (old ratio) of remaining partners is gaining ratio i.e. 3 : 1
- Calculation of Cash brought in (or paid off) by remaining partner.

	Chandra (Rs.)	Tillu (Rs.)
Total Capital of Chandra and Tillu (Rs. 68,460 + Rs. 62,820 = Rs. 1,31,280 in the ratio of 3 : 1)	98,460	32,820
Adjusted existing Capital	68,460	62,820
Excess of Deficit	30,000	30,000
	(Excess)	(Deficit)

9.3.7 Death of a Partner

On the death of a partner, the accounting treatment regarding goodwill, revaluation of assets and reassessment of liabilities, accumulated reserves and undistributed profit are similar to that of the retirement of a partner. On the death of partner the amount payable to him/her is paid to his/her legal representatives. The legal representatives are entitled to the followings:

- (a) The amount standing to the credit of the capital account of the deceased partner.
- (b) Interest on capital, if provided in the partnership deed upto the date of death.
- (c) Share of goodwill of the firm.
- (d) Share of undistributed profit or reserves.
- (e) Share of profit on the revaluation of assets and liabilities.
- (f) Share of profit upto the date of death.
- (g) Share of Joint Life Policy.

The following amounts are debited to the account of the deceased partner's legal representatives :

- (i) Drawings
- (ii) Interest on drawings
- (iii) Share of loss on the revaluation of assets and liabilities;
- (iv) Share of loss that have occurred till the date of his/her death.

The above adjustments are made in the capital account of the deceased partner and then the balance in the capital account is transferred to an account opened in the name of his/her executor.

Illustration 13

Nitin, Suman and Shoba are partners in a firm sharing profits in the ratio of 5:3:2. on December 31st, 2021 their balance sheet was as under.

<i>Liabilities</i>		<i>Amount (Rs.)</i>	<i>Assets</i>		<i>Amount (Rs.)</i>
Creditors		52,000	Building		60,000
Reserve Fund		15,000	Plant		50,000
Capitals :			Stock		27,000
Nitin	60,000		Debtors		25,000
Suman	45,000		Cash		10,000
Shoba	<u>30,000</u>	1,35,000	Bank		30,000
		<u>2,02,000</u>			<u>2,02,000</u>

Nitin died on 1 July 2022. It was agreed between his executor and the remaining partners that :

- (i) Goodwill to be valued at $2\frac{1}{2}$ years purchase of the average profits of the last Four years, which were: 2018 Rs. 25,000; 2019 Rs.20,000; 2020 Rs.40,000 and 2021 Rs.35,000.
- (ii) Building is valued at Rs.70,000; Plant at Rs.46,000 and Stock at Rs.32,000.
- (iii) Profit for the year 2022 be taken as having accrued at the same rate as that of the previous year.
- (iv) Interest on capital is provided at 9% p.a.
- (v) On 1 July 2022 his drawings account showed a balance of Rs.20,000.
- (vi) Rs.25,950 are to be paid immediately to his executor and the balance is transferred to his Executors Loan Account.

Prepare Nitin's Capital Account and Nitin's Executor's Account as on 1st July 2022.

Solution :

- (i) Valuation of Goodwill :

$$\begin{aligned} \text{Total Profit} &= \text{Rs.}25,000 + \text{Rs.}20,000 + \text{Rs.}40,000 + \text{Rs.}35,000 \\ &= \text{Rs.}1,20,000 \end{aligned}$$

$$\text{Average Profit} = \text{Rs.}1,20,000/4 = \text{Rs.}30,000$$

$$\text{Hence, Goodwill at } 2\frac{1}{2} \text{ year's purchase} = \text{Rs.}30,000 \times 2\frac{1}{2} = \text{Rs.}75,000$$

Nitin's share of goodwill = Rs.75,000 × 5/10 = Rs.37,500

It is adjusted into the Capital Accounts of Suman and Shoba in the gaining ratio of 3 : 2 i.e. Rs.22,500 and Rs.15,000 respectively.

- (ii) Share of Profit payable to Nitin [upto the date of death]
 = Rs.35,000 × 6/12 × 5/10
 = Rs.8,750
- (iii) Nitin's Share of Reserve Fund = Rs.15,000 × 5/10
 = Rs.7,500
- (iv) Interest on Nitin's Capital = Rs.60,000 × 9/100 × 6/12
 = Rs.2,700

Dr. Revaluation Account Cr.

<i>Particulars</i>		<i>Amount (Rs.)</i>	<i>Particulars</i>		<i>Amount (Rs.)</i>
Plant		4,000	Building		10,000
Profit transferred to			Stock		
Nitin Capital	5,500		5,000		
Suman Capital	3,300				
Shoba Capital	2,200	11,000			
		15,000			
					15,000

Nitin's Capital Account

Dr. Cr.

<i>Particulars</i>		<i>Amount (Rs.)</i>	<i>Particulars</i>		<i>Amount (Rs.)</i>
Drawings		20,000	Balance b/d		60,000
Nitin's Executor's		1,01,950	Reserve fund		7,500
			Suman's Capital (Goodwill)		15,000
			Shoba's Capital (Goodwill)		22,500
			Profit & Loss (Suspense)		8,750
			Revaluation A/c		5,500
			Interest on Capital		2,700
		1,21,950			1,21,950

Dr.**Nitin's Executor's Accounts****Cr.**

<i>Particulars</i>	<i>Amount (Rs.)</i>	<i>Particulars</i>	<i>Amount (Rs.)</i>
Bank	25,950	Nitin's Capital	1,01,950
Nitin's Executor's Loan A/c (Transfer)	76,000		
	1,01,950		1,01,950

WHAT YOU HAVE LEARNT

- **Retirement**

1. Due to some reasons like old age, poor health, strained relations etc., an existing partner may decide to retire from the partnership. Due to retirement, the existing partnership comes to an end and the remaining partners form a new agreement and the partnership firm is reconstituted with new terms and conditions.
2. At the time of retirement the following accounting issues are dealt:
 - (a) New profit sharing ratio and gaining ratio.
 - (b) Goodwill
 - (c) Adjustment of changes in the value of Assets and liabilities
 - (d) Treatment of reserve and accumulated profits.
 - (e) Settlement of retiring partner's dues,
 - (f) New capital of the continuing partners.

- **Death**

1. On the death of a partner, the amount payable to him is paid to his/her legal representatives.
2. The representatives of deceased partner is entitled to the followings:
 - (a) The amount standing to the credit of the capital account of the deceased partner.

- (b) Interest on capital, if provided in the partnership deed, upto the date of death.
- (c) Share of the value of goodwill of the firm.
- (d) Share of undistributed profit or reserves.
- (e) Share of profit on the revaluation of assets and liabilities.
- (f) Share of profit upto the date of death.
- (g) Share of Joint Life Policy.

The following amounts are debited to the account of the deceased partner's legal representatives :

- (i) Drawings
 - (ii) Interest on drawings
 - (iii) Share of loss on the revaluation of assets and liabilities
 - (iv) Share of loss that have occurred till the date of his/her death
3. Calculation of Profit up to the date of death Two Methods
- (i) Time basis
 - (ii) Sales basis

Terminal Exercise

Section - A

- 1. Retirement of a Partner
- 2. Gaining Ratio

Section - B

- 1. Explain the accounting treatment of goodwill on retirement of a partner.
- 2. What problems involving finance arise when a partner dies? How would you deal with them as an accountant?
- 3. Seenu, Mohan and Meena were partners in a firm sharing profit in the ratio of 7 : 6 : 7. Mohan retired and his share was divided equally between Seenu and Meena. Calculate the new profit sharing ratio of Seenu and Meena.
- 4. Anitha , Akshiita and Akruti are partners sharing profits in the ratio of 4 : 3 : 2. Anitha retires, assuming Akshita and Akruti will share profits in future in the ratio 5 : 3, determine the gaining ratio.

Section - C

1. P, Q and R are partners in a firm, sharing profit in the ratio of 3: 2 : 1. Their Balance Sheet as on March 31, 2022 was as follows :

<i>Liabilities</i>	<i>Amount (Rs.)</i>	<i>Assets</i>	<i>Amount (Rs.)</i>
Sundry Creditors	3,200	Cash in hand	1,200
General Reserve	12,000	Cash at Bank	2,000
Capitals :		Debtors	18,000
P 20,000		Stocks	14,000
Q 20,000		Machinery	12,000
R <u>20,000</u>	60,000	Building	28,000
	75,200		75,200

On the date of Balance Sheet R retires from firm. It is agreed to adjust the value of assets as follows :

- (a) Provide a reserve of 5% on Sundry Debtors for Doubtful Debts.
- (b) Building to be revalued at ` 30,200.
- (c) Depreciate stock by 5% and Machinery by 10%.

Prepare Revaluation account, Partners Capital account and Balance Sheet of P and Q.

2. L, M and N are partners sharing profit and losses in the ratio of 3 : 2 : 1 respectively. The firm's Balance Sheet on March 31, 2023 was as follows :

<i>Liabilities</i>	<i>Amount (Rs.)</i>	<i>Assets</i>	<i>Amount (Rs.)</i>
Sundry Creditors	38,000	Plant & Machinery	70,000
Bills Payable	10,000	Building	90,000
General Reserve	24,000	Motor Car	16,000
Capitals :		Debtors 32,000	
L 80,000		Less : Provision	
M 60,000		for bad debts <u>1,000</u>	31,000
N <u>50,000</u>	1,90,000	Stock	50,000
	2,62,000	Cash	5,000
			2,62,000

M retires on that date, subject to the following adjustments :

- (a) The Goodwill of the firm to be valued at Rs.36,000.
- (b) Plants and Machinery to be depreciated by 10% and Motor Car by 15%.
- (c) Stock to be appreciated by 20% and Building by 10%.
- (d) Provision for Doubtful debts to be increased by Rs.3,900.

Prepare Revaluation Account and M's Capital account.

3. D, E and F are partners sharing profit and losses in the ratio of 3 : 2 : 1 respectively. The Balance Sheet as on March 31, 2020 was as follows:

<i>Liabilities</i>	<i>Amount (Rs.)</i>	<i>Assets</i>	<i>Amount (Rs.)</i>
Sundry Creditors	31,200	Plant & Machinery	37,600
Dhruv Loan	10,000	Building	24,000
Capitals :		Debtors	24,800
D	51,840	Less : Provision	
E	27,360	for bad debts	2,400
F	14,240	Stock	18,400
	93,440	Cash	32,240
	1,34,640		1,34,640

D retired on March 31, 2020 and E and F continued in partnership sharing profits and losses in the ratio of 2 : 1. D was paid Rs. 20000 on 1.4.2020 and it was agreed that the remaining balance due to him should be kept as his loan to the firm,

For the purpose of D's retirement it was agreed that

- (a) Building be revalued at Rs. 48,000 and Plant and Machinery at Rs. 31,600.
- (b) The provision for bad debts was to be increased by Rs. 800.
- (c) A provision of Rs. 1,000 included in creditor was no longer required.
- (d) Rs. 2,400 was to be written off from the stock in respect of damaged items included therein.
- (e) A provision of Rs. 8,480 made in respect of outstanding legal charges.
- (f) The goodwill of the firm to be valued at Rs. 28,800.

Prepare Revaluation Account, Capital A/c of partners and Balance sheet of the reconstituted firm.

4. Suri, Hari and Rani are partners in a firm. Their Balance sheet as on December 31, 2022 is as under:

<i>Liabilities</i>		<i>Amount (Rs.)</i>	<i>Assets</i>		<i>Amount (Rs.)</i>
Creditors		20,000	Plant & Machinery		40,000
General Reserve		20,000	Furniture & Fittings		5,000
Capitals :			Debtors		30,000
Suri	40,000		Stock		21,000
Hari	30,000		Investment		24,000
Rani	<u>10,000</u>	80,000			
		<u>1,20,000</u>			<u>1,20,000</u>

Hari died on 30.06.2023 The partnership deed provides that the representative of the deceased partner shall be entitled to:

- (i) Balance of the capital account of deceased partner.
- (ii) Interest on Capital at 8% p.a. upto date of death.
- (iii) His share of profit up to date of death on the average of last three years profit.
- (iv) His share of any undistributed profit and losses as per last balance sheet.
- (v) Profit for the last three years was Rs. 30,000, Rs. 40,000 and Rs. 50,000.

Ascertain the amount payable to the legal representatives of Hari.

DISSOLUTION OF PARTNERSHIP FIRM

Naresh and Mahesh were very good friends. They were running a business as a partnership firm. They were very successful in their business. People were jealous of their relations. But one day people came to know that they have closed the business. Some dispute had arisen between the two on a small issue. Similarly, firm may come to an end because of dispute among the partners or firm running in losses for last few years or because of order of the court and so on. We can say that the partnership firm is dissolved. In this lesson, you will learn about the accounting treatment in case of dissolution of partnership firm.

Objectives

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

- state the meaning of dissolution of partnership firm;
- distinguish between dissolution of partnership and dissolution of partnership firm;
- explain the Realisation account and disposal of assets and payment of liabilities;
- illustrate the treatment of unrecorded assets and liabilities; and
- prepare partners' capital accounts and bank and/or cash account.

9.4.1 Dissolution of Partnersip and Dissolution of Partnership Firm

The term dissolution means coming to an end or discontinuation. The dissolution of the firm implies a complete breakdown of the partnership relation among all the partners. Dissolution of the partnership (owing to retirement, death or insolvency of a partner), merely involves change in the relation of the partners but it does not end the firm; the partnership would certainly come to an end but the firm, the reconstituted one might continue under the same name. So the dissolution of the partnership may or may not include the dissolution of the firm but the dissolution of the firm necessarily means the dissolution of the partnership. On dissolution of the firm, the business of the firm ceases to exist since its affairs are wound up by selling the assets and by paying the liabilities and discharging the claims of the partners. The dissolution of partnership among all partners of a firm is called dissolution of the firm.

- (i) **Dissolution by Agreement** : A firm is dissolved in case
- all the partners give consent or
 - as per the terms mentioned in partnership agreement .
- (ii) **Compulsory dissolution** : A firm is dissolved compulsorily in the following cases:
- When all the partners or all excepting one partner becomes insolvent or of unsound mind.
 - When the business becomes unlawful.
 - When all the partners excepting one decide to retire from the firm.
 - When all the partners or all excepting one partner die.
 - A firm is also dissolved compulsorily if the partnership deed includes any provision regarding the happening of the following events:
 - (a) expiry of the period for which the firm was formed,
 - (b) completion of the specific venture or project for which the firm was formed.
- (iii) **Dissolution by Notice**: In case of a partnership at will, the firm may be dissolved if any one of the partner gives a notice in writing to the other partners.
- (iv) **Dissolution by Court** : A court may order a partnership firm to be dissolved in the following cases:
- (a) When a partner becomes of unsound mind
 - (b) When a partner becomes permanently incapable of performing his/her duties as a partner,
 - (c) When partner deliberately and consistently commits breach of agreements relating to the management of the firm;
 - (d) When a partner's conduct is likely to adversely affect the business of the firm;
 - (e) When a partner transfers his/her interest in the firm to a third party;
 - (f) When the court regards dissolution to be just and equitable.

Distinction Between Dissolution of Partnership and Dissolution of Partnership Firm

You have already studied that on the occasion of admission, retirement and death existing partnership comes to an end, but the business of the firm continues under a new agreement. When a firm decides to wind up its business operations under any of the circumstances mentioned, it stands dissolved. Dissolution of a partnership firm is different from the dissolution of a partnership.

Dissolution of a firm means that the firm closes its business and comes to an end. While dissolution of a partnership means termination of old partnership agreement and a reconstitution of firm due to admission, retirement and death of a partner. In dissolution of a partnership the remaining partners may agree to carry on the business under a new agreement.

9.4.2 Treatment of Assets and Liabilities

When the partners decide to discontinue the business of the firm, it becomes necessary to settle its accounts. For this purpose, it disposes off all its assets (except cash and bank balances) for satisfying all the claims against it. For this purpose a separate account called 'Realisation Account' is opened. Realisation Account is an account in which assets excluding cash in hand and bank are transferred at their book value and all external liabilities are transferred at their book value.

It also shows what amount were realised on the sale of assets and which liabilities were discharged at what amount.

In order to record the disposal of assets and discharge of liabilities, the following journal entries are recorded:

- 1. For Transfer of Assets :** Assets account is closed by transferring it to the Realisation Account at its Book Value.

Realisation A/c	Dr.
To Assets A/c	(Individually)

(Transfer of assets)

It is to be noted that the following items on the assets side of the Balance Sheet are not transferred to the Realisation Account:

- (i) Undistributed loss (i.e. Debit Balance of Profits and Loss account)
- (ii) Fictitious assets or deferred revenue expenditures such as preliminary expenses.

All the above items are closed by transferring them to the partners' Capital Account in their profit sharing ratio. The Journal entry is made:

Partner's capital A/c Dr. (Individually)

 To Profit & Loss A/c

 To Fictitious Assets A/c

(Transfer of loss and fictitious Assets)

- (b) Cash in hand, and Cash at Bank, will be the opening balance of the Cash/ Bank account;
- (c) Provisions and reserves against assets should be closed by crediting the Realisation Account.

The Journal entry is made :

 Provision for Doubtful Debts A/c Dr.

 Provision for Depreciation A/c Dr.

 Any other Provision A/c Dr.

 To Realisation A/c

(Transfer of provision on assets)

2. **For Transfer of Liabilities:** The accounts of various external liabilities are closed by transferring them to the Realisation Account. The loan given to the firm by a partner's wife is treated as an external liability and is transferred to the credit of Realisation Account. The relevant Journal entry is as under :

External Liabilities A/c Dr. (Individually)

 To Realisation A/c

(Transfer of external liability)

Capital and Loan account of the partners' are treated separately and so are not transferred to the Realisation Account.

3. **Treatment of Accumulated Reserves and Profit/Loss :** Any balance of accumulated reserves (e.g. general reserves), Profit and Loss Account (Cr.), Reserve Fund and other reserves on the date of dissolution will be credited to the Partners'

Capital accounts on the basis of profit sharing ratio. The following journal entry will be recorded :

Profit and Loss A/c Dr.

General Reserve A/c Dr.

Any Other Fund Dr.

 To Partners' Capital A/c (Individually)

(Transfer of profit and reserve)

4. For Sale of Assets (for cash)

Bank/ Cash A/c Dr. (Realised Value)

 To Realisation A/c

(Sale of assets)

5. For Assets taken Over by the Partner

Partners' Capital A/c Dr.

 To Realisation A/c (Agreed Price)

(Assets taken over by partner)

Bank/Cash/Partners capital A/c Dr.

 To Partner's Loan A/c

(Settlement of loan to a partner)

6. Settlement of loans given by the Partner

Partners' Loan A/c Dr.

 To Bank/Cash/Partners' capital A/c

(Settlement of loan given by the partner)

7. Payment of Liabilities in Cash

Realisation A/c Dr.

 To Cash A/c

(Payment of liabilities)

8. Payment of Liabilities by the Partner(s)

Realisation A/c Dr.
 To Partner Capital A/c
(Liabilities taken over by partner)

Treatment of Unrecorded Assets and Liabilities

Sometimes, there may be some assets that have already been written off completely in previous years and thus, do not appear in the Balance Sheet but physically they still exist for operational purposes. For example, there is an old computer, which is still in working condition though its book value is zero. Similarly, there may be some liabilities, which do not appear in the Balance Sheet, but actually they are still there. For example, a bill discounted with bank, on dissolution it was dishonoured and had to be taken up by the firm for payment purposes.

It is to be kept in mind that an unrecorded asset would never be transferred to the debit of the Realisation Account, because the amount realised from its sale is in nature of a gain and the Realization Account is only credited accordingly. Similarly, an unrecorded liability need not be transferred to Realisation.

Reason being that its payment is a loss and Realisation Account is only debited with the actual payment. In such cases, the following journal entries are made:

- (a) When the amount realised from the sale of an unrecorded asset.

Cash/Bank A/c Dr.
 To Realisation A/c
(Sale of unrecorded assets)

- (b) When an unrecorded asset is taken over by a partner at an agreed value.

Partner's Capital A/c Dr.
 To Realisation A/c
(Unrecorded assets taken by partner)

- (c) When unrecorded liability has been discharged by the firm.

Realisation A/c Dr.
 To Bank/Cash A/c
(Payment of unrecorded liabilities)

- (d) When an unrecorded liability is discharged by a partner on behalf of the firm.

Realisation A/c Dr.

 To Partner's Capital A/c

(Unrecorded Liabilities payment by partner)

Payment of Realisation Expenses

- (a) When realisation expenses are paid by the firm (i.e. borne by the firm). The following journal entry will be recorded:

Realisation A/c Dr.

 To Bank/ Cash A/c

(Payment of realisation expenses)

- (b) When Realisation expenses are paid by the partner on behalf of the firm (i.e. realisation expenses paid by the partner but borne by the firm). The following journal entry is made:

Realisation A/c Dr.

 To Partners' Capital A/c

(Payment of realisation expenses by partner on behalf of firm)

- (c) Realisation expenses were agreed to be paid by the partner and were paid by the firm

Partner's Capital A/c Dr.

 To Cash/Bank A/c

(Realisation expenses paid and borne by partner)

Closing of Realisation Account

The balance in the realisation account would show either profit or loss on dissolution. If the total of the credit side is more than the debit side, then there is a profit and following journal entry is made :

Realisation A/c Dr. (Individually)

 To Partner's Capital/ Current A/c (Individually)

(Profit on realisation transferred to capital accounts)

If, the debit side is more than credit side, then there is a loss on dissolution and following journal entry is made :

Partner's Capital/Current A/c Dr. (Individually)

 To Realisation A/c

(Loss on realisation transferred to capital account)

Format of Realisation Account

Dr.		Realisation Account		Cr.	
<i>Particulars</i>	<i>Amount (Rs.)</i>	<i>Particulars</i>	<i>Amount (Rs.)</i>		
All Assets A/c (Book Value) (Except Cash/Bank)		All External Liabilities A/c (Book Value)			
Cash/Bank A/c (Payment of external liabilities)		Cash/Bank A/c (Amount realised on sale of various assets)			
Partners Capital A/c (if any liability paid by partner)		Partners' capital A/c (If any asset is taken over)			
Cash/Bank A/c (Expenses on realisation)		Partners Capital A/c (For transferring loss on realisation)			
Partners Capital A/c (Expenses on realisation paid by a partner)					
Partners Capital A/c (For transferring profit on realisation)					

9.4.3 Partner's Capital Account and Cash/Bank Account

Settlement of Partners' Capital Accounts

After all the adjustments related to partners' capital accounts and transfer of profit or loss on realisation to the partners' capital accounts, the capital accounts are closed in the following manner:

- (a) If the Partner's Capital Account shows a debit balance, the partner has to bring the necessary amount of cash. The following journal entry is made :

Bank/Cash A/c Dr.

 To Partner's Capital A/c

(Cash brought by the partner)

- (b) If the Partner's Capital Account shows a credit balance, he/she is to be paid off the necessary amount of cash. The following journal entry will be made:

Partner's Capital A/c Dr.

 To Bank/Cash A/c

(Cash paid to partner)

Preparation of Cash/Bank account

After closing the partners' capital accounts, bank account is prepared and all entries pertaining to the bank/cash are posted in it including any cash brought in by the partner on the dissolution of firm. Partners' capital accounts are closed by making payment from the bank account and thereby bank account stands closed by making/receiving payment. In this way all the accounts stand closed. If cash/bank account does not show any balance, it implies that all the accounts of the dissolved firm have been closed properly.

Illustration 1

Akshay and Sakshi are equal partners in a firm. They decided to dissolve the partnership on December 31, 2022 when the balance sheet stood as under:

Balance Sheet as on December 31, 2022

<i>Liabilities</i>	<i>Amount (Rs.)</i>	<i>Assets</i>	<i>Amount (Rs.)</i>
Sundry creditors	54,000	Cash at Bank	22,000
Reserve fund	20,000	Sundry Debtors	24,000
Loan	80,000	Stock	84,000
Capital :		Furniture	50,000
Akshay 1,20,000		Plant	94,000
Sakshi 1,20,000	2,40,000	Leasehold Land	1,20,000
	3,94,000		3,94,000

Assets were realised as follows:

	Rs.
Leasehold land	1,44,000
Furniture	45,000
Stock	81,000
Plant	96,000
Sundry debtors	21,000

The creditors were paid Rs.51,000 in full settlement. Expenses of realisation amounted to Rs.6,000.

Prepare Realisation account, Bank account, partners' capital accounts to close the books of the firm.

Solution :

Books of Akshay and Sakshi Realisation Account

Dr.

Cr.

<i>Particulars</i>	<i>Amount (Rs.)</i>	<i>Particulars</i>	<i>Amount (Rs.)</i>
Assets Transferred		Sundry Creditors	54,000
Sundry Debtors 24,000		Loan	80,000
Plants 94,000		Bank	
Stock 84,000		Sundry Debtors 21,000	
Leashold Land 1,20,000		Plant 96,000	
Furniture 50,000	3,72,000	Stock 81,000	
Bank		Leasehold Land 1,44,000	
Creditors 51,000		Furniture 45,000	3,87,000
Loan 80,000			
Realisation Expense 6,000			
Profit Transferred to	1,37,000		
Akshay's Capital 6,000			
Sakshi's Capital 6,000			
	12,000		
	5,21,000		5,21,000

Capital Accounts

Dr. **Cr.**

<i>Particulars</i>	<i>Akshay (Rs.)</i>	<i>Sakshi (Rs.)</i>	<i>Particulars</i>	<i>Akshay (Rs.)</i>	<i>Sakshi (Rs.)</i>
Bank	1,36,000	1,36,000	Balance b/d	1,20,000	1,20,000
			Reserve Fund	10,000	10,000
			Realisation (Profit)	6,000	6,000
	1,36,000	1,36,000		1,36,000	1,36,000

Bank Account

Dr. **Cr.**

<i>Particulars</i>	<i>Amount (Rs.)</i>	<i>Particulars</i>	<i>Amount (Rs.)</i>
Balance b/d	22,000	Realisation A/c	1,37,000
Realisation A/c	3,87,000	Akshay's Capital	1,36,000
		Sakshi's Capital	1,36,000
	4,09,000		4,09,000

Illustration 2

Hari and Giri are partners, who shared profit as 2:1. Following is the balance sheet as on December 31, 2021

Balance Sheet as on December 31, 2021

<i>Liabilities</i>	<i>Amount (Rs.)</i>	<i>Assets</i>	<i>Amount (Rs.)</i>
Creditors	38,000	Cash in Hand	15,000
Bills Payable	29,500	Cast at Bank	45,000
Profit & Loss A/c	13,500	Stock	7,500
Hari's Capital	32,500	Sundry Debtors	21,500
Giri's Capital	11,500	<i>Less</i> : Provision for bad debt	500
		Land & Building	36,500
	1,25,000		1,25,000

The firm was dissolved on December 31, 2021. Close the books of the firm with the following information:

- (i) Debtors realised at a discount of 5%.
- (ii) Stock realised at Rs. 7,000.
- (iii) Building realised at Rs. 42,000.
- (iv) Realisation expenses amounted to Rs. 1,500.
- (v) Creditors and bills payable are paid in full.

Prepare necessary ledger accounts.

Solution :

Books of Hari and Giri Realisation Account

Dr.

Cr.

<i>Particulars</i>	<i>Amount (Rs.)</i>	<i>Particulars</i>	<i>Amount (Rs.)</i>
Assets Transferred		Provision for bad debts	500
Stock	7,500	Creditors	38,000
Sundry Assets	21,500	Bills Payable	29,500
Land & Building	<u>36,500</u>	Bank	
Bank	65,500	Debtors	20,425
Creditors	38,000	Stock	7,000
Bills Payable	29,500	Land & Building	<u>42,000</u>
Realisation (Expense)	<u>1,500</u>		69,425
Profit Transferred to			
Hari's Capital	1950		
Giri's Capital	975		
	2,925		
	<u>1,37,425</u>		<u>1,37,425</u>

Capital Accounts

Dr. **Cr.**

<i>Particulars</i>	<i>Hari (Rs.)</i>	<i>Giri (Rs.)</i>	<i>Particulars</i>	<i>Hari (Rs.)</i>	<i>Giri (Rs.)</i>
Bank	43,450	16,975	Balance b/d	32,500	11,500
			Profit & Loss A/c	9,000	4,500
			Realisation (Profit)	1,950	975
	43,450	16,975		43,450	16,975

Bank Account

Dr. **Cr.**

<i>Particulars</i>	<i>Amount (Rs.)</i>	<i>Particulars</i>	<i>Amount (Rs.)</i>
Balance b/d	45,000	Realisation	69,000
Cash	15,000	Hari's Capital	43,450
Realisation	69,425	Giri's Capital	16,975
	1,29,425		1,29,425

Illustration 3

Bhanu, Sonu and Rahim were partners in a firm sharing profits in the ratio of 3 : 2 : 1. On 31 December, 2022, they decided to dissolve the firm. Following was the balance sheet of the firm on that date.

Balance Sheet as on December 31, 2022

<i>Liabilities</i>	<i>Amount (Rs.)</i>	<i>Assets</i>	<i>Amount (Rs.)</i>
Creditors	50,400	Cash	13,700
Investment fluctuation fund	10,000	Stock	20,100
Reserve Fund	12,000	Sundry Debtors	62,600
Bhanu's Capital	30,000	Investments	16,000
Sonu's Capital	20,000	Furniture	20,000
Rahim's Capital	10,000		
	1,32,400		1,32,400

Dr. **Partner's Capital Account** **Cr.**

<i>Particulars</i>	<i>Bhanu (Rs.)</i>	<i>Sonu (Rs.)</i>	<i>Rahim (Rs.)</i>	<i>Particulars</i>	<i>Bhanu (Rs.)</i>	<i>Sonu (Rs.)</i>	<i>Rahim (Rs.)</i>
Realisation (Assets)	18,000	17,500	20,000	Balance b/d	30,000	20,000	10,000
Cash	19,400	7,433	-	Reserve Fund (Assets)	6,000	4,000	2,000
				Realisation (Profit)	1,400	933	467
				Cash	-	-	7,533
	37,400	24,933	20,000		37,400	24,933	20,000

Cash Account

Dr. **Cr.**

<i>Particulars</i>	<i>Amount (Rs.)</i>	<i>Particulars</i>	<i>Amount (Rs.)</i>
Balance b/d	13,700	Realisation	54,900
Cash	60,500	Hari's Capital	19,400
Realisation	7,533	Giri's Capital	7,433
	81,733		81,733

Illustration 4

Tanu, Manu and Chetan are in partnership sharing profit in the proportion of $\frac{1}{2}$, $\frac{1}{3}$, $\frac{1}{6}$ respectively. They dissolve the partnership firm on the December 31, 2020, when the balance sheet of the firm stood as under:

Balance Sheet as on December 31, 2020

<i>Liabilities</i>	<i>Amount (Rs.)</i>	<i>Assets</i>	<i>Amount (Rs.)</i>
Sundry Creditors	30,000	Bank	37,500
Bills Payable	25,000	Sundry Debtors	58,000
Manu's Loan	40,000	Stock	39,500
Capital		Investment	42,000
Tanu	90,000	Machinery	48,000
Manu	75,000	Freehold Property	90,000
Chetan	<u>55,000</u>		
	2,20,000		
	<u>3,15,000</u>		<u>3,15,000</u>

The machinery was taken over by Manu for Rs.45,000,

Tanu took over the investment for Rs. 40,000 and freehold property was taken over by Chetan at Rs. 95,000.

The remaining assets realised as follows:

Sundry Debtors Rs. 56,500 and Stock Rs.36,500. Sundry creditors were settled at discount of 5%.

Bills payable is taken over by Chetan for Rs. 23,000.

Their liabilities amounting to Rs. 3,000 not shown in books are also to be paid.

An office computer, not shown in the books of accounts, realised Rs. 9,000

Realisation expenses amounted to Rs. 3,000.

Prepare Realisation Account, Partners Capital account and Bank Account.

Solution :

Books of Tanu Manu and Chetan

Realisation Account

Dr.

Cr.

<i>Particulars</i>	<i>Amount (Rs.)</i>	<i>Particulars</i>	<i>Amount (Rs.)</i>
Assets Transferred		Sundry Creditors	30,000
Sundry Debtors	58,000	Bills Payable	25,000
Stock	39,500	Tanu Capital (Investment)	40,000
Machinery	48,000	Manu Capital (Machinery)	45,000
Investment	42,000	Chetan Capital	95,000
Freehold Property	<u>90,000</u>	(Freehold Propety)	
Chetan Capital		S. Debtors	56,500
(Bills Payable)	23,000	Stock	36,500
Bank		Computer	<u>9,000</u>
S. Creditors	28,500		1,12,000
Liabilities	3,000		
(Unrecorded)			
Realisation	<u>6,000</u>		
(Expense)	37,500		
Profit Transferred to			
Tanu Capital	4,500		
Manu Capital	3,000		
Chetan Capital	<u>1,500</u>		
	9,000		
	<u>3,47,000</u>		<u>3,47,000</u>

Capital Account

Dr.

Cr.

<i>Particulars</i>	<i>Tanu (Rs.)</i>	<i>Manu (Rs.)</i>	<i>Chetan (Rs.)</i>	<i>Particulars</i>	<i>Tanu (Rs.)</i>	<i>Manu (Rs.)</i>	<i>Chetan (Rs.)</i>
Realisation (Assets)	40,000	45,000	95,000	Balance b/d	90,000	75,000	55,000
Bank	54,500	33,000	-	Reserve Fund (Assets)	-	-	23,000
				Realisation (Profit)	4,500	3,000	1,500
				Cash	-	-	15,500
	94,500	78,000	95,000		94,500	78,000	95,000

Capital Account

Dr.

Cr.

<i>Particulars</i>	<i>Amount (Rs.)</i>	<i>Particulars</i>	<i>Amount (Rs.)</i>
Balance b/d	37,500	Realisation	37,500
Realisation	1,12,000	Manu's Loan	40,000
Chetan Capital	15,500	Tanu Capital	54,500
		Manu Capital	33,000
	1,65,000		1,65,000

WHAT YOU HAVE LEARNT

- When a firm decides to close its business and no business activity is carried out by the firm, it is said to be dissolved.
- Dissolution of a firm is different from the dissolution of a partnership. Dissolution of a firm means that the firm closes its business and comes to an end. While dissolution of a partnership means termination of old partnership agreement and a reconstitution of firm due to admission, retirement and death of a partner.
- On dissolution of the firm the books of accounts are closed. All assets and liabilities are transferred to an account called “Realisation Account”. This account records the realisation of assets and the payment of liabilities.

- When the partners decide to discontinue the business of the firm, it becomes necessary for it to settle its accounts. For this purpose, it disposes off all its assets (except cash and bank balances) for satisfying all the claims against it.
- An unrecorded asset would never be transferred to Realisation Account, because the amount realised from its sale is in the form of a gain and the Realization Account is only credited accordingly.
- After all the adjustments related to partners' capital accounts and transfer of profit or loss on realisation to the partners capital accounts, the capital accounts are closed.
- Partners capital accounts are closed through making payment from the bank account and thereby bank account stands closed by making/ receiving payment.

Terminal Exercise

Section - A

1. Dissolution of Partnership
2. Realisation Account

Section - B

1. Distinguish between dissolution of partnership firm and dissolution of partnership.
2. Under what circumstances can the court dissolve the partnership firm?

Section - C

1. Sumit and Anish are equal partners in a firm. They decided to dissolve the partnership on December 31, 2014 when the balance sheet is as under:

Balance Sheet as on December 31, 2021

<i>Liabilities</i>	<i>Amount (Rs.)</i>	<i>Assets</i>	<i>Amount (Rs.)</i>
Sundry Creditors	30,000	Cash at Bank	7,000
Reserve Fund	7,000	Sundry Debtors	23,000
Bills Payable	30,000	Stock	42,000
Sumit 70,000		Furniture	35,000
Anish <u>60,000</u>	1,30,000	Plant	40,000
		Leashold Land	50,000
	<u>1,97,000</u>		<u>1,97,000</u>

Assets were realised as :

	Rs.
Leasehold land	62,000
Furniture	30,500
Stock	40,500
Plant	48,000
Sundry debtors	22,500

Sundry creditors were paid Rs.29,500 in full settlement. Bills payable paid 5% less. Expenses of realisation amounted to Rs.2,500.

Prepare realisation account, Bank account and partners' capital accounts to close the books of the firm.

2. Ashu and Hemani are Partners sharing profit and losses in the ratio of 3 : 2. They decided to dissolve the firm on December 31, 2020. Their balance sheet on the above date was :

Balance Sheet as on December 31, 2020

<i>Liabilities</i>		<i>Amount (Rs.)</i>	<i>Assets</i>		<i>Amount (Rs.)</i>
Capital			Building		90,000
Ashu	1,00,000		Machinery		60,000
Hemani	<u>92,000</u>	1,92,000	Furniture		10,000
Creditors		88,000	Stock		24,000
Bank Overdraft		20,000	Investments		50,000
			Debtors		48,000
			Cash in Hand		18,000
		<u>3,00,000</u>			<u>3,00,000</u>

Ashu is to take over the building at Rs.98,000 and machinery and furniture is to be taken over by Hemani at value of Rs.70,000. Ashu agreed to pay creditor and Hemani agreed to meet bank overdraft. Stock and investments are taken by both partners in

their profit sharing ratio.

Debtors realised for Rs. 46,000, expenses of realisation amounted to Rs. 3,000. Prepare necessary ledger accounts.

3. Tarun, Neeru and Vikas shared profit in the ratio of 3:2:1. On December 31, 2022 their balance sheet was as follows:

Balance Sheet as on December 31, 2014

<i>Liabilities</i>	<i>Amount (Rs.)</i>	<i>Assets</i>	<i>Amount (Rs.)</i>
Capital		Plant	80,000
Tarun	90,000	Debtors	70,000
Neeru	1,00,000	Furniture	22,000
Vikas	80,000	Stock	70,000
Creditors		Investments	60,000
Bills Payable		Bills Receivable	46,000
Reserve		Cash in Hand	32,000
	2,70,000		
	60,000		
	30,000		
	20,000		
	3,80,000		3,80,000

On this date the firm was dissolved. The assets realised as follows: Plant Rs.85,000, Debtors Rs. 69,000 Furniture Rs.20,000, stock 95% of the book value, Investments Rs.86,000 and Bills receivable Rs.31,000. An office Electronic Typewriter, not shown in the books of accounts realised Rs.9,000. Expenses of realisation amounted to Rs.4,500. Creditor are taken over by Vikas at book value. Prepare realisation account, Capital accounts and cash account

4. The following was the balance sheet of Anu and Hema as on December 31, 2021:

Balance Sheet as on December 31, 2021

<i>Liabilities</i>	<i>Amount (Rs.)</i>	<i>Assets</i>	<i>Amount (Rs.)</i>
Sundry Creditors	42,000	Cash at Bank	13,000
Bills Payable	26,000	Sundry Debtors	50,000
Hema's Loan	20,000	Stock	40,000
Reserve Fund	6,000	Bills Receivable	28,000
Provision of Bad Debts	2,000	Machinery	60,000
Capital		Investment	30,000
Anu	90,000	Fixtures	27,000
Hema	62,000		
	1,52,000		
	2,48,000		2,48,000

The firm was dissolved on December 31, 2021 and assets realised and settlements of liabilities was as follows :

(a) The realisation of the assets were as follows:

	<i>Rs.</i>
Sundry debtors	48,000
Stock	38,000
Bills receivable	27,000
Machinery	62,000

(b) Investment was taken over by Hema at agreed value of Rs.36,000 and agreed to pay of creditors. Bills payable is paid 3% less.

(c) Fixture are value less.

(d) The expenses incurred on realisation were Rs.2,200.

Journalise the entries to be made on the dissolution and prepare realisation account, bank account and partners capital accounts.

5. Rohit and Tina were partners in a firm and shared profit as 3 : 2. They decided to dissolve their firm on March 31, 2023 when their balance sheet was as follows:

Balance Sheet as on March 31, 2023

<i>Liabilities</i>		<i>Amount (Rs.)</i>	<i>Assets</i>		<i>Amount (Rs.)</i>
Capital			Machinery		80,000
Rohit	80,000		Investments		60,000
Tina	90,000	1,70,000	Stock		22,000
Sundry Creditors		70,000	Sundry Debtors		80,000
Reserve		10,000	Cash at Bank		8,000
		2,50,000			2,50,000

The assets and liabilities were disposed off as follows:

- (a) Machinery were given to creditors in full settlement of their account and stock is taken over by Rohit at Rs.19,000.
- (b) Investment were taken over by Tina at book value. Sundry debtors of book value Rs.50,000 taken over by Rohit at 10% less and remaining debtors realised for Rs.28,000.
- (c) Realisation expenses amounted to Rs.2,000 paid by Rohit.

Prepare necessary ledger accounts to close the books of the firm.

You may have come across the name of organisation with suffix limited (Ltd.), for example Hindustan Motors Ltd. or Hindustan Aeronautics Ltd. etc. Have you ever thought what does this indicate? Names of organisations with Ltd. indicate that these are forms of organisations which are different from sole proprietorship or partnership. These are called joint stock companies.

As you know that the sole proprietorship and partnership forms of business organisations could not meet the growing needs of huge capital and managerial skills required for increased scale of business and growing economic activities. The liability of owner/owners of these organisations is unlimited. In order to overcome these problems a new form of business organisation known as 'company' came into existence.

In this lesson, we shall study about company, its features and the methods of raising capital through issue of shares.

Objectives

After studying this lesson you will be able to:

- state the meaning of company as a form of business organisation;
- describe the characteristics, types of companies;
- describe various types of companies;
- accounting treatment in issue of shares;
- accounting treatment in issue of debentures;
- understand company final accounts;

10.1 Company-Meaning and Characteristics

A company is a voluntary association of individuals formed to carry on business to earn profits or for non profit purposes. These persons contribute towards the capital by buying its shares in which it is divided. A company is an association of individuals incorporated

as a company possessing a common capital i.e. share capital contributed by the members comprising it for the purpose of employing it in some business to earn profit.

Section 2(20) of the Companies Act 2013 “Company means a company incorporated under this Act or any previous company Law.”

Characteristics of a Company

Following are the main characteristics of a company:

- **Artificial Legal Person :** A company is an artificial person as it is created by law. It has almost all the rights and powers of a natural person. It can enter into contract. It can sue in its own name and can be sued.
- **Incorporated Body :** A company must be registered under Companies Act. By virtue of this, it is vested with corporate personality. It has an identity of its own. Although the capital is contributed by its members called shareholders yet the property purchased out of the capital belongs to the company and not to its shareholders.
- **Capital Divisible into Shares :** The capital of the company is divided into shares. A share is an indivisible unit of capital. The face value of a share is generally of a small denomination which may be of ` 1, ` 2, ` 5, ` 10, ` 25 or ` 100 etc.
- **Transferability of Shares :** The shares of the company are easily transferable. The shares can be bought and sold in the stock market.
- **Perpetual Existence :** A company has an independent and separate existence distinct from its shareholders. Changes in its membership due to death, insolvency etc. does not affect its existence and its continuity.
- **Limited Liability :** The liability of the shareholders of a company is limited to A the extent of face value of shares held by them. No shareholder can be called upon to pay more than the face value of the shares held by them. At the time of winding up, if necessary, the shareholders may be asked to pay the unpaid value of shares.
- **Representative Management :** The number of shareholders is so large and scattered that they cannot manage the affairs of the company collectively. Therefore they elect some persons among themselves to manage and administer the company. These elected representatives of shareholders are individually called the 'directors' of the company and collectively the Board of Directors.
- **Common Seal :** A common seal is the official signature of the company. Any document bearing the common seal of the company is legally binding on the company.

- **Membership :** In the case of a private company a minimum of two members and (7) seven members are required to form a company. The maximum limit is fifty (50) in case of private company and unlimited in public limited company.
- **Women Director :** As per the companies Act 2013, the Board of specific companies should consist of atleast one women director in a public company.

Nature of Company

In the beginning, the size of business firms were very small. Sole proprietorship was therefore, the usual form of business organisation. Later on partnership become popular when the size of business firms increased. But sole proprietorship and partnership could not meet the growing demand of big size business because of their limitations such as limited capital, limited managerial ability, unlimited liability and other drawbacks. Therefore, in the present days of business world, it is only the Joint stock company form of business organisation which proved to be useful.

A company is a voluntary association of persons formed for some common purpose. with capital divisible into parts, known as shares and with a limited liability. It is created by law and is known as an artificial person with a perpetual succession and a common seal. It has a separate legal entity.

10.2 Types of Companies

Companies can be classified under the following heads :

1. On the basis of formation.
2. On the basis of liability.
3. On the basis of ownership.
4. On the basis of commencement of business.

On the basis of formation companies can be categorised as :

- (a) **Statutory Company :** A company formed by a Special Act of parliament or state legislature is called a Statutory Company. Reserve Bank of India, Industrial Financial Corporation of India, Life Insurance Corporation of India, Delhi State Finance Corporation are some of its examples.
- (b) **Registered Company :** A company formed and registered under the Companies 2013 Act, 1956 or earlier Companies Acts is called a Registered Company. The working of such companies is regulated by the provisions of the Companies Act.

2. On the basis of Liability

On the basis of liability, companies can be categorised as:

- (a) **Company Limited by Shares** : The liability of the member of such company “is limited to the face value of shares held by him/her.
- (b) **Company Limited by Guarantee** : The liability of each member of such company is limited to the extent of guarantee undertaken by the member. It may arise in the event of it being wound up.
- (c) **Unlimited Company** : The company not having any limit on the liability of its members, is called on unlimited company. Liability in such a case extends to the personal property of its shareholders, Such companies do not use the word 'limited' at the end of their name.
- (d) **Company Under Section 25** : A company created under section-25 is to promote art, culture and societal aims. Such companies need not use the term limited at the end of their name. Punjab, Haryana, Delhi chambers of commerce. etc. are the examples of such companies.

3. On the basis of Ownership

On the basis of ownership, companies can be categorised as:

- (a) **Private Company** : A private company is one which by its Articles of Association:
 - (i) restricts the right of members to transfer its shares;
 - (i) limits the number of its members to fifty (excluding its past and present employees).
 - (i) prohibits any invitation to the public to subscribe to its shares, debentures.
 - (iv) The minimum paid up capital of the company is one lakh rupees (` 100000). The minimum number of shareholders in such a company is two and the company has to add the words 'private limited' at the end of its name. Private companies do not involve participation of public in general.
- (i) **Small Company** : According Sec. 2 (85) of Indian Companies Act 2013, a small company is a company other than public company. It consists of following features.
 - 1. It has a Share Capital which does not exceed ` 50 lakhs, in case of higher amount it should not exceed 5 crores.
 - 2. Its turnover does not exceed ` 2 crore. In case of higher amount (if any) prescribed should not exceed ` 20 crore.
- (ii) **One Person Company** : As per Companies Act 2013 “One Person Company (OPC) means a company which has only one person as member.” This is a company in which only one man holds practically the whole of the share capital of the company and dummy members are usually nominees of the shares. The members carries on the business with limited liability.

(b) **Public Company** : A company which is not a private company is a public company. Its Articles of association does not contain the above mentioned restrictions.

Main features of a public company are:

- (i) The minimum number of members is seven.
 - (ii) There is no restriction on the maximum number of members.
 - (iii) It can invite public for subscription to its shares.
 - (iv) Its shares are freely transferable.
 - (v) It has to add the word 'Limited' at the end of its name.
 - (vi) Its minimum paid up capital is five lakhs rupees (₹ 5,00,000).
- (c) **Government Company**: A Government company is one in which not less than 51% of its paid up capital is held by (1) Central Government or (2) State Government, or (3) partly by Central Government and partly by State Government Example of a Government company is Hindustan Machine Tools Limited, (HMT) State Trading Corporation (STC). Minerals and Metals trading corporation (MMTC).
- (d) **Foreign Company** : A foreign company is one which is incorporated outside India but has a place of business in India, for example Philips, L.G, etc.
- (e) **Holding Company and Subsidiary Company** : A holding company is a company which controls another company (called subsidiary company) either by acquiring more than half of the equity shares of another company or by controlling the composition of Board of Directors of another company or by controlling a holding company which controls another company.

Listed Company and Unlisted Company : A company is required to file an application with stock exchange for listing of its securities on a stock exchange. When it qualifies for the admission and continuance of the said securities upon the list of the stock exchange, it is known as listed company. A company whose securities do not appear on the list of the stock exchange is called unlisted company.

On the basis of commencement of business :

- (a) **Dormant Company** : It is a company which does not carry any accounting transaction for a period of two years. Such company apply to registrar of companies for calling or declaring it is “Dormant Company.”
- (b) **Difunct Company** : A company which has no assets and liabilities and failed to commence business within one year of its incorporation, such company is called as difunct company.

Difference between public company and private company :

The major differences between public company and private company are as follows :

Difference between Public Company and Private Company

<i>Basis of Difference</i>	<i>Public Company</i>	<i>Private Company</i>
1. Minimum Number of Members	Minimum number of members required to form a public company is seven.	Minimum number of members required to form a private company is two.
2. Maximum number of Members	No limit on maximum number of members	Maximum number of members is fifty.
3. Name	The word 'Limited' is used at the end of the company's name	The word 'Private Limited' is used at the end of the company's name.
4. Commencement of Business	It can start its business only after getting a certificate of commencement of business.	It can commence its business as soon as it obtains Certificate of Incorporation.
5. Invitation to Public	It invites public to subscribe to its shares.	It cannot invite public to subscribe to its shares.
6. Transfer of Shares	There is no restriction on transfer of its shares.	There is restriction on the transfer of its shares.
7. Number of Directors	It must have at least three directors.	It must have at least two directors.
8. Minimum Capital	It must have a minimum paid up capital of five lakh rupees (₹ 500000)	It must have a minimum paid up capital of one lakh rupees (₹ 100000).
9. Loans	Directors can borrow from the private company.	Directors cannot borrow money from the public company
10. Quorum	Minimum members required for a meeting is two (2).	Minimum members required for a meeting is five (5).

10.3 Shares-Meaning and Its Kinds

A joint stock company divides its capital into units of equal denomination. Each unit is called a share. These units i.e shares are offered for sale to raise capital. This is termed as issuing shares. A person who buys share/shares of the company is called a shareholder and by acquiring share or shares in the company he/she becomes one of the members of the company.

Thus, a share is an indivisible unit of capital. It expresses the proprietary relationship between the company and the shareholder. The denominated value of a share is its face value. The total capital of a company is divided into number of shares.

Kinds of Shares

According to the Companies Act, a company can issue the following types of Shares:

- (i) Preference Shares (ii) Equity Shares
- (i) Preference Shares : A preference share is one which carries following preferential rights over other type of shares called equity shares in regard to the following:
- Payment of dividend
 - Repayment of capital at the time of winding up of the company.

Characteristics of Preference Shares

- i. Such type of shareholders have priority in the payment of dividend before any other class of shareholders get their payment of dividend.
 - ii. The rate of dividend of such shares are pre-determined.
- (ii) **Equity Shares** : All shares which are not preference shares are equity shares. Holders of these shares receive dividend out of the profits of the company after the payment of dividend has been made to the preference shareholders.

Characteristics of Equity Shares

- i. Its dividend rate can change from year to year
- ii. Dividend on Equity shares is paid after the payment of dividend to preference shareholders.
- iii. In the event of winding up of company the repayment of capital to equity shareholder is made at last.

iv. They are real owners of the company.

Equity shareholders have the right to elect directors of the company. Equity shares are the permanent source of capital.

Difference between Equity Shares and Preference Shares

<i>Basis of Difference</i>	<i>Public Company</i>	<i>Private Company</i>
1. Rate of Dividend	Rate of dividend on these shares is not fixed and depends upon the decision of the Board of directors.	Rate of dividend on these shares is fixed.
2. Payment of Dividend	Dividend on these shares is paid after payment of dividend to preference shareholders.	Dividend on these shares is paid before payment of dividend to equity shareholders.
3. Refund of Share Capital of Winding up of the Company	On winding up of the company equity share holders get refund of capital only after preference share holders have been paid off.	Preference shareholders have a preference over equity shareholders in regard to refund of capital in case of winding up of the company.
4. Voting Rights	Shareholders have voting rights in all matters.	Shareholders can vote only in special circumstances.
5. Redemption	Shares cannot be redeemed during the life of the company.	Shares can be redeemed as per terms of issue.

10.4 Share Capital-Meaning and its types

A joint stock company estimates its future capital requirements. The amount of the capital is mentioned in the capital clause of the Memorandum of Association registered with the Registrar of the Companies. Total capital is divided into a number of small indivisible units of fixed amount and each such unit is called a share. A share is nothing but a part in the share capital of the company. As the total capital of the company is divided into shares, the capital of the company is called share capital. Share capital of the company is divided into following categories:

- **Nominal/Authorised/Registered Capital :** It refers to the maximum amount of share capital which a company is authorised to issue as per its Memorandum of Association.
- **Issued Capital :** Issued capital is that part of the authorised capital which the company offers to public, that may include vendors, for subscription or purchase. A company may issue its entire authorised capital or may issue it in parts from time to time as per the needs of the company. It means and includes the nominal value of shares issued by the company for (a) cash, and (b) consideration other than cash to (i) promoters of a company, and (ii) others.
- **Subscribed Capital :** It is that part of issued capital which is taken up or subscribed by those who are offered for subscription. Company may receive application for equal to, more than or less than shares issued. This capital can be equal to or less than the issued capital. The portion of nominal value of the issued share capital which is actually paid (or subscribed) by the shareholders forms part of the Subscribed capital.
- **Called up Capital :** It is that part of the issued/subscribed capital which is called up by company to pay on the allotted shares and is to be paid by the shareholders. The portion of the issue price of the shares which a company has demanded or called from shareholders is known as called up capital.
- **Uncalled Capital :** Uncalled Capital is that portion of the issued/subscribed capital that is not called up by the company on the shares allotted.
- **Paid up Capital :** It is the portion of called up capital which has been paid by the shareholders, to calculate the paid up capital, the amount of instalments in arrears is deducted from the called up capital.

Unpaid Capital : That part of the called up capital which has been called but has not been paid by the shareholders is called unpaid capital. Le calls-in- arrears.

Reserve Capital : Company may keep some part of its share capital uncalled and keep in reserve to be called only in case of need at the time of its winding up. This is known as Reserve capital. For this, a special resolution will have to be passed by the company. Thus, it is that portion of the uncalled capital which a company has decided to call only in case of liquidation of the company.

10.5 Private Placement of Shares

According to Section 42 of Companies Act, 2013 private placement of shares are allotment of shares to a selected group of persons other than by way of a public issue through a private placement offer letter.

A private company limited by shares is prohibited by the Companies Act from issue of shares for public subscription. It also need not file a statement in lieu of prospectus. Its shares are issued privately to a small number of persons known as promoters or related to them by family connections. This is an easy way of raising capital which involves less legal formalities. However, a public company can also raise the capital by placing the shares privately and without inviting the public for subscription. Such Private Placement requires special resolutions to be passed by the company or consent of Central Government. An underwriter or broker finds clients who wish to buy shares. Since, no public offer is made, there is no need to issue prospectus. Statement in lieu of prospectus should be filed with registrar of companies in such a case.

10.6 Procedure of Issue of Shares

Face value of a share is the par value of the share. It is also known as the Nominal value or denomination of a share. To issue shares a company follows a definite procedure which is controlled and regulated by the Companies Act and Securities Exchange Board of India (SEBI). There are different ways of issue of shares which may be:

- (A) For consideration other than cash
- (B) For cash

(A) ISSUE OF SHARES FOR CONSIDERATION OTHER THAN CASH

Sometimes shares are issued to the promoters of the company in lieu of the services provided by them during the incorporation of the company. The issue price of these shares is normally debited to 'Goodwill A/c' and journal entry is made as follows:

Goodwill A/c Dr.

 To Share Capital A/c

In case a company does not have sufficient funds for the purchase of fixed assets or for payment to creditors it may offer and allot its shares to vendors/creditors in lieu of cash. Any allotment of shares against which cash is not to be received is called issue of shares for consideration other than cash. For example building is purchased and payment is made by issuing shares.

In case of purchase of assets like building, machinery, stock of materials, etc. the following journal entry is made:

1. Assets A/c Dr.

 To Vendors/Creditors A/c (Assets purchased)

2. Vendors/Creditors A/c Dr.

To Share Capital A/c

(Issue of shares of *.....each fully paid up)

(B) ISSUE OF SHARES FOR CASH

In general, shares are issued for cash. The company may call the share money either in one instalment or in two or more instalments. But company always collects this money through its bankers.

(i) Receipt of Share Money in One Instalment : The company may receive the share money in one instalment along with application. In this case the following journal entries are made in the books of the company

1. On Receipt of Application Money

Bank A/c Dr.

To Share Application A/c

(Application money received on....shares of Rs....each)

2. On transferring the Application Money

Share Application A/c Dr.

(To Share Capital A/c

(Application money transferred to share capital A/c)

(ii) Share Money Received in Two or More Instalments : Instead of receiving““payment in one instalment i e. at the time of application the company collects it in two or more instalments. The first, instalment which the applicants have to pay along with the applications for shares is known as application money. On the allotment of shares the allottees are required to pay the second instalment which is termed as allotment money. If the company decides to call the share money in more than two instalments the other instalment is/are termed as call money (i.e. first-call, second call or final call).

In the above case the transactions are recorded in journal as given below:

(a) On Receipt of Application Money

Bank A/c

Dr

Greeshma Company Ltd.
Journal Entries

<i>Date</i>	<i>Particulars</i>	<i>L.F.</i>	<i>Debit</i>	<i>Credit</i>
1.	Bank A/c Dr. To Share Application A/c (Application money received @ 2 per share)		4,00,000	4,00,000
2.	Share Application A/c Dr. To Share Capital A/c (Share application money for 2,00,000 shares transferred to share capital A/c)		4,00,000	4,00,000
3.	Share Allotment A/c Dr. To Share Capital A/c. (Allotment money made due on 200000 shares @ ` 3/- per share)		6,00,000	6,00,000
4.	Bank A/c Dr. To Share Allotment A/c. (Allotment money received on 200000 shares @ ` 3 per share)		6,00,000	6,00,000
5.	Share First & Final call A/c. Dr. To Share Capital A/c (Call money on 2,00,000 share @ ` 5 per share made due)		10,00,000	10,00,000
6.	Bank A/c Dr. To Share First & Final call A/c. (Call money received on 2,00,000 shares @ ` 5 per share)		10,00,000	10,00,000

Note : Although shares may be equity shares or preference shares but if the term shares is used it means equity shares)

Relevant Accounts

Bank A/c

Dr.

Cr.

Date	Particulars	J.F.	Amount	Date	Particulars	J.F.	Amount
	To Share Application A/c		4,00,000		Balance bd		20,00,000
	To Share Allotment A/c		6,00,000				
	To Share First and Final						
	To Call A/c		10,00,000				
			20,00,000				20,00,000
	Balance b/d		20,00,000				

Share Application A/c

Dr.

Cr.

Date	Particulars	J.F.	Amount	Date	Particulars	J.F.	Amount
	To Share Capital A/c		4,00,000		By Bank A/c		4,00,000
			4,00,000				4,00,000

Share Capital A/c

Dr.

Cr.

Date	Particulars	J.F.	Amount	Date	Particulars	J.F.	Amount
	To Balance c/d		20,00,000		By Share Application A/c		4,00,000
					By Share Allotment A/c		6,00,000
					By Share First and		
					Final call A/c		10,00,000
			20,00,000				20,00,000
					Balance b/d		20,00,000

Share Allotment A/c

Dr.

Cr.

Date	Particulars	J.F.	Amount	Date	Particulars	J.F.	Amount
	To Share Capital A/c		6,00,000		By Bank A/c		6,00,000
			6,00,000				6,00,000

Share First and Final Call A/c

Dr.

Cr.

Date	Particulars	J.F.	Amount	Date	Particulars	J.F.	Amount
	To Share Capital A/c		10,00,000		By Bank A/c		10,00,000
			10,00,000				10,00,000

10.7 Full, Under and Over Subscription

A company decides to issue number of shares to raise capital. It invites public to buy these shares. Now there may be three situations :

- I. Full Subscription :** Company may receive applications equal to the number of shares company has offered to people. It is called full subscription.
- II.** The company does not receive applications equal to the number of shares offered for subscription, there may be two situations : (i) under subscriptions; (ii) over subscription
 - (i) Under Subscription :** The issue is said to have been under subscribed when the company receives applications for less number of shares than offered to the public for subscription. In this case company is not to face any problem regarding allotment since every applicant will be allotted all the shares applied for. But the company can proceed with allotment provided the subscription for shares is at least equal to the minimum required number of shares termed as minimum subscription.
 - (ii) Over Subscription :** When company receives applications for more number of shares than the number of shares offered to the public for subscription it is a case of over subscription. A company cannot allot more shares than what it has offered. In case of over subscription, company has the following options:

10.8 Issue of Shares at Premium

A company can issue its shares at their face value. When company issues its shares at their face value, the shares are said to have been issued at par. Company can also issue its shares at more than or less than its face value ie, at 'Premium' When shares are issued at premium an accounting treatment different from shares issued at par is required.

The Companies Act, 2015 (section 52 (1)) requires that the amount of the premium received on securities is to be credited to Securities Premium Account, i.e., Securities Premium Reserve Account.

If a company issues its shares at a price more than its face value, the shares are said to have been issued at Premium. The difference between the issue price and face value or nominal value is called 'Premium'. If a share of ₹ 10 is issued at ₹ 12, it is said to have been issued at a premium of ₹ 2 per share. The money received as premium is transferred to Securities Premium A/c A company issues its shares at premium only when its financial position is very sound. It is a capital gain to the company. The Premium money may be demanded by the company with application, allotment or with calls.

The Companies Act has laid down certain restrictions on the utilisation of the amount of premium.

According to Section 8 of this Act, the amount of premium can be utilised for :

- (i) Issuing fully-paid bonus shares:
- (ii) Writing off preliminary expenses, discount on issue of shares and debentures, underwriting commission or expenses on issue;
- (iii) Paying premium on redemption of Preference shares or Debentures:
- (iv) Buy Back of Shares.

Further, the company may demand the total amount of premium in more than one instalment. In case the company doesn't specify the particular call with which Securities Premium is to be paid it is supposed to be called at the time of Allotment.

1. Equity and Liabilities

There are broadly two headings shown on the Equity and Liabilities side. First, being the equity, i.e., liability of the company towards shareholders. It is termed as Shareholders' Funds. It includes Share Capital, Reserves and Surplus and Money received against share warrants. Second, being liability of the company towards the outsiders. It is termed as Liabilities.

1. Shareholders' Funds

- (a) **Share Capital** : It is the first item under shareholders' funds. Details required to be shown are :
- (i) ● **Authorised Share Capital** : Authorised Share Capital is stated in the Memorandum of Association and is divided into different categories such as equity share capital and preference share capital. It is the amount of share capital that a company is authorised to issue under each category. It is shown by way of information in the notes attached to the Balance Sheet. The above information is shown for information only. i.e., it is not added to liability.
- **Issued Share Capital** : It is that part of the authorised share capital which the company has issued for subscription up to the authorised share capital which the company has issued for subscription up to the date of Balance Sheet. It includes a number and classes (Equity or Preference) of shares and their face value, etc.
- **Subscribed Share Capital** : It is that part of issued share capital which has been subscribed by the applicants.
- **Called-up Share Capital** : It is that part of the issued share capital that has been called-up to be paid by the company.
- **Paid-up Share Capital** : It refers to that part of subscribed share capital which has been paid-up by the subscriber towards share capital.
- (ii) If a company has issued different types of Equity and Preference shares, detail of each type of shares is given.
- (iii) Amount of Calls-in-Arrear is shown as deduction from called-up capital or 'subscribed capital' to ascertain the paid-up capital of the company and shown as liability in the Balance Sheet.

Calls-in Arrear from Directors and Officers of the company have to be disclosed.

- (iv) Forfeited shares amount, ie, amount originally paid up is shown by adding it to subscribed capital. But in case of profit on reissue of forfeited shares, it is transferred to Capital Reserves.

It is to be noted that details regarding share capital or in fact, any item of Balance Sheet and Statement of Profit and Loss is to be given in the notes.

- (b) **Reserve and Surplus** : Reserve and Surplus include following items and ““are shown separately:

- (i) Capital Reserves
- (ii) Capital Redemption Reserve
- (iii) Securities Premium Reserve
- (iv) Debentures Redemption Reserve
- (v) Revaluation Reserves
- (vi) Share Options Outstanding Account
- (vii) Other Reserves (to specify the nature and purpose of each reserve)
- (viii) Balance in the statement of Profit and Loss after appropriations towards proposed dividend and transfer to reserves. In case, Reserves and Surplus has a balance under the head, profit (surplus) or loss (deficit) for the year is added to it. Thereafter, appropriation is made by transfer to reserves or for provision for dividend.

If the balance after transfer of profit to the existing balance results in negative figure, it is shown under Reserves and Surplus as a negative amount. It means it is deducted to arrive at the total reserves.

The balance of the reserve and surplus, whether positive or negative, is shown under shareholders funds.

10.9 Calls in Advance and Calls in Arrears

If a shareholder pays any amount to company before it is demanded, it is called Call-in-Advance, This amount is put in a separate account known as Calls-in-Advance A/c. This amount is not shown as capital of the company, till such time the company makes a demand from all the shareholders. Call-in-Advance A/c is shown on the liabilities side of

the Balance Sheet. For example if a company issued shares of ₹ 10 on which it has already called ₹ 5. Against the uncalled portion of ₹ 5 per share the company makes a call ₹ 3 per share, the entry for call money due will be made only for 3 per share. Now suppose a shareholder pays ₹ 5 per share including the uncalled amount of ₹ 2 per share along with the call money, it means he has paid ₹ 2 per share in advance, which will be credited to calls in Advance A/c. The company is required to pay interest on this amount @ 6% till the date of its appropriation

Accounting Treatment

Following journal entry is made for calls-in-advance.

Bank A/c	Dr.
To Calls-in-Advance A/c	
(Calls in advance received on shares @ ₹ per share)	

Appropriation of calls-in-Advance A/c say in the final call

Journal entry will be :

Calls-in-Advance A/c	Dr.
To Share Final call A/c	
(Calls in advance amount adjusted)	

For interest given on Calls-in-Advance

Journal entry will be :

Interest on calls-in-Advance A/c	Dr.
To Bank A/c	
(Interest paid on the amount of Call-in-Advance)	

Calls in Arrears

When the company sends notice to the shareholders to pay allotment and/or call money, it has to be paid by them within the specified time period. If it is not paid by any one or more of the shareholders, the unpaid amount becomes arrears due from them. Such arrears are transferred to an account termed as Calls-in-Arrears A/c. The company is authorised to charge interest on calls-in-Arrears @ 5% p.a. for the intervening period. (The period between date of non-receipt of the due amount and the date of actual receipt of the due

amount).

Accounting Treatment

Following journal entry is made for calls-in-advance.

Calls-in-Arrears A/c	Dr.
To Share Allotment/Call A/c	

(Share allotment / Call money not received onshares)

When the unpaid balance is received later on the following journal entry is made :

Bank A/c	Dr.
To Calls in Arrears A/c	

(Amount due on allotment/call remaining unpaid
now recieved onshares.)

The company may charge interest on the amount of calls in arrears at a given rate from the date of amount due till it is paid journal entry will be

Bank A/c	Dr.
To Interest on calls in arrears A/c	

10.10. Forfeiture of Shares

Meaning and Procedure

If a shareholder fails to pay the due amount of allotment or any call on shares issued by the company, the Board of directors may decide to cancel his/her membership of the company. With the cancellation, the defaulting shareholder also loses the amount paid by him/her on such shares. Thus, when a shareholder is deprived of his/her membership due to non payment of calls, it is known as forfeiture of shares. The result of forfeiture of shares is :

Cancellation of membership of the shareholder.

Reduction of issued share Capital of the company

Let us take an example to make it more clear. S.K. Ltd. issued 100000 shares of ` 10 each payable as ` 2 on application, ` 2 on allotment, ` 3 on first call and 3 on second and final

call. Mr. Harish, the allottee of 100 shares, fails to pay the second and final call money made by the company. In this case if the Board of Directors decide to forfeit his shares, his membership will be cancelled and the amount of ₹ 700 paid by him (on 100 shares ₹ 2 on application, ₹ 2 on allotment and ₹ 3 on first call per share) will be forfeited. Now Mr. Harish will no longer be the member of the company and the issued capital of the company will be reduced by ₹ 1000.

Procedure of forfeiture of shares

The authority to forfeit shares is given to the Board of Directors in Articles of Association of the company. The Board of Directors has to give at least fourteen days notice to the defaulting members calling upon them to pay outstanding amount with or without interest as the case may be before the specified date. The notice must also state that if the shareholders fail to remit the amount mentioned therein within the stipulated period, their shares will be forfeited. If they still fail to pay the amount within the specified period of time, the Board of Directors of the company may decide to forfeit such shares by passing a resolution. The decision regarding the forfeiture of shares should be communicated to the concerned allottees and should be asked to return the allotment letters and share certificates of the forfeited shares to the company.

Disclosure of Forfeited Shares in the Balance Sheet

Till the time forfeited shares are reissued, balance of the forfeited shares account is added to paid-up capital under subscribed capital in the note to accounts on 'share capital' being part of shareholders' funds shown under equity and liabilities part of the balance sheet.

10.11 Debenture and its types

A Debenture is a unit of loan amount. When a company intends to raise the loan amount from the public it issues debentures. A person holding debenture or debentures is called a debenture holder. A debenture is a document issued under the seal of the company. It is an acknowledgment of the loan received by the company equal to the nominal value of the debenture. It bears the date of redemption and rate and mode at a specified rate as stated in the document. of payment of interest at a specified rate as stated in the document. A debenture holder is the creditor of the company.

As per section 2(30) of Companies Act 2013. "Debenture includes debenture stock, bond and any other securities of the company whether constituting a charge on the company's assets or not".

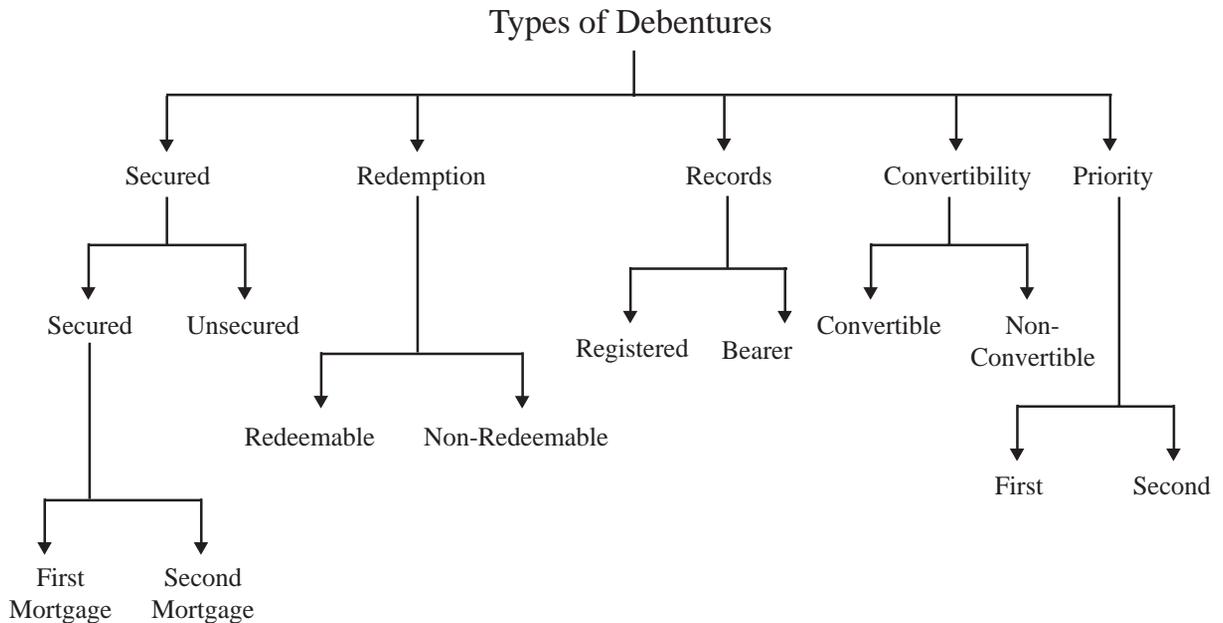
Characteristics or Feature of Debentures

1. Debenture is a written document or certificate acknowledging debt by the company.
2. Mode and period of repayment of principal and interest is fixed.

3. Rate of interest on the debenture is specified. It is a practice to prefix “Debentures” with the rate of interest. For example, if the rate of interest is 9% the title of the debentures will be 9% Debentures.
4. It is borrowing of the company.
5. It is normally secured by way of charge on the assets of the company.
6. Interest on debentures is a charge against profit.

Types of Debentures

Debenture can be classified as under :



1. From Security Point of View

(i) **Secured or Mortgage Debentures :** These are the debentures that are secured by a charge on the assets of the company. These are also called mortgage debentures. The holders of secured debentures have the right to recover their principal amount with the unpaid amount of interest on such debentures out of the assets mortgaged by the company. In India, debentures must be secured. Secured debentures can be of two types:

- (a) **First Mortgage Debentures :** The holders of such debentures have a first claim on the assets charged.
- (b) **Second Mortgage Debentures :** The holders of such debentures have a second claim on the assets charged.

(ii) **Unsecured Debentures:** Debentures which do not carry any security with regard to

the principal amount or unpaid interest are called unsecured debentures. These are called simple debentures. Such debentures do not have any charge on the assets of the company.

2. On the Basis of Redemption

- (i) **Redeemable Debentures** : These are the debentures which are issued for a fixed period. The principal amount of such debentures is paid off to the debenture holders on the expiry of such period. These can be redeemed by annual drawings or by purchasing from the open market.
- (ii) **Non-redeemable Debentures** : These are the debentures which are not redeemed in the life time of the company. Such debentures are paid back only when the company goes into liquidation.

3. On the Basis of Records

- (i) **Registered Debentures** : These are the debentures that are registered with the company. The amount of such debentures is payable only to those debenture holders whose name appears in the register of the company.
- (ii) **Bearer Debentures** : These are the debentures which are not recorded in a register of the company. Such debentures are transferrable merely by delivery. Holder of these debentures is entitled to get the interest.

4. On the Basis of Convertibility

- (i) **Convertible Debentures** : These are the debentures that can be converted into shares of the company on the expiry of predecided period. The term and conditions of conversion are generally announced at the time of issue of debentures.
- (ii) **Non-convertible Debentures** : The debenture holders of such debentures cannot convert their debentures into shares of the company.

5. On the Basis of Priority

- (i) **First Debentures** : These debentures are redeemed before other debentures.
- (ii) **Second Debentures** : These debentures are redeemed after the redemption of first debentures.

10.12 Issue of Debentures

By issuing debentures means issue of a certificate by the company under its seal which is an acknowledgment of debt taken by the company.

The procedure of issue of debentures by a company is similar to that of the issue of shares. A Prospectus is issued, applications are invited, and letters of allotment are issued. On rejection of applications, application money is refunded. In case of partial allotment, excess application money may be adjusted towards subsequent calls.

Issue of Debenture takes various forms which are as under:

1. Debentures issued for cash
2. Debentures issued for consideration other than cash
3. Debentures issued as collateral security.

Further, debentures may be issued

(i) at par. (ii) at premium, and (iii) at discount

Accounting treatment of issue of debentures for cash

I. Debentures Issued for Cash at Par :

Following journal entries will be made:

(i) Application money is received

Bank A/c	Dr.
	To Debentures Application A/c

(Application money received for Debentures)

(ii) Transfer of debentures application money to debentures account on allotment of debentures

Debentures Application Alc	Dr
	To Debentures A/c

(Application money transferred to debenture account on allotment)

(iii) Money due on allotment

Debentures Allotment A/c	Dr.
	To Debentures A/c

(Allotment money made due)

Gayatri Industries Ltd.

<i>Date</i>	<i>Particulars</i>	<i>L.F.</i>	<i>Debit</i>	<i>Credit</i>
1.	Bank A/c Dr. To 9% Debentures Application A/c (Application money received for 10000 per share)		2,50,000	4,00,000
2.	9% Debentures Application A/c Dr. To 9% Debentures A/c (Application money transferred to Debentures A/c on allotment)		2,50,000	2,50,000
3.	9% Debentures Application A/c Dr. To 9% Debentures A/c (Allotment money on 10000 debentures @ ` 25 per debenture)		2,50,000	2,50,000
4.	Bank A/c Dr. To 9% Debentures Allotment A/c. (Allotment money received)		2,50,000	2,50,000
5.	9% Debentures First and Final call A/c Dr. To 9% Debentures A/c (Debentures first and final call money made due @ ` 50 per debenture)		5,00,000	5,00,000
6.	Bank A/c Dr. To Debenture First and Final call A/c (Receipt of 9% Debentures first and final call money)		5,00,000	5,00,000

Various cases of issue of debentures from the point of view of redemption.

Debentures issued at par, at premium or at discount may be redeemed either at par or at premium. If the debentures are redeemed at premium, premium paid at the time of redemption is provided in the books of account at the time of issue following the prudence concept of accounting.

The term redeemable at par means debentures are redeemable at their nominal (face) value. For example, a debenture has a nominal (face) value of Rs. 100 and is to be redeemed by paying Rs. 100, it is a case of redemption of debentures at par.

The term Redeemable at Premium means debentures are redeemable at a value that is higher than their nominal (face) value. For example, a debenture has a nominal (face) value of Rs. 100. and is to be redeemed by paying Rs. 110, it is a case of redemption of debentures at premium.

There are six cases of issue and their redemption as follows :

<i>Case</i>	<i>Conditions of Issue</i>	<i>Conditions of redemption</i>
1.	Issued at par	Redeemable at par
2.	Issued at discount	Redeemable at par
3.	Issued at premium	Redeemable at par
4.	Issued at par	Redeemable at premium
5.	Issued at discount	Redeemable at premium
6.	Issued at premium	Redeemable at premium

Issued at par redeemable at par

(i) Bank A/c Dr.

To Debentures Application Account

(Issue of debentures of Rs. at par)

(ii) Debentures Application Dr.

To Debentures A/c

(Debentures application amount transferred to debentures account)

Issued at discount and redeemable at par

(i) Bank A/c Dr.

To Debentures A/c

(Issue of debentures of Rs. at a discount of Rs.)

(ii) Debentures A/c Dr.

Discount on issue of Debentures A/c Dr.

To Debentures Account

(Debentures application amount transferred to debentures account)

Issued at premium redeemable at a par

- (i) Bank A/c Dr.
To Debentures Application A/d
(Issue of debentures of Rs. at a premium of Rs.)
- (ii) Debentures Application Dr.
To Debentures A/c
To Securities Premium A/c
(Debenture Application amount transferred to debenture account)

Issued at par, redeemable at premium

- (i) Bank A/c Dr.
To Debentures A/c
(Issue of debentures of Rs. a redeemable at a premium of Rs.)
- (ii) Debentures Application A/c Dr.
Loss on issue of Debentures A/c Dr.
To Debentures A/c
To Premium on Redemption of Debentures
(Debenture application amount transferred to debenture A/c &
(recognised loss on issue)

Issued at discount and redeemable at premium

- (i) Bank A/c Dr.
To Debentures Application A/c
(Issue of debentures of Rs. at a discount of
Rs. redeemable at a premium of Rs.)

(ii) Debentures Application A/d Dr.
Discount on issue of Debenture A/c Dr
Loss of issue of Debentures Dr

To Debentures A/c

To Premium on Redemption of Debentures

(Transferred debentures approving to Debentures A/c & recognised loan on issue of debentures)

Difference between Premium on Issue of Debentures and Premium on Redemption of Debentures.

<i>Basis</i>	<i>Premium on Issue of Debentures</i>	<i>Premium on Redemption of Debentures</i>
1. Capital Profit / Loss	It is a capital profit and is used for the purposes specification Sec. 52(2) of the Companies Act, 2013	It is a Capital Loss
2. Nature	It is a reserve	It is a liability
3. Outflow of cash	It does not involve outflow of cash	It is paid when the debentures are redeemed
4. How shown in Balance Sheet	The Balance is shown in the Equity and Labilities part of the Balance Sheet under main head Shareholders' funds and sub-head Reserves and surplus	It is shown in the Equity and Liabilities part of the Balance Sheet under the main head, 'Non-Current Liabilities' and Sub-head 'other Long-term Liabilities.

10.13 Company Final Accounts

We have come across the companies issuing shares for raising the capital of the company. Equity shares are the most commonly issued class of shares and carry the maximum 'risks and rewards of the business; the risks being losing part or all the of the value of shares if the business incurs losses, the rewards being payment of higher dividends and appreciation in the market value.

A company may also need additional amount of money for a long period. It cannot issue shares everytime. It can raise loan from the public in the form of 'Debentures'.

Objectives

After going through the chapter you will be able to.

- prepare income statement as per companies act 2013.
- find out the operating income before tax.
- find out the operating income after tax.
- know what are equities and liabilities.
- differentiate between current assets and non-current assets.

Income Statement - Meaning and its importance.

Schedule III of the Companies Act, 2013 provides the manner in which every company registered under the Act shall prepare its Statment of Profit and Loss, Balance Sheet and Notes to Accounts or Notes to Financial Statements.

A income statement is a financial statement that shows us the company's income and expenditures. It also shows whether a company is making profit or loss for a given period.

The income statement focuses on four key terms. revenue, expenses, gains and losses. It does not differentiate between cash and non-cash receipts (sales in cash vs. sales on credit) or cash vs. non cash. The income statement, along with balance sheet and cash flow statement helps us to understand the financial health of a business.

The income statement, also known as a profit and loss statement, statement of operation, statement of financial result or income, or earnings statement.

Importance of an Income Statement

An income statement helps business owners decide whether they can generate profit by

increasing revenues, by decreasing costs, or both. It also shows the effectiveness of the strategies that the business sets at the beginning of a financial period. The business owners can refer to this document to see if the strategies have paid off. Based on their analysis, they can come up with the best solutions to yield more profit.

The following are the few other things that an income statement informs.

1. **Frequent reports** : The income statement is generated either quarterly or monthly. Due to this, business owners and investors can track the performance of the business closely and make informed decisions.
2. **Pin pointing expenses** : This statement highlights the future expenses or any unexpected expenditures which are incurred by the company, and any areas which are over or under budget. Expenses include building rent, salaries and other overhead costs.
3. **Overall analysis of the Company** : This statement gives investors an overview of the business in which they are planning to invest. Banks and other financial institutions can also analyze this document to decide whether the business is loan-worthy.

Income statement with major components

The following information is covered in an income statement

1. **Revenue or Sales** : This is the first section on the income statement, and it gives the summary of gross sales made by the company. Revenue can be classified into two types. Operating and non-operating. Operating revenue refers to the revenue gained by a company by performing primary activities like manufacturing a product or service. Non-operating revenue is gained by performing non-core business activities such as installation, operation, or maintenance of a system.
2. **Cost of goods sold (CGS)** : This is the cost of sales or services, also referred to as the cost incurred to manufacture of goods or services. The sales made only can be considered for calculating the cost of goods sold which includes only direct costs.
3. **Gross Profit** : Gross profit is defined as net sale s minus the total cost of goods sold in the business. Net sales is the amount of money received on the goods sold. Cost of goods sold is the money spent on the goods for production.
4. **Gains** : Gains indicate the amount of money realized by the company from various business activities like the sale of an operating segment. The profits from one time non-business activities are also included as gains for the business.

5. **Expenses** : Expenses are the costs that the company has to pay in order to generate revenue. Expenses may be of two types operating and non operating expenses.

Operating expenses are the expenses incurred on the core activities of the business. Ex : Sales Commission, Electricity Charges, Etc. Non Operating Expenses are the expenses incurred on the non-core activities of the business ex : inventory charges, legal charges etc.

6. **Administrative Expenses** : It can be defined as the expenditure incurred by a business or company as a whole rather than being the ones associated with specific departments of the same company. Ex. : Salaries, Rent, etc.

7. **Earnings Before Tax (EBT)** : This is a measure of a company’s financial performance. EBT is arrived at subtracting expenses from income, before taxes.

8. **Net-income** : The amount of money earned by a company after deducting allowable business expenses. It is calculated by subtracting total expenses from total revenue.

Income Statement Format

The Income Statement (Profit and Loss) records all income and expenses of the business during a specified time period, and is the accepted method of determining profits and losses. The Internal Revenue Service requires all businesses to submit this report at the end of each year.

PROFIT AND LOSS STATEMENT

From : 20 to 20

Sales or Gross Receipts¹ \$

Less Cost of Goods Sold² \$

Gross Profit..... \$

Less Operating Expenses³

Rent..... ..

Depreciation

Repairs & Maintenance..... ..

Salaries & Wages

Payroll Taxes & Fringe Benefits

Taxes, Licenses & Fees.....	.....
Insurance.....	.....
Accounting, Legal and Professional Fees.....	.....
Bad Debts.....	.....
Telephone.....	.....
Utilities.....	.....
Suppliers.....	.....
Security.....	.....
Auto and Truck.....	.....
Advertising and Promotion.....	.....
Interest.....	.....
Miscellaneous.....	.....
Total Operating Expenses	\$
Net Profit Before Taxes ⁴	\$
Federal Income Taxes (Corporation Only).....	\$
Net Profit (or Loss).....	\$

¹**Sales or Gross Receipts** - represents total amount of money that the business makes from the sale of its merchandise, less discounts and refunds.

²**Cost of Goods Sold** - the cost of the merchandise that the business sells. These costs differ with each type of business.

³**Operating Expenses** - all business costs other than the costs of merchandise.

⁴**Net Profit (Loss)** - sales less cost of goods sold less operating expenses.

Conclusion :

An income statement is a rich source of information about the key factors responsible for a company's profitability. It gives timely updates because it is generated much more frequently than any other statement for a good financial decision.

2. Balance Sheet

A balance sheet is a financial statement that contains details of a company's assets or liabilities at a specific point of time. It is one of the three core financial statements (income statement and cash flow statement) for evaluating the performance of a business.

A balance sheet serves as a reference documents for investors and other stakeholders to get an idea of the financial health of an organization. It enables them to compare current assets and liabilities to determine the business's liquidity or calculate the rate at which the company generates returns. Comparing two or more balance sheets from different points in time can also show how a business has grown. The creditors can also analyse the company's short term obligations and its financial risk. The stakeholders can also understand the company's prospects.

Key Elements & Components of a Balance Sheet.

A balance sheet consists of two main headings : assets and liabilities.

Assets :

An asset is something that the company owns and that is beneficial for the growth of the business. Assets can be classified based on convertibility, physical existence and usage.

(a) Convertibility

1. **Current Assets** : Assets which can be easily converted into cash or cash equivalents within a duration of one year.

Examples : Short term deposits, marketable securities, etc.

2. **Fixed Assets** : Assets which cannot be easily or readily converted to cash. For Example : Buildings, Machinery etc

(b) Physical Existence :

1. **Tangible Assets** : Assets which we can see and feel, like office supplies, machinery, equipment and buildings.
2. **Intangible Assets** : Assets which do not have physical existence, like patents, brands and copyrights.

(C) Usage :

1. **Operating Assets** : Assets which are necessary to conduct business operations. For example : Machinery and Equipment, Buildings.

2. **Non-Operating Assets :** Short-term investments or marketable securities that are not necessary for daily operations.

Liabilities :

Liabilities are what the company own to other parties. This includes debts and other financial obligations that arise as an outcome of business transactions. Companies settle their liabilities by paying them back in cash or providing an equivalent service to the other party.

Depending on context, liabilities can be classified as current and non-current.

1. **Current Liabilities :** These include debts or obligations that have to be fulfilled within a year. Current liabilities are also called short-term liabilities like interest payable, bills payable.
2. **Non-Current Liabilities :** These are the debts or obligations for which the due date is more than a year. Non-current liabilities include bonds payable, long-term notes payable, etc.

Owner's Equity / Earnings

Owner's equity is equal to total assets minus total liabilities. It is the amount handed over to share holders after the debts have been paid and the assets have been liquidated. Part of Shareholder's Equity is retained earnings, which is a fixed percent of the shareholders equity that has to be paid as dividends.

Balance Sheet Equation

The balance sheet equation follows the accounting equation, where a company pays for what it owns (assets) by borrowing money as service (liabilities) or taking from the shareholders or investors (equity).

$$\text{Assets} = \text{Liabilities} + \text{Shareholder's Equity.}$$

FORMAT OF COMPANY'S BALANCE SHEET

The format of Balance Sheet as prescribed in Schedule III, Part I of the Companies Act, 2013 is as follows :

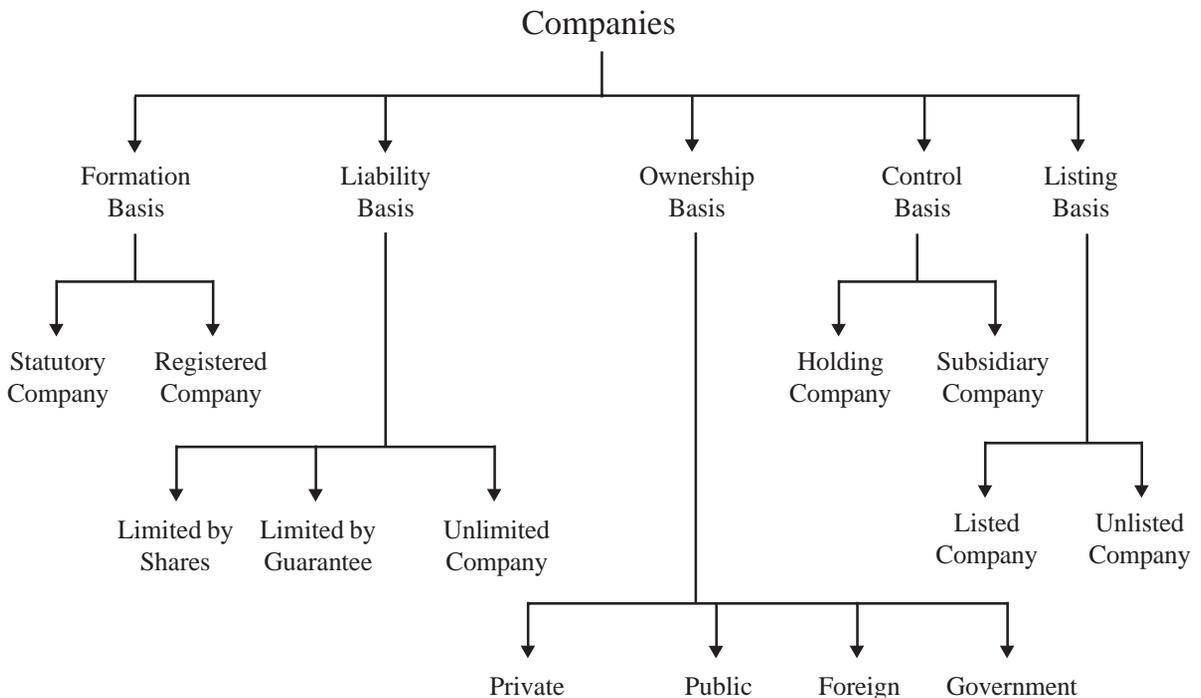
BALANCE SHEET AS AT(MAIN HEADS ONLY)

<i>Particulars</i>	<i>Note No.</i>	<i>Figures as at the end of Current Reporting Period (Rs.)</i>	<i>Figures as at the end of Previous Reporting Period (Rs.)</i>
I. EQUITY AND LIABILITIES			
1. Shareholder's Funds			
(a) Share Capital	
(b) Reserves and Surplus	
(c) Money received against Share Warrants	
2. Share Application Money Pending Allotment	
3. Non-Current Liabilities	
(a) Long-term Borrowings	
(b) Deferred Tax Liabilities (Net)	
(c) Other Long-term Liabilities	
(d) Long-term Provisions	
4. Current Liabilities			
(a) Short-term Borrowings	
(b) Trade Payables	
(c) Other Current Liabilities	
(d) Short-term Provisions	
Total	
II. ASSETS			
1. Non-Current Assets			
(a) Fixed Assets :			
(i) Tangible Assets	
(ii) Intangible Assets	
(iii) Capital Work-in-Progress	
(iv) Intangible Assets under Development	
(b) Non-Current Investments	
(c) Deferred Tax Assets (Net)	
(d) Long-term Loans and Advances	
(e) Other Non-Current Assets	
2. Current Assets			
(a) Current Investments	
(b) Inventories	
(c) Trade Receivables	
(d) Cash and Cash Equivalents	
(e) Short-term Loans and Advances	
(f) Other Current Assets	
Total	

Schedule III of the Companies Act, 2013 prescribes that details of items of Balance Sheet are to be given in the Notes to Accounts and Note number be put against the item in the Balance Sheet.

WHAT YOU HAVE LEARNT

- Company is an association of persons who contribute to its capital and is registered under Companies Act, 1956
- Characteristics of a company are : Seperate Legal Entity; Incorporated Body; Perpetual Existence : Limited Liability : Common Seal.
- Types of companies are :



- Private companies are companies which by their Articles of Association
 - Restrict the maximum number of members to fifty
 - Restrict the transferability of shares
 - Put restriction on inviting public to buy its shares

Minimum paid up capital of such company is one Lakh rupees.

- Private company must add the words 'Private Limited' as a suffix to its name.
- Companies that are not private companies are public companies.
- Company raises its capital through issue of shares.

- **Shares are of two types :** Equity shares and preference shares. Preference shares carry preference over other shares with regard to payment of dividend and refund of capital in case of its winding up. Shares other than preference shares are called equity shares".
- **Share Capital :** Authorised/Nominal; Issued; Subscribed; Called up : Uncalled Paid up: Unpaid; ReserveShare: Share means to possess a right on specific amount of Share Capital.
- **Types of Shares :** Equity Shares and Preference Shares shares may be issued to vendors as purchase considerations for purchase of assets. Such shares can be issued at par. at premium or at discount.
- When shares are issued to a selected lot of people without issuing of prospectus it is called private placement of shares.
- Face value of a share is its par value. Shares can be issued for considerations other than cash i.e., for purchase of assets or payment to creditors or promoters.
- Share money can be collected in lump sum or in instalment.
- The first instalment is termed as Share Application money and second instalment““is known as Share Allotment money.
- In case share money is collected in more than two instalments this is call money.
- Applications for shares may be received equal to the number of shares offered, (full subscription) less than number of shares offered (under subscription) or for more than the number of shares offered (over subscription)
- When shares are issued at more than their face value these are said to be issued at premium. The premium amount can be utilised only for purposes as specified under section 52(2) of Companies Act.
- If a shareholder fails to pay Share Allotment money or share call money when demanded by the company, the unpaid amount is called calls in Arrears. If a shareholder pays the amount for calls not made, the amount paid is known as Call-in-Advance.
- Debentures includes bedenture stock, bond and all other securities issued by a company.

- Issue debentures : Debentures can be issued at face value (i.e.) cash or other than cash. If a company receives more applications than issued then they are called as over subscribed.
- Issue of debentures takes various forms such as :
 1. Debentures issued at par
 2. Debentures issued at premium.
 3. Debentures issued at discount.
- Debentures are redeemed after the redemption of first debentures.
- Schedule III of the Companies Act 2013 provides the manner in which every company registered under the Act prepare its Statement of Profit & Loss, Balance Sheet.
- An income statement is a financial statement that shows us the Company's Income and Expenditures.
- Revenue or Sales.
- $\text{Cost of Goods Sold} = \text{Beginning Inventory} + \text{Purchases} - \text{Ending Inventory}$.
- Balance Sheet is the financial statement that contains details of a Company's assets or liabilities at a specific point of time.

Terminal Exercise

Section - A

1. Joint Stock Company
2. Equity Share
3. Preference Share
4. Private Placement
5. Forfeiture of Share
6. Debenture

Section - B

1. Write any four differences between equity share and preference shares.
2. What is meant by a Joint Stock Company ?
3. What is meant by private placement of shares ?
4. What is meant by over subscription of shares ?
5. What is meant by 'Shares Issued at Premium'? State the purpose for which Premium amount can be utilised.
6. Explain in brief the terms :
 - (i) Calls-in Arrears.
 - (ii) Calls-in-Advance

Section - C

1. Define company. Explain in brief its characteristics.
2. List the various restrictions on a private company. Distinguish between a public company and a private company.
3. What is share capital? Explain different types of share capital.
4. Explain different types of companies.
5. State the characteristics of equity shares.
6. Make journal entries :
 - (a) Rishik Limited whose share capital is divided into ` 60,000 equity shares of ` 10 each, issued 6,000 shares to the public. The entire money is payable along with the application. All the shares were subscribed and application money was received.
 - (b) Sunayana Ltd. issued ` 80,000 equity shares of ` 10 each payable of ` 3 on application, ` 5 on allotment and ` 2 on first and final call. All the money was duly received. Pass necessary Journal entries in the books of sunayana.
 - (c) Balu Ltd. issued ` 50,000 equity shares of ` 20 each, payable as ` 6 on application, ` 8 on allotment and ` 6 on first and final call. All the money was duly received. Pass necessary entries in the books of Balu.

- (d) Vedanth Limited issued 40,000 equity shares of ₹ 100 each, payable ₹ 25 per share on application, ₹ 25 per share on allotment, and ₹ 25 on each of the two subsequent calls. All the money was duly received.
- (e) Charan Ltd., issued 70,000 shares of ₹ 10 each at ₹ 15 payable ₹ 3 on application, Rs. 8 on allotment (including the premium of ₹ 5) and ₹ 4 on call. All the shares are subscribed, allotted and paid for at due dates.
- (f) Krishna Ltd. issued ₹ 30,000 equity shares of ₹ 20 each with ₹ 25 premium paid as follow. ₹ 5 on application, ₹ 15 on allotment (inclusive of ₹ 4 premium) and ₹ 5 on first and final call. Assuming all the money was duly received. Pass necessary journal entries in books of Krishna Ltd.

7. What do you mean by debenture ? State in brief the various types of debentures.

8. Explain the characteristics / features of debentures.

9. Anand Ltd. issued 4,000. 9% Debentures of Rs. 100 each payable as follows :

on application Rs. 25

on allotment Rs. 25

on first and final call Rs. 50

Applications were received for all the debentures along with the application money and allotment was made. Call money was duly received. Pass necessary Journal entries in the books of the company.

10. Jananya Ltd. issued Rs. 2,000. 10% Debentures of Rs. 100 each payable as follows :

on application Rs. 20

on allotment Rs. 20

on first call Rs. 30

on second and final call Rs. 30

Applications were received for all the debentures alongwith the application money and allotment was duly made. Call money was also received on the due date. Pass necessary Journal entries in the books of the company.

11. Pass Journal entries in the books of Krishna Ltd. for issue of debentures in each of the following alternative cases.
 - (i) 10% Debentures of Rs. 100 each issued at Rs. 100, repayable at Rs. 100.
 - (ii) 10% Debentures of Rs. 100 each issued at Rs. 95, repayable at Rs. 100.
 - (iii) 10% Debentures of Rs. 100 each issued at Rs. 105, repayable at Rs. 100.
 - (iv) 10% Debentures of Rs. 100 each issued at Rs. 100, repayable at Rs. 105.
 - (v) 10% Debentures of Rs. 100 each issued at Rs. 95, repayable at Rs. 105.
 - (vi) 10% Debentures of Rs. 100 each issued at Rs. 105, repayable at Rs. 110.
12. What is an income statement ? What is the importance of an income statement.
13. Explain any important major components of the income statement.
14. Show the income statement format.
15. Explain the key components of a Balance Sheet.
16. Show the proforma of a Companys' Balance Sheet.

CONCEPTUAL FRAMEWORK OF SPECIALISED ACCOUNTING

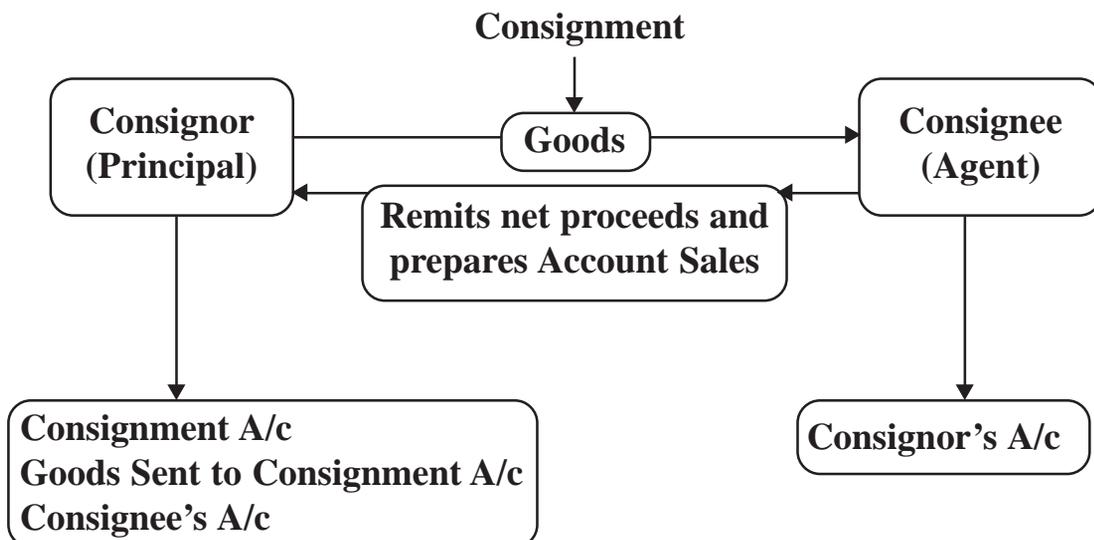
11.1 CONSIGNMENT ACCOUNTING

Need for Consignment :

Nowadays it is quite common that manufacturers or wholesale dealers sell their goods to their Agents on commission basis. In this context the role of agent is very crucial as the agent will have perfect knowledge on local conditions which will enhance the sales. Moreover, it is very expensive for the manufacturer to sell the goods directly either in the domestic market or in the foreign market. Therefore different agents are appointed for different places.

Meaning of Consignment :

A shipment of goods by a manufacturer or wholesale dealer to an agent to be sold by him on commission basis, on the risk and account of the former, is known as consignment. The person who sends the goods to the agent to be sold by him on commission basis is called Consignor. The person to whom the goods are sent for sale on commission basis is called the Consignee. To the consignor, the consignment of goods is known as outward consignment and to the consignee, it is known as inward consignment. The goods consigned to the agent cannot be treated as sales at the time of the consignment; they are treated as sales only when these are sold by the consignee. Therefore, such goods require special treatment in accounts.



Distinction Between Sales and Consignment :

The following are the main differences between a Consignment and a Sale.

Consignment refers to a commercial arrangement in which goods are delivered to the agent by the seller, for the purpose of sale to the customers, on behalf of the seller. Typically, Sale is a transaction between two parties in which the ownership, title and possession of goods are transferred from seller to buyer for the money consideration. The scope of sale is wider in comparison to a consignment, as consignment is also a type of sale. The main difference between these two trading arrangements is that in the case of consignment the parties follow the relationship of principal and agent, whereas, in the case of the sale, the parties follow the relationship of debtor and creditor.

Consignment Vs. Sales

Bais	Consignment	Sale
Meaning	When goods are delivered to the agent by the owner for the selling purpose, is known as Consignment	A transaction in which goods are exchanged for a price is known as Sales
Parties	Consignor & Consignee	Seller & Buyer
Relationship	Principal & Agent	Creditor & Debtor
Ownership	Possession of goods is transferred but not the ownership.	Both are transferred with the transfer of goods
Returning back of Goods	The Consignee can transfer/return the unsold goods to the Consignor	The Buyer can not return the goods to Seller
Risk	Born by Consigner	Born by the Buyer
Expenses	Met by Consigner	Met by Buyer
Consideration	Commission to the Agent	Profit to the Seller

Invoice & Account Sales :

An invoice is a time-stamped commercial document that itemizes and records a transaction between a buyer and a seller. If goods or services were purchased on credit, the invoice usually specifies the terms of the deal and provides information on the available methods of payment. An invoice is a document that maintains a record of a transaction between a buyer and seller, such as a paper receipt from a store or online record from an e-tailer.

Invoices are a critical element of accounting internal controls and audits. Invoices generally outline payment terms, unit costs, shipping, handling, and any other terms outlined during the transaction. Generally, The Consignor receives an advance against the goods from the Consignee. Such goods can be sent by the consignor either at cost price or at invoice price for which the consignor will prepare a Proforma Invoice. Such Invoice is exactly like invoice in appearance without being actually the invoice but it does not make the consignee responsible to pay the amount mentioned therein.

An account sale is a frequently used document in consignment business. Account sales is periodically prepared by consignee and forwarded to the consignor so that he can update his business and accounting records related to that particular consignment. Typically, an account sales includes information regarding type and quantity of goods sold by consignee, per unit sales price, total sales proceeds realized up to current date, commission charged by consignee, expenses incurred by consignee on behalf of the consignor and the balance amount payable to the consignor.

Difference between Invoice and Account Sales :

Bais	Consignment	Sale
Prepared by	Invoice is prepared by the seller and is sent to the buyer.	Account Sale is the statement which the selling agent prepares and submits to his principal.
Sending Time	Invoice is prepared after sending the goods to the buyer.	Account sale is prepared by the agent after selling whole goods or periodically.
Expenses	All the expenses made by the buyer are added to the cost of goods sold.	The expenses incurred by the agent and his commission is deducted from the amount of sale.
Discount	If there is any trade discount it is deducted from the number of goods.	No question arises of any discount in the account sales.
Commission	No question arises of any commission in the invoice.	The commission is the reward for agents' efforts.
Types	It is of two kinds: Invoice (ordinary) Proforma Invoice.	It is of only one kind.
Conditions	If there is any term or condition of payment, it is mentioned in the invoice.	No question arises of any term or condition in the calculation of sales.
Signed by	Invoice is signed by the seller or the person authorised by him to do so.	Account sale is signed by the sales agent or by the person authorised by him.

Types of Commissions :

Commission of the consignee is calculated on gross sale made by the consignee. It is a reward to the consignee by the consignor for selling the goods of the former. The rate of commission is fixed considering the prevailing market practices and with due agreement between the consignor and consignee. Sometimes goods consigned with insurance coverage may be damaged and the compensation is realized from the insurance company. The compensation received from the insurance company could be treated as sales but no commission is allowed to the consignee on such a realized compensation amount. Following are the various kinds of commissions allowed in consignment.

- i) Ordinary Commission/Simple Commission: The commission charged by the consignee on the gross sale proceeds is known as ordinary or simple commission. It is calculated at a fixed percentage of total sales.

$$\text{Commission} = \text{Gross sales} \times \text{Fixed rate percent of commission}$$

- ii) Del-credere Commission: This type of commission is an additional commission for an endeavor of increasing sales in the form of credit. It is calculated at a certain predetermined rate of gross sales.
- iii) Special/Extra/Overriding Commission: In normal practice, if a consignee sells the goods at the price higher than the normal selling price, he will be entitled a commission for excess amount realized over the normal selling price. The commission provided on the excess amount realized over the normal selling price is known as overriding commission.

Accounting Treatment :

The consignor sends goods to the consignee and incurs certain expenses in sending the goods to the consignee. Generally consignor receives advance against the goods from the consignee. Such goods can be sent by the consignor either at cost price or at invoice price for which the consignor will prepare a proforma invoice such invoice is exactly like invoice in appearance. The consignee will incur some expenses for taking the delivery of goods and bringing these to the shop. He will try to sell the goods either for cash or on credit. He will get Commission for the sales which he has made on behalf of the consignor besides getting reimbursement of actual expenses incurred by him on the half of the consignor. When goods are sold by consignee on credit there is a possibility that the amount may not be realised. The consignee in order to increase the sales commission may be given on Sale of goods on credit without any responsibility for collection updates. In order to check this tendency the consignor gives the consignee Delcredere Commission sometimes and extra Commission is given by the consignor to the consignee for working hard to push a new line of product in the market such commission is overriding Commission. After a particular fixed time or as and when the goods consigned and sold

by the consignee, consignee is required to send statement known as account sales Which will show the quality and quantity of good sold, the gross proceeds realised and the amount to due to the consignor after deducting expenses on consignment of goods, Commission payable to the consignee and advance paid by the consignee from the gross sale proceeds. The account sales is sent to the consignor with a view to enable them to note entries regarding concernment

Journal Entries in the books of Consignor :

1. When goods sent to the consignee

Consignment A/C	Dr.
To Goods sent on Consignment A/C	

2. For Consignor Expenses

Consignment A/C	Dr.
To Cash A/C	

3. For Advance Given by the Consignee

Bank or B/R A/C	Dr.
To Consignee A/C	

4. For Consignee Expenses

Consignment A/C	Dr.
To Consignee A/C	

5. For Sales by the Consignee

Consignee A/C	Dr
To Consignment A/C	

6. For Consignee's Commission

Consignment A/C	Dr
To Consignee A/C	

7. Fir Remittance by the Consignee

Bank or B/R A/C	Dr.
To Consignee A/C	

Illustrations :

1. Mr. R consigned 10,000 litres of oil @ ` 3 per liter and paid ` 2,000 as forwarding expenses. Mr. S, agent of Mr. R received the stock and sold ` 6,000 liters @ ` 6 per liter, and paid ` 1,000 as selling expenses. He was entitled for 10% commission on sales. There was a normal loss of 2%. Prepare Consignment account in the books of Mr. R.

Solution :

Consignment Account

Dr.

Cr.

<i>Particulars</i>	<i>Amount</i>	<i>Particulars</i>	<i>Amount</i>
To Goods sent on consignment (10000 Litre @ 3)	30,000	By Agent (6000 litres @ 6)	36,000
To Cash (forwarding exp.)	2,000	By Stock on Consignment (1)	12,408
To Agent :			
Selling Exp. 1,000			
Commission <u>3,600</u>	4,600		
To Profit & Loss A/c	11,808		
	48,408		48,408

Working Notes :

Calculation of Closing Stock

<i>Quantity (in Litres)</i>	<i>Amount (in `)</i>
10,000	32,000 (30,000 + 2,000)
Less : Normal Loss of 2%	-
200	
9,800	32,000
3,800	12,408

2. Mr. A consigned 200 cycles @ ` 500 each and paid ` 3,000 on freight. During the transit 20 cycles were lost by theft. Mr. B received the remaining stock and paid ` 3,600 on its clearing. He sold 150 cycles @ ` 800 per cycle. He was entitled for 10% commission

on sales. He paid ₹ 5,000 as miscellaneous expenses. Prepare Consignment Account in books of Mr. A.

Solution :

Dr.		Consignment Account		Cr.	
<i>Particulars</i>	<i>Amount</i>	<i>Particulars</i>	<i>Amount</i>	<i>Particulars</i>	<i>Amount</i>
To Goods sent on consignment (200 @ ₹ 500)	1,00,000	By Profit & Loss A/c (Abnormal Loss) (1)	10,300		
To Cash (Freight)	3,000	By Agent (150 @ ₹ 800)	1,20,000		
To Agent :		By Stock			
Clearing Charges	3,600	on Consignment A/c (2)	16,050		
Commission	12,000				
Miscellaneous Exp.	5,000				
To Profit & Loss A/c	22,750				
	1,46,350				1,46,350

Working Notes :

1. Calculation of Abnormal Loss	
20 Cycles @ 500 each	= 10,000
Direc expenses	= + 300
	10,300
2. Stock Valuation (at invoice price)	
30 cycles @ 500 each	= 15,000
Direct expenses (before loss)	= + 450
Direct expenses (after loss)	= + 600
	16,050

3. A consigned 10,000 kg. of oil @ ₹ 20 per kg. and paid ₹ 4,000 as forwarding expenses. B received the Consignment and sold 6,000 kg @ 50 per kg. He paid ₹ 10,000 as selling expenses. He was entitled for 5% Commission on Sales. He informed that 1,000 kg. of oil was destroyed by fire. There was a normal loss of 2%. Prepare Consignment A/c in the books of A.

Solution :

Consignment Account

Dr.

Cr.

<i>Particulars</i>	<i>Amount</i>	<i>Particulars</i>	<i>Amount</i>
To Goods sent on Consignment A/c (10,000 x 20)	2,00,000	By B (6000 x 50)	3,00,000
To Cash/Bank A/c (Forwarding Exp.)	4,000	By Profit & Loss (1) (Abnormal Loss)	20,816
To B : Selling Expenses	10,000	By Stock on Consignment A/c (2)	58,286
Commission	15,000		
To Profit & Loss A/c	1,50,102		
	3,79,102		3,79,102

Working Notes :

Calculation of Abnormal Stock

<i>Quantity (in Kg.)</i>	<i>Amount (in ₹)</i>
10,000	2,04,000 (2,00,000 + 4,000)
Less : Normal Loss of 2%	-
9,800	2,04,000
1,000	20,816

Calculation of Stock on Consignment (at invoice price)

<i>Quantity (in Kg.)</i>		<i>Amount (in `)</i>
	10,000	2,04,000 (2,00,000 + 4,000)
Less : Normal Loss of 2%	200	-
	9,800	2,04,000
	2,800	58,286

4. A Company consigned 200 boxes of ` 100 each at an invoice price of ` 120 per box. The Company paid ` 1200 as forwarding expenses. Agent received the consignment and paid ` 800 on carriage, ` 1000 on godown rent & charged 10% commission on sales. He sold 150 boxes @ ` 200 per box. He informed us that 20 boxes were lost by theft in godown. Prepare Consignment Account in the books of the Company.

Solution :

Consignment Account

Dr.

Cr.

<i>Particulars</i>	<i>Amount</i>	<i>Particulars</i>	<i>Amount</i>
To Goods sent on Consignment (200 x 200)	24,000	By Goods Sent on Consignment or Loading (200 @ 20)	4,000
To Cash/Bank (Forwarding Exp.)	1,200	By Agent (150 x 200)	30,000
To Agent :		By P & L A/c (1) (Abnormal Loss)	2,200
Carriage 800		By Stock on Consignment (2)	3,900
Godown Rent 1000			
Commission 3,000	4,800		
To Stock Reserve or Stock Suspense A/c (30 x 20)	600		
To Profit & Loss A/c	9,500		
	40,100		40,100

Working Notes :

1. Calculation of Abnormal Loss	
20 Boxes @ 100 each	= 20,000
Direc expenses	= + 200
	2,200
2. Stock Valuation (at invoice price)	
30 Boxes @ 120 each	= 3,600
Direct expenses	= + 300
	3,900

5. Somesh of Calcutta consigned 100 cases of candles to Sailesh of Bankura. Which cost him ` 30 per case. He incurred the following costs packing ` 40 carriage ` 20 and Railway Freight (paid in advance) ` 40. Some of the cases were damaged in transit and Sailesh took delivery of 90 cases only. He (Sailesh) spent ` 10 for carriage and ` 40 for godown rent and sold consignment at ` 35 per case. He sent the net amount to Somesh after deducting his expenses and commission at the rate of 5 per cent on the sale proceeds together with his Account sales. Somesh also received ` 180 from the Railway as damages. Show how the transactions would appear in the books of Somesh.

Solution : In the book of Somesh (Consignor)

Dr.		Consignment Account		Cr.
<i>Particulars</i>	<i>Amount</i>	<i>Particulars</i>	<i>Amount</i>	
To Goods sent on Consignment A/c	3,000	By Sailesh	3,150	
To Cash A/c		By Abnormal Loss A/c	310	
Packing 40				
Carriage 20				
Freight <u>40</u>	100			
To Sailesh A/c				
Carriage 10				
Rent <u>40</u>	50			
To Sailesh A/c (Commission)	158			
To Profit Transferred to P&L A/c	152			
	3,460			3,460

With the freight, words 'paid in advance' is written it should not be mis-understood as 'prepaid' which means for the next financial year. Here it is paid before the journey starts hence advance is written, but it is for this consignment only and hence treated as expense.

Dr.		Sailesh Account (Consignee)		Cr.	
<i>Particulars</i>	<i>Amount</i>	<i>Particulars</i>	<i>Amount</i>		
To Consignment A/c (Sales)	3,150	By Consignment A/c (Exp. Paid)	50		
		By Consignment A/c (Comm. Due)	158		
		By Cash/Bank A/c (Bal. Recovered)	2,942		
	3,150		3,150		

Dr.		Goods sent on Consignment A/c		Cr.	
<i>Particulars</i>	<i>Amount</i>	<i>Particulars</i>	<i>Amount</i>		
To Trading A/c	3,000	By Consignment A/c	3,000		
	3,000		3,000		

Dr.		Abnormal Loss A/c		Cr.	
<i>Particulars</i>	<i>Amount</i>	<i>Particulars</i>	<i>Amount</i>		
To Consignment A/c	310	By Cash (Claim from Railway)	180		
		By Net abnormal Loss Trf. to P & L A/c	130		
	310		310		

Calculations

	Abnormal Loss (10 Cases)
Basic Cost @	300
Freight, Packing @	10
Total Cost	310

In the books of Sailes (Consignee)

Somesh (Consignors) A/c

Dr.

Cr.

<i>Particulars</i>	<i>Amount</i>	<i>Particulars</i>	<i>Amount</i>
To Cash Bank (Exp. Paid)	50	By Cash/Bank/Debtors	
To Commission A/c (Due)	158	(Sales Made)	3,150
To Cash/Bank (Net Balance Paid)	2,942		
	3,150		3,150

Commission A/c

Dr.

Cr.

<i>Particulars</i>	<i>Amount</i>	<i>Particulars</i>	<i>Amount</i>
To P&L A/c (Income Transferred)	158	By Somesh A/c	158
	158		158

Terminal Exercise

Section - A

- 1) Invoice 2) Account Sales 3) Consideration
- 4) Consignment 5) Delcredere Commission

Section - B

- 1) Explain different types of Commissions in Consignment?
- 2) What is Account Sales? What are its salient features?
- 3) Draw a chart to understand the Consignment Process?
- 4) The cost of the goods sent on consignment is Rs. 20,000 but the invoice price is 10% more than the cost price, what will be the invoice price of the goods?
- 5) Jeevan Surya sent goods on consignment of invoice price Rs. 15,000. This price is 20% more than the cost price. What will be the cost price of the goods?

Section - C

- 1) What is Consignment? Differentiate between Sales and Consignment?
- 2) What is Invoice? Distinguish between Invoice and Account Sales?
- 3) On 1st January, 2016 Lila & Co. of Calcutta consigned 100 cases of Milk Powder to Shila & Co. of Bombay. The goods were charged at a proforma invoice value of ₹ 10,000 including a profit of 25% on invoice price. On the same date the consignor paid ₹ 600 for freight and insurance. On 1st July, the consignees paid import duty ₹ 1,000, dock dues ₹ 200. On 1st August, they sold 80 cases for ₹ 10,500 and sent a remittance for the balance due to the consignor after deducting commission at the rate of 5% on gross sale proceeds. Show the Consignment Account and Shila & Co's Account in Lila & Co's Book.(Profit Rs. 2535)
- 4) The Swastik Oil Mills, Bombay, consigned 10,000 Kg. of Castor Oil to Dass of Calcutta on 1st April 2016. The cost of the oil was ₹ 2 per Kg. The Swastik Oil Mills paid ₹ 5,000 as freight and insurance. During transit 250 Kg. were accidentally destroyed for which the insurers paid, directly to the consignors, ₹ 450 in full settlement of the claim. Dass took delivery of the consignment on the 10th April. On 30th June, 2016, Dass reported that 7,500 Kg. were sold at ₹ 300 the expenses being on godown rent ₹ 200/- on advertisement ₹ 1,000 and on salesman's ₹ 2,000.

Dass is entitled to a commission of 3 per cent plus 1.5 per cent *del credere*. A party which had bought 1,000 was able to pay only 80% of the amount due from it.

Dass reported a loss of 100 kg. as handling loss. Assuming that Dass paid the amount due by bank draft, show the account in the books of Consignor. The Swastik Oil Mills Ltd. close books on 30th June. (Loss Rs. 653)

- 5) On August 1, 2016, JBC Inc. consigned to Mags Store 10 ladies handbags costing Rs. 3,000 each, paying freight charge of Rs. 3,000. At the end of the month, Mags Store reported sales of 6 handbags of Rs. 6,000 each and expenses incurred of 2,500, and remitted the net proceeds due to JBD after deducting a 20% commission. How much net income did JBD realize in August on the consignment? (Profit Rs. 6500)
- 6) Manasa consigned goods worth Rs. 60,000 to Suhas. Manasa paid transport charges Rs. 4,000. Suhas sent the account sales of consignment stating that the entire stock was sold for Rs. 75,000. He paid Rs. 2,000 for cartage. He is entitled commission of Rs. 3,000. He sent a bank draft for the balance. Write journal entries in the books of both the parties.
- 7) Hari of Hyderabad consigned goods worth Rs. 30,000 to Sumalatha of Surath. Hari paid for forwarding charges Rs. 1,500 and drew a bill of two months on Sumalatha for Rs. 15,000. The bill was discounted for Rs. 14,500. Sumalatha sent account sales of consignment stating that the entire stock was sold for Rs. 38,000, agent commission Rs. 2,000 and sent bank draft for the balance. Write journal entries in the books of both the parties.

11.2 NON TRADING CONCERNS ACCOUNTING :

Organizations are broadly divided into two categories, viz.

- a) **trading organisations** - whose main objective is to earn profits from business operations. Trading companies purchase a particular variety of products, preserve a stock or a shop, and sell the products to customers. Retailers, Wholesalers, Dealers, Service Providers etc., are a few examples of which come under this category.
- b) **non-trading organisations** - whose main objective is not to earn profits but to serve the members of the society. Hospitals, Educational Institutions, Clubs, Charities etc., are a few examples which come under the second category. Organisations undertake only those activities which are of service nature are called Non-Trading organisations. The important features of these organisations are presented as under.

Features :

- a) It is a voluntary organisation
- b) It renders service to the society
- c) It does not operate with the objective of making profit
- d) It secures necessary funds from its members and governments
- e) It does not conduct trading activities
- f) It is governed and managed by elected members, in the same way a company is managed by a board of directors.

Important Terms :

- i) **Legacy :** It is the amount given to a non-trading concern as per the will of a deceased person. It is a peculiar receipt received by non-trading concerns as per the will of the deceased person. Hence, it has to be capitalised and directly shown in the Balance Sheet.
- ii) **Donations :** It is a voluntary gift received in the form of money from some person or from some organisation. It appears as a receipt in the books of accounts. Based on the nature of donations like General Donation or Specific Donation, the treatment of it is decided in the books of accounts. If it is a specific donation, it is capitalised and shown in the balance sheet. If it is a general donation, it is treated as income and shown in the Income and Expenditure account.
- iii) **Life Membership Fees :** This is the lump sum amount paid by the life member to the concern. Such an amount should be shown in the Balance Sheet and added to the Capital Fund.
- iv) **Entrance Fees :** It is the amount paid by a new member to the concern at the time of becoming a member. It is a regular custom for the organisation to invite new members and some entrance fees from them. Entrance Fee is paid as admission fees. Generally, it is treated as Receipt and given the treatment of Income.
- v) **Honorarium :** It is the specific amount paid to a person other than a regular employee, who has done some casual service to the concern. It is a revenue item and shown as expenses.
- vi) **Subscriptions :** It is a regular periodic payment made by the members to continue their membership. Subscriptions are the only available regular source of revenue for non-profit organisations.

Accounts : The accounting of non-trading organisations is different from the accounting of trading organisations. The following three accounts/statements are maintained by every non-trading organisations.

- a) **Receipts & Payments Account :** Receipts and Payments Account is another form of cash account. This account is prepared according to the basic rule of a real account i.e., debit what comes in and credit what goes out. Actually this account is prepared in lieu of a cash book. It records cash receipts and cash payments whether they relate to current year, preceding or succeeding year.
- b) **Income & Expenditure Account :** It is the other form of Profit and Loss Account which is prepared in trading concerns. This account is prepared according to the basic rule of nominal account i.e., Debit all expenses and losses and Credit all incomes and gains. The balance at the end of this account is either surplus (income over expenditure) or deficit (expenditure over income).
- c) **Balance Sheet :** The balance sheet of a non-trading concern is prepared on the same procedure as required in the case of trading concerns. The excess of assets over liabilities is termed as capital fund.

Distinction between Receipts & Payments Account and Income & Expenditure Account :

Receipts & Payments Account	Income & Expenditure Account
i) It is a Real Account	i) It is a Nominal Account
ii) It is prepared the place of cash book	ii) It is prepared in place of Profit and Loss Account
iii) Receipts are shown on the debit side and Payments are shown on the credit Side	iii) Incomes are shown on the credit side and Expenditures are shown on the debit side.
iv) It records cash transactions relating to any period	iv) It records only current year transactions
v) It includes both revenue and capital items	v) It covers only revenue items
vi) It does not include outstanding receivables and payables	vi) It considers both outstanding receivables and payables.
vii) Balance in the beginning represents cash in hand	vii) There is no opening balance

Proforma Receipts and Payments Account :

Illustrations :

1. From the following information of the Red Cross Society, prepare Receipts and Payments Account for the year ended Dec. 31, 2019. Cash in hand on Jan. 1, 2019 ` 35,000 and Cash at Bank on Jan. 1, 2019, ` 50,000. Donation Received during the year ` 25,000 & Subscription received is ` 20,000. Utilities Charges Paid ` 5,000; Salary Paid ` 45,000 and Outstanding Salary is ` 5,000 Honorarium paid to trainer ` 15,000 and Rent Paid ` 7,500. Life membership Fees received ` 15,000 and Interest Received on Govt. Bond ` 1,000 Purchase of computer by check ` 30,000 and Purchase of Furniture for Cash ` 4,000 Entrance Fees Received ` 10,000. Purchase of Supplies Material for Cash ` 6,000 and Purchase of Government Bond ` 20,000. Payment to Petty Cashier ` 500. Cash in Hand Dec. 31, 2019 ` 8,000 and Cash in Bank Dec. 31, 2019 ` 15,000.

Solution:

Red Cross Society Receipts and Payments Account *for the Year Ending 31-12-2019*

<i>Receipts</i>	<i>Amount</i>	<i>Payments</i>	<i>Amount</i>
To Balance b/d		By Utilities	5,000
Cash	35,000	By Salaries	45,000
Bank	50,000	By Computers	30,000
To Donations	25,000	By Petty Cash	500
To Subscriptions	20,000	By Furniture	4,000
To Life Membership Fee	15,000	By Supply	6,000
To Interest on Bonds	1,000	By Bonds	20,000
To Entrance Fee	10,000	By Rent	7,500
		By Balance c/d	
		Cash	8,000
		Bank	15,000
	1,56,000		1,56,000

2. The following Receipts and Payment account is prepared by Blue Cross Society for the year ended Dec. 31, 2019.

Blue Cross Society
Receipts and Payment Account
for the year ended Dec. 31, 2019

<i>Receipts</i>	<i>Amount</i>	<i>Payments</i>	<i>Amount</i>
To Balance b/d		By Utilities	5,000
Cash	35,000	By Salaries	45,000
Bank	50,000	By Computers	30,000
To Donations	25,000	By Petty Cash	500
To Subscriptions	20,000	By Furniture	4,000
To Life Membership Fee	15,000	By Supply	6,000
To Interest on Bonds	1,000	By Bonds	20,000
To Entrance Fee	10,000	By Rent	7,500
		By Balance c/d	
		Cash	8,000
		Bank	15,000
	1,56,000		1,56,000

Information :

Subscription Received includes ` 2,000 for 2020 and ` 3,000 for 2018.

Subscription Outstanding on Dec. 31, 2019 is ` 4,000

Subscription received in advance in 2018 is ` 1,000 that is subscription for 2019.

Computer was Purchased on April 1, 2019 and Furniture on 1 July 2019.

The Society had other fixed assets ` 1,50,000 as on Jan. 1 2019.

Depreciation Rate on Fixed Assets and Furniture is 10% per year and on Computer 15% per Year.

The Govt. Bonds are purchased on 1 July 2019 and rate of interest is 12% per year.

Outstanding Salary is ` 5,000 for 2019 and Donation is general Donation. From the above information Prepare Income and Expenditure account of Blue Cross Society.

Solution:

Blue Cross Society
Income and Expenditure Account
for the year ended Dec. 31, 2019

<i>Expenditure</i>	<i>Amount</i>	<i>Income</i>	<i>Amount</i>
To Utilities	5,000	By Subscriptions	20,000
To Salary 45,000		By Donations	25,000
Add: Outstanding 5,000	50,000	By Int Recd 1,000	
To Honorarium	15,000	Add : Accrued Interest 200	1,200
To Rent	7,500	By Deficit	
To Supply	6,000	(Excess of Exp over Income)	54,850
To Depreciation	17,550		
Other F Assets 1,500			
Furniture 300			
Computer 2,250			
	1,01,050		1,01,050

1. Computation of Subscription:

Subscription received in 2019 :	` 20,000
Less: advance subscription received for 2020.	- (3,000)
Less: Arrears of subscription received for 2018.	- (2,000)
Add: Subscription received in advance in 2018	+ 1,000
Add: Outstanding subscription at end for 2019	+ 4,000
Subscription to be shown for the year 2019	` 20,000

2. Computation of Depreciation :

$$\text{Depreciation on other Fixed Assets} = 150,000 \times 10\% \times 1 = 15,000$$

$$\text{Depreciation on Furniture} = 4,000 \times 10\% \times 9/12 = 300$$

$$\text{Depreciation on Computer} = 30,000 \times 15\% \times 6/12 = 2,250$$

$$\text{Total Depreciation} = 15,000 + 300 + 2,250 = \text{` 17,550}$$

3. Prepare income and expenditure account and balance sheet from the following receipt and payment account of a nursing society.

Receipts and Payment Account

<i>Receipts</i>	<i>Amount</i>	<i>Payments</i>	<i>Amount</i>
To Balance at Bank	2,010	By Salaries of Nurses	656
To Subscriptions	1,115	By Board, Laundry and Help	380
To Fee from Non Members	270	By Rent, Rates, Taxes	200
To Municipal Grants	1,000	By Cost of Car	2,000
To Donation for Building	1,560	By Car Expenses	840
		By Drug Exp	670
		By Balance c/d	1,247
	5,993		5,993

The society owns freehold land costing Rs. 8,000 on which it is proposed to build the nurse's hostel. A donation of Rs.100 received to the building fund was wrongly included in the subscription account. A bill for medicine purchased during the year amounting to Rs.128 was outstanding.

Nursing Society Income and Expenditure Account

<i>Expenditure</i>	<i>Amount</i>	<i>Income</i>	<i>Amount</i>
To Salaries of Nurses	656	By Subscriptions	1,115
To Board, Laundry and Help	380	Less: Wrong inclusion	100
To Rent, Rates, Taxes	200	By Fee from Non Members	270
By Car Expenses	840	By Muncipal Grant	1,000
By Drug Exp	670	By Interst	38
To Outstanding Exp	798	By Deficit	551
	2,874		2,874

Nursing Society Balance Sheet

<i>Liabilities</i>	<i>Amount</i>	<i>Assets</i>	<i>Amount</i>
Building	1,560	Cash	1,247
Add : Omision	100	Motor Car	2,000
Outstanding Exp	128	Land	8,000
Capital Fund	10,010		
Less : Deficiency	551		
	11,247		11,247

4. From the following Receipts and payments a/c of Amaravathi Sports Club for the year ended 31st Dec – 2008, prepare income and expenditure account.

Receipts and Payment Account

<i>Receipts</i>	<i>Amount</i>	<i>Payments</i>	<i>Amount</i>
To Balance b/d	300	By Rent	5,200
To Entrance Fee	500	By Stationary Exp	3,068
To Subscriptions		By Wages	5,330
2007	200	By Billiards Table	3,900
2008	16,900	By Repairs	806
2009	300	By Interest	1,500
To Locker Rent	500	By Balance c/d	2,396
To Spl Sub for Govt Party	3,450		
	22,200		22,200

Lockers Rent Rs. 60, Pertained to 2007 and Rs. 90 is still owing. Rent Rs. 1,300 pertained to 2007 and Rs. 1,300 is still due. Stationery Expenses rs. 312 relating to 2007 and Rs. 364 is still owing. Subscription Receivable for 2008 is Rs. 468.

Solution:

Amaravathi Sports Club Income and Expenditure Account *for the year ending 31-12-2008*

<i>Expenditure</i>	<i>Amount</i>	<i>Income</i>	<i>Amount</i>
To Rent	5,200	By Subscriptions	16,900
Less: Last Yr.	1,300	Add: Receivable 2008	468
	3,900	By Entrance Fee	550
Add: Outstanding	1,300	By Locker Rent	500
To Stationary	3,068	Less: Last Year	60
Less: Last Yr	312		440
	2,756	Add: Outstanding 2008	90
Add: Outstanding	364	By Spl Subscriptions for	
To Wages	5,330	Governor's Party	3,490
To Repairs	806		
To Interest	1,500		
To Surplus			
(Income over expend)	5,492		
	21,898		21,898

5. From the following Receipts and Payments of Nethajee Sports Club, Prepare income and Expenditure A/c for the year ended on 31-Mar-2012

Receipts and Payment Account

<i>Receipts</i>	<i>Amount</i>	<i>Payments</i>	<i>Amount</i>
To Balance b/d(1.4.2011)	23,000	By Salaries	16,000
To Subscriptions	13,000	By Rent	3,000
To Interest	1,000	By Stationary	1,000
To Sale of Old Furniture (Book Value Rs.2000)	1,600	By Sports Material Purchased	12,000
To Entrance Fee	8,000	By Balance c/d(31.3.2012)	14,600
	46,600		46,600

Additional Information :

- a) Subscriptions Include Rs. 1,000 Received for the last year.
- b) Rent Includes Rs. 600 paid for the last year.

From the above particulars Prepare Income and Expenditure A/c for the year ending 31-03-2012.

Nethajee Sports Club Income and Expenditure Account for the year ending 31-03-2012.

<i>Expenditure</i>	<i>Amount</i>	<i>Income</i>	<i>Amount</i>
To Salaries	16,000	By Subscription	13,000
To Rent	3,000	Less: Last Year	1,000
Less: Last Yr	600	By Interest	1,000
To Stationary	1,000	By Entrance Fee	8,000
To Loss on Sale of Furniture (2000-1600)	400		
To Surplus (Excess of Income over Exp)	1,200		
	21,000		21,000

Terminal Exercise

Section - A

- 1) Legacy 2) Honorarium 3) Subscriptions
- 4) Non Trading Concern 5) Receipts & Payments Accounts

Section - B

- 1) What are the features of Non-Trading Concerns?
- 2) What are the important points to be noted about Receipts & Payments Account?
- 3) What is an Income & Expenditure Account? Distinguish between Income & Expenditure Account and Receipts & Payments Account?
- 4) What is Non-trading Concern? What are the different Accounting requirements in it - explain them in detail.
- 5) From the following particulars, prepare Receipts and Payments A/c.

Cash in hand ` 2,000, Cash at bank ` 4,000, Subscriptions received ` 30,000, Donations Received ` 5,600 Purchase of furniture ` 9,000, Rent Paid ` 5,000 General Expenses ` 2,000, Postage and Telegram 800 Sundry Expenses ` 100, Cash balance at close ` 200

(Ans : Cash at bank closing ` 24,300)

- 6) Visakha Town Club provided Receipts and Payments A/c for the year ended 31-Mar- 2013. Prepare Income and Expenditure A/c.

Receipts and Payment Account

<i>Receipts</i>	<i>Amount</i> `	<i>Payments</i>	<i>Amount</i> `
To Balance b/d(1.4.2011)	11,500	By Salaries	8,000
To Subscriptions	6,500	By Rent	1,500
To Interest	500	By Stationary	500
To Sale of Old Furniture	800	By Govt Bonds	6,000
To Entrance Fee	4,000	By Balance c/d(31.3.2012)	7,300
	23,300		23,300

Adjustments :

- a) Subscriptions include Rs. 500 received for last year.
- b) Rent includes Rs. 300 paid for last year.
- c) Book value of Furniture sold Rs. 1,000.

(Ans: Surplus 600)

- 7) From the following Receipts and Payments A/c of Karimnagar Sports Club for the year ending 31-Mar-2012, Prepare income and Expenditure A/c.

Receipts and Payment Account

<i>Receipts</i>	<i>Amount</i>	<i>Payments</i>	<i>Amount</i>
To Balance b/d	14,000	By Salaries	1,400
To Subscriptions (Previous Year 1000)	18,000	By Repairs	600
To Legacies	2,000	By Purchase of Sports Equip	2,000
To Life Membership Fee	5,000	By Furniture	8,000
To Sale of Tickets	500	By Honorarium Paid	5,000
To Lockers Rent	1,500	By Books	2,000
To Entrance Fee	1,000	By Investments	10,000
To Interest on Investments	200	By Office Exp	1,200
	200	By Balance c/d	12,000
	42,200		42,200

Additional Information :

- a) Outstanding Salaries Rs. 600
- b) Opening values of sports equipments Rs. 1,000, closing value Rs. 500
- c) Interest accrued on investments Rs. 200
- d) Subscription receivable for the year 2012 Rs. 3,000.

(Ans: Surplus: Rs. 12,100)

- 8) The receipts and payments account of Nice Sports Club for the year 2018 is given below:

Receipts and Payment Account

<i>Receipts</i>	<i>Amount</i>	<i>Payments</i>	<i>Amount</i>
To Balance b/d	1,500	By Salaries	3,600
To Subscriptions		By Stationary	400
2017 1,000		By Taxes	750
2018 9,600		By Tele Charges	300
2019 1,500	12,100	By Investment in Govt Bonds	1,500
To Receipts from Sports	2,000	By Sports Exp	1,150
To Sale of Car	2,000	By Mis Exp	800
To Int on Investments	1,400	By Balance c/d	10,500
	19,000		19,000

You are also provided with the following additional information :

1. Subscription amounting to 360 was outstanding on December 31, 2018.
2. The taxes for the first three months of the year 2019 were paid in advance.
3. The telephone expenses amounting to 75 were outstanding on December 31, 2018.
4. The miscellaneous expenses amounting to 100 were outstanding on December 31, 2017.
5. The value of investment was 18,500 on December 31, 2017.
6. The stock of stationary was 250 on December 31, 2017 and 190 on December 31, 2018.
7. On December 31, 2017, the book value of building and motor car was 20,000 and 2,500 respectively.
8. The depreciation @ 5% is to be provided on the book value of the building.
9. The club sold its car at a loss of 500 during the year. No depreciation is to be provided on the car.

Required: Using above information, prepare an income and expenditure account for the year ended 2018 and a balance sheet as on December 31, 2018. (**Surplus: 4975, Balance Sheet: 50200**)

- 9) Dr. Krishna commenced practice as an eye-specialist investing Rs. 25,000 in equipment on January 1,2017. The Receipts and Payments for the year was as follows :

Receipts and Payment Account

<i>Receipts</i>	<i>Amount</i>	<i>Payments</i>	<i>Amount</i>
To Fee	5,000	By Rent	3,000
To Misc. Receipts	100	By Salaries	7,500
To Equipment Sold	2,000	By Journals	1,000
		By Library Books	3,000
		By Equipment Purchased	4,000
		By Drawings	12,000
		By Balance	
		Bank	21,500
		Cash	100
	52,100		52,100

Rs. 1500 of the fees was still outstanding. Equipment was sold and purchased on October 1,2017; 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 2017.

(Answer : Surplus Rs. 31,850; Balance Sheet Rs. 45,850).

FINANCIAL STATEMENTS - ANALYSIS

You have already learnt about the preparation of financial statements i.e. Balance Sheet and Trading and Profit and Loss Account in the module titled “Financial Statements of Profit and Not for Profit Organisation’. In the case of a company the Trading and Profit and Loss Account is known as Statement of Profit and Loss. After preparation of the financial statements, one may be interested in analysing the financial statements with the help of different tools such as comparative statement, common size statement, ratio analysis, trend analysis, fund flow analysis, cash flow analysis, etc. In this process a meaningful relationship is established between two or more accounting figures for comparison. In this lesson you will learn about analysing the financial statements by using comparative statement, common size statement and trend analysis.

OBJECTIVES

After studying this lesson, you will be able to :

- understand the major and sub-headings of Statement of Profit & Loss and Balance Sheet.
- explain the meaning, need and purpose of financial statement analysis;
- identify the parties interested in analysis of financial statements;
- explain the various techniques and tools of analysis of financial statements.

12.1 FINANCIAL STATEMENTS ANALYSIS (MEANING, PURPOSE AND PARTIES INTERESTED)

We know business is mainly concerned with the financial activities. In order to ascertain the financial status of the business every enterprise prepares certain statements, known as financial statements. Financial statements are mainly prepared for decision making purposes. But the information as provided in the financial statements is not adequately helpful in drawing a meaningful conclusion. Thus, an effective analysis and interpretation of financial statements is required.

Analysis means establishing a meaningful relationship between various items of the two financial statements with each other in such a way that a conclusion is drawn.

The term financial analysis is also known as analysis and interpretation of financial statements. It refers to the establishing meaningful relationship between various items of the two financial statements i.e., Statement of Profit & Loss and Balance Sheet It determines financial strength and weaknesses of the firm.

Analysis of financial statements is an attempt to assess the efficiency and performance of an enterprise. Thus, the analysis and interpretation of financial statements is very essential to measure the efficiency, profitability, financial soundness and future prospects of the business units. Financial analysis serves the following advantages :

- **Measuring the Profitability :** The main objective of a business is to earn a satisfactory return on the funds invested in it. Financial analysis helps in ascertaining whether adequate profits are being earned on the capital invested in the business or not. It also helps in knowing the capacity to pay the interest and dividend.
- **Indicating the Trend of Achievements :** Financial statements of the previous years can be compared and the trend regarding various expenses, purchases, sales, gross profits and net profit etc. can be ascertained. Value of assets and liabilities can be compared and the future prospects of the business can be envisaged.
- **Assessing the Growth Potential of the Business :** The trend and other analysis of the business provides sufficient information indicating the growth potential of the business.
- **Comparative Position in Relation to Other Firms :** The purpose of financial statements analysis is to help the management to make a comparative study of the profitability of various firms engaged in similar businesses. Such comparison also helps the management to study the position of their firm in respect of sales, expenses, profitability and utilising capital, etc.
- **Assess overall financial strength :** The purpose of financial analysis is to assess the financial strength of the business. Analysis also helps in taking decisions, whether funds required for the purchase of new machines and equipments are provided from internal sources of the business or not if yes, how much? And also to assess how much funds have been received from external sources:
- **Assess solvency of the firm :** The different tools of an analysis tell us whether the firm has sufficient funds to meet its short term and long term liabilities or not.

Limitations of Financial Analysis

Financial analysis helps the interested parties to make an assessment of the earning capacity and financial soundness of a business enterprise. But such analysis has its own limitations. Such limitations should be kept in mind while using the informations provided by the financial analysis. Some of the limitations are as follows:

- (i) **Limitations of Financial Statements :** Financial analysis is based on financial statements. But financial statements themselves suffer from certain limitations, hence of fin the limitations of financial statements are also the limitations of their analysis. For example, (a) sometimes the information given in financial statements are incomplete and c and not authentic, (b) financial Statements are based on accounting concepts and based conventions. As such, the utility of financial analysis is decreased

due to the shortcomings of financial statements.

- (ii) **Affected by Window-dressing** : Some firms resort to window-dressing their financial statements to cover up bad financial position on the eve of accounting date. For example, they may not record the purchases made at the end of the year or they may overvalue their closing stock. In such cases, the results obtained by analysis of financial statements will be misleading.
- (iii) **Different Accounting Policies** : If two firms adopt different accounting policies, the comparison between the two will be unreliable. For example, one firm may provide depreciation on original cost method, whereas the other firm may adopt the written down value method for providing the depreciation. Similarly, the method of valuation of closing stock may also differ from one firm to another. The results obtained from the comparison of the financial statements of such firms may give misleading picture.
- (iv) **Difficulty in Forecasting** : Financial statements are a record of past events and historical facts. In the fast changing and developing modern business, the analysis of past information may not be of much use in future forecasting. Continuous changes take place in the demand of the product, policies adopted by the firm, the position of competition etc. As such, no estimate based on the analysis of historical facts can be made for future.
- (v) **Lack of Qualitative Analysis** : Financial statements record only those events and transactions which can be expressed in terms of money, qualitative aspects of business units are omitted from the books at all as these cannot be expressed in monetary terms. Thus, changes in management, reputation of the business, cordial management-labour relations, firm's ability to develop new products, efficiency of management, satisfaction of firm's customers etc. which have a vital bearing on the profitability of the company are all ignored and omitted from being recorded because all of these are qualitative in nature.
- (vi) **Limited Use of Single Year's Analysis of Financial Statements** : Results obtained from financial analysis assume significance only when compared with the figures of previous periods. For example, the profit of a firm to sales is 12%, whether this is satisfactory or not, will depend upon the figures of previous years. If the firm earned 10% of sales as profit in the previous year, it may be considered to have done better this year. However, the financial statements of two years may not be comparable due to the changes in accounting policies.

It is clear from the above mentioned limitations that the results obtained from analysis of financial statements should not be taken as the true indicators of the strength and weaknesses of the concern. The results obtained from analysis must be read carefully and cautiously. The limitations of analysis must be kept in mind while taking decisions based on the results obtained from such analysis.

12.2 TECHNIQUES AND TOOLS OF FINANCIAL STATEMENT ANALYSIS

Financial statements give complete information about assets, liabilities, equity, reserves expenses and profit & loss of an enterprise. They are not readily understandable to interested parties like creditors, shareholders, investors etc. Thus, various techniques are used for analysing and interpreting the financial statements. Techniques of analysis of financial statements.

The analysis and interpretation of financial statements is used to determine the financial position. A number of tools or methods or devices are used to study the relationship between financial statements. However, the following are the important tools which are commonly used for analysing and interpreting financial statements :

- Comparative financial statements
- Common size statements
- Trend analysis
- Ratio and analysis
- Funds flow analysis
- Cash flow analysis

I. Comparative financial Statements

In brief, comparative study of financial statements is the comparison of the financial statements of the business with the previous year's financial statements. It enables identification of weakpoints and applying corrective measures. Practically, two financial statements (balance sheet and income statement) are prepared in comparative form for analysis purposes.

1. Comparative Balance Sheet : The comparative balance sheet shows the different assets and liabilities of the firm on different dates to make comparison of balances from one date to another. The comparative balance sheet has two columns for the data of original balance sheets. A third column is used to show change (increase/decrease) in figures. The fourth column may be added for giving percentages of increase or decrease. While interpreting comparative Balance sheet the interpreter is expected to study the following aspects :

- (i) Current financial position and Liquidity position
- (ii) Long-term financial position
- (iii) Profitability of the concern

- (i) For studying current financial position or liquidity position of a concern one should examine the working capital in both the years. Working capital is the excess of current assets over current liabilities.
- (ii) For studying the long-term financial position of the concern, one should examine the changes in fixed assets, long-term liabilities and capital. (i) The next aspect to be studied in a comparative balance sheet is the profitability of the concern. The study of increase or decrease in profit will help the interpreter to observe whether the profitability has improved or not.

After studying various assets and liabilities, an opinion should be formed about the financial position of the concern.

Format of Comparative Balance Sheet

Comparative Balance Sheet as at

<i>Particulars</i>	<i>Note No.</i>	<i>Previous Year Rs. (A)</i>	<i>Current Year Rs. (A)</i>	<i>Absolute Change (Increase/Decrease) (C = B - A)</i>	<i>Percentage Change (Increase/Decrease) (D = C/A x 100)</i>
I. Equity and Liabilities					
1. Shareholder's Funds					
(a) Share Capital :					
(i) Equity Share Capital	
(ii) Preference Share Capital	
(b) Reserves and Surplus	
2. Non-Current Liabilities					
(a) Long-term Borrowings	
(b) Long-term Provisions	
3. Current Liabilities					
(a) Short-term Borrowing	
(b) Trade Payables	
(c) Other Current Liabilities	
(d) Short-term Provisions	
Total	
II. Assets					
1. Non-Current Assets					
(a) Fixed Assets :					
(i) Tangible Assets	
(ii) Intangible Assets	
(b) Non-current Investments	
(c) Long-term Loans and Advances	

2. Current Assets					
(a) Current Investments		...	...	...	...
(b) Inventories		...	...	...	...
(c) Trade Receivables		...	...	...	...
(d) Cash and Cash Equivalents		...	...	...	...
(e) Short-term Loans and Advances		...	...	...	...
(f) Other Current Assets		...	...	...	...
Total		...	...	...	...

Illustration 3

From the following Balance Sheets of SRR Ltd. as at 31st March, 2023 and 2022, Prepare a Comparative Balance Sheet :

Balance Sheet as at 31st March 2023 and 2022

<i>Particulars</i>	<i>Note No.</i>	<i>31st March 2023 (Rs)</i>	<i>31st March 2022 (Rs)</i>
I. EQUITY AND LIABILITIES			
1. Shareholder's Funds			
Share Capital (Equity)		18,00,000	12,00,000
2. Non-Current Liabilities			
Long-term Borrowings : 8% Debentures (Secured)		6,00,000	6,00,000
3. Current Liabilities			
Trade Payables			
Total		30,00,000	21,00,000
II. Assets			
1. Non-Current Assets			
Fixed Assets : Tangible Assets		18,00,000	15,00,000
2. Current Assets			
(a) Trade Receivables		10,00,000	5,00,000
(b) Cash and Cash Equivalents		2,00,000	1,00,000
Total		30,00,000	21,00,000

Solution :

SRR Ltd. **Comparative Balance Sheet** *as at 31st March, 2022 and 2023*

<i>Particulars</i>	<i>Note No.</i>	<i>31st March 2022 Rs. (A)</i>	<i>31st March 2023 Rs. (B)</i>	<i>Absolute Change (Increase/Decrease) Rs. (C = B - A)</i>	<i>Percentage Change (Increase/Decrease) Rs. (D = C/A x 100)</i>
I. EQUITY AND LIABILITIES					
1. Shareholder's Funds					
Share Capital :					
Equity Share Capital		12,00,000	18,00,000	6,00,000	50.00
2. Non-Current Liabilities					
Long-term Borrowings :					
Secured Loans - 5% Debentures		6,00,000	6,00,000	-----	-----
3. Current Liabilities					
Trade Payable		3,00,000	6,00,000	3,00,000	100.00
Total		21,00,000	30,00,000	9,00,000	42.86
II. ASSETS					
1. Non-Current Assets					
Fixed Assets (Tangible)		15,00,000	18,00,000	3,00,000	20.00
2. Current Assets					
(a) Trade Receivables		5,00,000	10,00,000	5,00,000	100.00
(b) Cash and Cash Equivalents		1,00,000	2,00,000	1,00,000	100.00
Total		21,00,000	30,00,000	9,00,000	42.86

Illustration : 9

Prepare Comparative Balance Sheet of PSR Ltd. :

<i>Particulars</i>	<i>31st March 2023 (Rs)</i>	<i>31st March 2022 (Rs)</i>
I. EQUITY AND LIABILITIES		
1. Shareholder's Funds		
(a) Share Capital : Equity Share Capital	3,60,000	3,00,000
(b) Reserves and Surplus	1,50,000	1,20,000
2. Non-Current Liabilities		
Long-term Borrowings	2,55,000	1,70,000

3. Current Liabilities			
Trade Payables		1,20,000	1,50,000
Total		8,85,000	7,40,000
II. Assets			
1. Non-Current Assets			
Fixed Assets :			
(i) Tangible Assets		6,50,000	5,00,000
(ii) Intangible Assets		1,00,000	1,00,000
2. Current Assets			
(a) Trade Receivables		1,25,000	1,20,000
(b) Cash and Cash Equivalents		10,000	20,000
Total		8,85,000	7,74,000

Solution :

Comparative Balance Sheet of PSR Ltd. as at 31st March, 2022 and 2023

Particulars	Note No.	31st March 2022 Rs. (A)	31st March 2023 Rs. (B)	Absolute Change (Increase/Decrease) Rs. (C = B - A)	Percentage Change (Increase/Decrease) Rs. (D = C/A x 100)
I. EQUITY AND LIABILITIES					
1. Shareholder's Funds					
(a) Share Capital :					
Equity Share Capital		3,00,000	3,60,000	60,000	20.00
(b) Reserves and Surplus		1,20,000	1,50,000	30,000	25.00
2. Non-Current Liabilities					
Long-term Borrowings :		1,70,000	2,55,000	85,000	50.00
3. Current Liabilities					
Trade Payable		1,50,000	1,20,000	(30,000)	(20.00)
Total		7,40,000	8,85,000	1,45,000	19.00
II. ASSETS					
1. Non-Current Assets					
Fixed Assets					
(i) Tangible Assets		5,00,000	6,50,000	1,50,000	30.00
(ii) Intangible Assets		1,00,000	1,00,000	-----	-----
2. Current Assets					
(a) Trade Receivables		1,20,000	1,25,000	5,000	4.17
(b) Cash and Cash Equivalents		20,000	10,000	(10,000)	(50.00)
Total		7,40,000	8,85,000	1,45,000	19.60

Comparative Income Statement or Comparative Statement of Profit & Loss

The income statement provides the results of the operations of a business. This statement traditionally is known as trading and profit and loss A/c. Important components of income statement are net sales, cost of goods sold, selling expenses, office expenses etc. The figures of the above components are matched with their corresponding figures of previous years individually and changes are noted. The comparative income statement gives an idea of the progress of a business over a period of time. The changes in money value and percentage can be determined to analyse the profitability of the business. Like comparative balance sheet, income statement also has four columns. The first two columns shows figures of various items for two years. Third and fourth columns are used to show increase or decrease in figures in absolute amount and percentages respectively.

The analysis and interpretation of income statement will involve the following :

- The increase or decrease in sales should be compared with the increase or decrease in cost of goods sold.
- To study the operating profits
- The increase or decrease in net profit is calculated that will give an idea about the overall profitability of the concern.

Format of Comparative Statement of Profit & Loss

COMPARATIVE STATEMENT OF PROFIT AND LOSS

for the year ended 31st March, 2022 and 2023

<i>Particulars</i>	<i>Note No.</i>	<i>31st March 2022 Rs. (A)</i>	<i>31st March 2023 Rs. (B)</i>	<i>Absolute Change (Increase/Decrease) Rs. (C = B - A)</i>	<i>Percentage Change (Increase/Decrease) Rs. (D = C/A x 100)</i>
I. Revenue from Operations		----	----	----	----
II. Other Income		----	----	----	----
III. Total Revenue (I + II)		----	----	----	----
IV. Expenses					
(a) Cost of Materials Consumed		----	----	----	----
(b) Purchases of Stock-in-Trade		----	----	----	----
(c) Change in Inventories of Finished Goods, Work-in-Progress and Stoc - in - Trade					
(d) Employees Benefit Expenses		----	----	----	----

(e) Finance Costs	----	----	----	----
(f) Depreciation Benefit Expenses	----	----	----	----
(e) Finance Costs	----	----	----	----
(f) Depreciation and Amortisation Expenses	----	----	----	----
(g) Other Expenses	----	----	----	----
Total	----	----	----	----
V. Profit before Tax (III-IV)	----	----	----	----
Less : Income Tax	----	----	----	----
VI. Profit after Tax	----	----	----	----

Illustration : 10

Prepare Comparative Statement of Profit and Loss from the following :

<i>Particulars</i>	<i>Note No.</i>	<i>31st March 2022 (Rs)</i>	<i>31st March 2023 (Rs)</i>
Revenue from Operations		15,00,000	10,00,000
Expenses		10,50,000	6,00,000
Other Income		1,80,000	2,00,000

Solution :

COMPARATIVE STATEMENT OF PROFIT AND LOSS for the year ended 31st March, 2022 and 2023

<i>Particulars</i>	<i>Note No.</i>	<i>31st March 2022 Rs. (A)</i>	<i>31st March 2023 Rs. (B)</i>	<i>Absolute Change (Increase/Decrease) Rs. (C=B-A)</i>	<i>Percentage Change (Increase/Decrease) Rs. (D = C/A x 100)</i>
I. Revenue from Operations		10,00,000	15,00,000	5,00,000	50.00
II. Other Income		2,00,000	1,80,000	(20,000)	(10.00)
III. Total Revenue (I + II)		12,00,000	16,80,000	4,80,000	40.00
IV. Less : Expenses		6,00,000	10,50,000	4,50,000	75.00
V. Profit before Tax (III-IV)		6,00,000	6,30,000	30,000	5.00

Illustration : 11

From the following statement of Profit and Loss of Moon Ltd. for the years ended 31st March, 2022 and 2023, Prepare a Comparative Statement of Profit and Loss :

<i>Particulars</i>	<i>Note No.</i>	<i>31st March 2023 (Rs)</i>	<i>31st March 2022 (Rs)</i>
Revenue from Operations		20,00,000	16,00,000
Expenses		10,00,000	8,00,000
Other Expenses		1,00,000	2,00,000

Solution :

COMPARATIVE STATEMENT OF PROFIT AND LOSS OF MOON LTD.

for the year ended 31st March, 2022 and 2023

<i>Particulars</i>	<i>Note No.</i>	<i>31st March 2022 Rs. (A)</i>	<i>31st March 2023 Rs. (B)</i>	<i>Absolute Change (Increase/Decrease) Rs. (C=B-A)</i>	<i>Percentage Change (Increase/Decrease) Rs. (D = C/A x 100)</i>
I. Revenue from Operations		16,00,000	20,00,000	4,00,000	25.00
II. Less : Expenses					
(a) Employees Benefit Expenses		8,00,000	10,00,00	2,00,000	25.00
(b) Other Expenses		2,00,000	1,00,000	(1,00,000)	(50.00)
Total Expenses		10,00,000	11,00,000	1,00,000	10.00
III. Profit before Tax (I-II)		6,00,000	9,00,000	3,00,000	50.00

Illustration : 12

Following information is extracted from the Statement of Profit and Loss of JSW Ltd., for the years ended 31st March, 2023 and 2022. Prepare Comparative Statement of Profit and Loss.

<i>Particulars</i>	<i>Note No.</i>	<i>31st March 2023 (Rs)</i>	<i>31st March 2022 (Rs)</i>
Revenue from Operations		40,00,000	32,00,000
Employees Benefit Expenses		20,00,000	16,00,000
Depreciation and Amortisation Expenses		50,000	40,000
Other Expenses		1,50,000	3,60,000
Tax Rate 30%			

Solution :

COMPARATIVE STATEMENT OF PROFIT AND LOSS OF JSW for the year ended 31st March, 2022 and 2023

<i>Particulars</i>	<i>Note No.</i>	<i>31st March 2022 Rs. (A)</i>	<i>31st March 2023 Rs. (B)</i>	<i>Absolute Change (Increase/Decrease) Rs. (C=B-A)</i>	<i>Percentage Change (Increase/Decrease) Rs. (D = C/A x 100)</i>
I. Revenue from Operations		32,00,000	40,00,000	8,00,000	25.00
II. Expenses					
(a) Employees Benefit Expenses		16,00,000	20,00,000	4,00,000	25.00
(b) Depreciation and Amortisation Expenses		40,000	50,000	10,000	25.00
(c) Other Expenses		3,60,000	1,50,000	(2,10,000)	(58.33)
Total Expenses		20,00,000	22,00,000	2,00,000	10.00
III. Profit before Tax (I-II)		12,00,000	18,00,000	6,00,000	50.00
Less : Tax @ 30%		3,60,000	5,40,000	1,80,000	50.00
IV. Profit after Tax		8,40,000	12,60,000	4,20,000	50.00

Illustration : 13

Prepare Comparative Statement of Profit and Loss from the following :

<i>Particulars</i>	<i>Note No.</i>	<i>31st March 2023 (Rs)</i>	<i>31st March 2022 (Rs)</i>
Revenue from Operations		8,00,000	4,20,000
Purchases of Stock-in-Trade		4,50,000	2,50,000
Change in Inventories of Stock-in-Trade		50,000	50,000
Other Expenses (% of Cost of Goods Sold)		8%	10%
Tax		30%	30%

Solution :

COMPARATIVE STATEMENT OF PROFIT AND LOSS for the year ended 31st March, 2022 and 2023

Particulars	Note No.	31st March 2022 Rs. (A)	31st March 2023 Rs. (B)	Absolute Change (Increase/Decrease) Rs. (C=B-A)	Percentage Change (Increase/Decrease) Rs. (D = C/A x 100)
I. Revenue from Operations (Sales)		4,20,000	8,00,000	3,80,000	90.47
II. Expenses					
(a) Purchases of Stock-in-Trade		2,50,000	4,50,000	2,00,000	80.00
(b) Change in Inventories of Stock-in-Trade		50,000	50,000	.....	.....
(c) Other Expenses		30,000	40,000	10,000	33.33
Total Expenses		3,30,000	5,40,000	2,10,000	63.64
III. Profit before Tax (I-II)		90,000	2,60,000	1,70,000	188.89
Less : Tax		27,000	78,000	51,000	188.89
IV. Profit after Tax		63,000	1,82,000	1,19,000	188.89

Note : Cost of Goods Sold = Purchases + Change in Inventories

INTEXT QUESTIONS 31.2

Fill in the blanks with suitable word/words:

- (i) Time series analysis is a technique of
- (ii) Comparative statement is a for financial statement analysis.
- (iii)is the comparison of the financial statements of business with the previous years financial statements.
- (iv) Comparative.....shows the different assets and liabilities of the firm on different dates to make comparison of balances from one date to another.
- (v)income statement gives an idea of the progress of a business over a period of time.

12.3 COMMON SIZE STATEMENTS AND TREND ANALYSIS

The common size statements (Balance Sheet and Income Statement) are shown in analytical percentages. The figures of these statements are shown as percentages of total assets, total liabilities and total sales respectively. Take the example of Balance Sheet. The total assets are taken as 100 and different assets are expressed as a percentage of the total. Similarly, various liabilities are taken as a part of total liabilities.

Common Size Balance Sheet

A statement where balance sheet items are expressed in the ratio of each asset to total assets and the ratio of each liability is expressed in the ratio of total liabilities is called common size balance sheet.

- Thus the common size statement may be prepared in the following way.
- The total assets or liabilities are taken as 100
- The individual assets are expressed as a percentage of total assets i.e. 100 and different liabilities are calculated in relation to total liabilities.

For example, if total assets are Rs. 10 lakhs and value of inventory is Rs. 1,00,000, then

inventory will be 10% of total assets $\left(\frac{1,00,000 \times 100}{10,00,000} \right)$

Format of Common Size Balance Sheet

COMMON SIZE BALANCE SHEET

as at 31st March, 2022 and 2023

Particulars (1)	Note No. (2)	Absolute Amounts		Percentage of Balance Sheet Total	
		31st March 2022 (Rs.) (3)	31st March 2023 (Rs.) (4)	31st March 2022 (Rs.) (5)	31st March 2023 (Rs.) (6)
I. EQUITY AND LIABILITIES					
1. Shareholder's Funds					
(a) Share Capital :					
(i) Equity Share Capital	
(ii) Preference Share Capital	
(b) Reserves and Surplus	
2. Non-Current Liabilities					
(a) Long-term Borrowings	
(b) Long-term Provisions	

3. Current Liabilities				
(a) Short-term Borrowings	.....	.....	.....	.....
(b) Trade Payables	.....	.....	.....	.....
(c) Other Current Liabilities	.....	.....	.....	.....
(d) Short-term Provisions	.....	.....	.....	.....
Total	.....	.....	100	100
II. ASSETS				
1. Non-Current Assets				
(a) Fixed Assets :				
(i) Tangible Assets	.....	.....	.....	.....
(ii) Intangible Assets	.....	.....	.....	.....
(b) Non-Current Investments	.....	.....	.....	.....
(c) Long-term Loans and Advances	.....	.....	.....	.....
2. Current Assets				
(a) Current Investments	.....	.....	.....	.....
(b) Inventories	.....	.....	.....	.....
(c) Trade Receivables	.....	.....	.....	.....
(d) Cash and Cash Equivalentents	.....	.....	.....	.....
(e) Short-term Loans and Advances	.....	.....	.....	.....
(f) Other Current Assets	.....	.....	.....	.....
Total	.....	.....	100	100

Illustration : 14

From the following Balance Sheets of ABC Ltd. as at 31st March, 2023 and 2022 prepare a Common-size Balance Sheet.

BALANCE SHEETS *as at 31st March, 2023 and 2022*

<i>Particulars</i>	<i>Note No.</i>	<i>31st March 2023 (Rs)</i>	<i>31st March 2022 (Rs)</i>
I. Equity and Liabilities			
1. Shareholder's Funds			
(a) Share Capital		10,00,000	5,00,000
(b) Reserves and Surplus		2,00,000	3,00,000
2. Non-Current Liabilities			
Long-term Borrowings		8,00,000	5,00,000
3. Current Liabilities			
Trade Payables		4,00,000	2,00,000
Total		24,00,000	15,00,000

II. Assets			
1. Non-Current Assets			
Fixed Assets - Tangible Assets		15,00,000	10,00,000
2. Current Assets			
Cash and Cash Equivalents		9,00,000	5,00,000
Total		24,00,000	15,00,000

Solution :

COMMON-SIZE BALANCE SHEET OF XYG LTD.
as at 31st March, 2022 and 2023

Particulars (1)	Note No. (2)	Absolute Amounts		Percentage of Balance Sheet Total	
		31st March 2022 (Rs.) (3)	31st March 2023 (Rs.) (4)	31st March 2022 (Rs.) (5)	31st March 2023 (Rs.) (6)
I. EQUITY AND LIABILITIES					
1. Shareholder's Funds					
(a) Share Capital		5,00,000	10,00,000	33.33	41.67
(b) Reserves and Surplus		3,00,000	2,00,000	20.00	8.33
2. Non-Current Liabilities					
Long-term Borrowings		5,00,000	8,00,000	33.34	33.33
3. Current Liabilities					
Trade Payables		2,00,000	4,00,000	13.33	16.67
Total		15,00,000	24,00,00	100.00	100.00
II. ASSETS					
1. Non-Current Assets					
Fixed Assets - Tangible Assets		10,00,000	15,00,000	66.67	62.50
2. Current Assets					
Cash and Cash Equivalents		5,00,000	9,00,000	33.33	37.50
Total		15,00,000	24,00,00	100.00	100.00

Note : % is calculated on the basis of total of equity and liabilities/total assets

$$\% \text{ of Share Capital (31st March, 2022)} = \frac{5,00,000}{15,00,000} \times 100 = 33.33\%$$

In the same manner, other percentages may be calculated.

Illustration : 15

From the following Balance Sheets of Sunrise Ltd., as at 31st March, 2023 and 2022 prepare Common-Size Balance Sheet.

<i>Particulars</i>	<i>Note No.</i>	<i>31st March 2023 (Rs)</i>	<i>31st March 2022 (Rs)</i>
I. Equity and Liabilities			
1. Shareholder's Funds			
(a) Share Capital		80,00,000	60,00,000
(b) Reserves and Surplus		12,00,000	8,00,000
2. Non-Current Liabilities			
Long-term Borrowings		24,00,000	20,00,000
3. Current Liabilities			
Short-term Borrowings		4,00,000	12,00,000
Total		1,20,00,000	1,00,00,000
II. ASSETS			
1. Non-Current Assets			
Fixed Assets :			
(i) Tangible Assets		80,00,000	60,00,000
(ii) Intangible Assets		4,00,000	12,00,000
2. Current Assets			
(a) Inventories		24,00,000	20,00,000
(b) Cash and Cash Equivalents		12,00,000	8,00,000
Total		1,20,00,000	1,00,00,000

Solution :

COMMON-SIZE BALANCE SHEET OF SUN LTD.

as at 31st March, 2022 and 2023

<i>Particulars</i>	<i>Note No.</i>	<i>Absolute Amounts</i>		<i>Percentage of Balance Sheet Total</i>	
		<i>31st March 2022 (Rs.)</i>	<i>31st March 2023 (Rs.)</i>	<i>31st March 2022 (Rs.)</i>	<i>31st March 2023 (Rs.)</i>
(1)	(2)	(3)	(4)	(5)	(6)
I. EQUITY AND LIABILITIES					
1. Shareholder's Funds					
(a) Share Capital		60,00,000	80,00,000	60.00	66.70
(b) Reserves and Surplus		8,00,000	12,00,000	8.00	10.00

2. Non-Current Liabilities					
Long-term Borrowings		20,00,000	24,00,000	20.00	20.00
3. Current Liabilities					
Shot-term Borrowings		12,00,000	4,00,000	12.00	3.30
Total		10,00,000	1,20,00,000	100.00	100.00
II. ASSETS					
1. Non-Current Assets					
Fixed Assets :					
(i) Tangible Assets		60,00,000	80,00,000	66.00	66.70
(ii) Intangible Assets		12,00,000	4,00,000	12.00	3.30
2. Current Assets					
(a) Inventories		20,00,000	24,00,000	20.00	20.00
(b) Cash and Cash Equivalents		8,00,000	12,00,000	8.00	10.00
Total		1,00,00,000	1,20,00,000	100.00	100.00

Illustration : 16

From the following Statement of Profit and Loss of Namish Ltd. for the years ended 31st March 2023 and 2022, Prepare a Common-Size Statement of Profit and Loss :

<i>Particulars</i>	<i>Note No.</i>	<i>31st March 2023 (Rs)</i>	<i>31st March 2022 (Rs)</i>
Revenue from Operations		20,00,000	16,00,000
Employees Benefit Expenses		10,00,000	8,00,000
Other Expenses		1,00,000	2,00,000

Solution :

COMMON-SIZE BALANCE SHEET OF NAMISH LTD.

for the years ended 31st March, 2022 and 2023

<i>Particulars</i>	<i>Note No.</i>	<i>Absolute Amounts</i>		<i>Percentage of Balance Sheet Total</i>	
		<i>2022 (Rs.)</i>	<i>2023 (Rs.)</i>	<i>2022 (%)</i>	<i>2023 (%)</i>
(1)	(2)	(3)	(4)	(5)	(6)
I. Revenue from Operations		16,00,000	20,00,000	100.00	100.00
II. Employees Benefit Expenses		8,00,000	10,00,000	50.00	50.00
Other Expenses		2,00,000	1,00,000	12.50	5.50
III. Total Expenses		10,00,000	11,00,000	62.50	55.00
IV. Profit before Tax (I-II)		6,00,000	9,00,000	37.50	45.00

Illustration : 17

From the following Statement of Profit and Loss, prepare Common-Size Statement of Profit and Loss and give comments.

<i>Particulars</i>	<i>31st March 2023 (Rs)</i>	<i>31st March 2022 (Rs)</i>
I. Income		
Revenue from Operations (Net Sales)	12,50,000	10,00,000
II. Expenses		
Purchases of Stock-in-Trade	8,70,000	7,20,000
Change in Inventories of Stock-in-Trade	(20,000)	30,000
Depreciation and Amortisation Expenses	30,000	30,000
Other Expenses	50,000	30,000
Total	9,30,000	8,00,000
III. Profit before Tax (I-II)	3,20,000	2,00,000
IV. Less : Income Tax	96,000	60,000
V. Profit after Tax (III-IV)	2,24,000	1,40,000

Solution :

COMMON-SIZE STATEMENT OF PROFIT AND LOSS *for the years ended 31st March, 2022 and 2023*

<i>Particulars</i>	<i>Note No.</i>	<i>Absolute Amounts</i>		<i>Percentage of Balance Sheet Total</i>	
		<i>31st March 2022 (Rs.)</i>	<i>31st March 2023 (Rs.)</i>	<i>31st March 2022 (Rs.)</i>	<i>31st March 2023 (Rs.)</i>
(1)	(2)	(3)	(4)	(5)	(6)
I. Revenue from Operations (Net Sales)		10,00,000	12,50,000	100.00	100.00
II. Expenses					
(a) Purchases of Stock-in-Trade		7,20,000	8,70,000	72.00	69.00
(b) Change in Inventories of Stock-in-Trade		30,000	(20,000)	3.00	(1.60)
(c) Depreciation and Amortisation Expenses		20,000	30,000	2.00	2.40
III. Total Expenses		8,00,000	9,30,000	80.00	74.40
IV. Profit before Tax (I-II)		2,00,000	3,20,000	20.00	25.60
V. Less : Income Tax		60,000	96,000	6.00	7.68
VI. Profit after Tax (III-IV)		1,40,000	2,24,000	14.00	17.92

Comments :

1. Purchases of Stock-in-Trade and Change in Inventories of Stock-in-Trade have decreased from 75% to 68%. There are two possible reasons for this change :
 - i. Efficient functioning of the purchased and production department.
 - ii. Increase in the sale price of the product without corresponding increase in the cost of inputs.
2. Increase in net profit is mainly due to decrease in the percentage of Cost of Goods Sold.

12.4 OBJECTIVES OF RATIO ANALYSIS

Ratios are regarded as a test of earning capacity, financial soundness and operating efficiency of a business organisation. The use of ratios in accounting and financial management analysis helps the management to know the profitability, financial position (liquidity and solvency) and operating efficiency of an enterprises.

The objectives of ratio analysis may be better understood by the following advantages of ratio analysis.

Advantages and Uses of Ratio Analysis

The advantages derived by an enterprise by the use of accounting ratios are :

- i. **Useful in Analysis of Financial Statements :** Accounting ratios are useful for understanding the financial position of the enterprise. Bankers, investors, creditors etc., all analyse Balance Sheets and Profit and Loss Accounts by means of ratios.
- ii. **Useful in Simplifying Accounting Figures :** Accounting ratio simplifies, summarises and systematises a long array of accounting figures to make them understandable. Its main contribution lies in communicating precisely the inter-relationships which exist between various elements of financial statements.
- iii. **Useful in Judging the Operating Efficiency of Business :** Accounting ratios are essential for understanding the affairs of an enterprise, specially its operating efficiency. Accounting ratios are also useful for diagnosis of the financial health of an enterprise. This is done by evaluating liquidity, solvency, profitability, etc. Such an evaluation enables the management to assess financial requirements and the capabilities of various business units.

- iv. **Useful for Forecasting :** Ratios are helpful in business planning and forecasting. The trend ratios are analysed and used as a guide to future planning. What should be the course of action in the immediate future is decided, many a times, on the basis of trend ratios, *i.e.*, ratios calculated for a number of years.
- v. **Useful in Locating the Weak Spots :** Accounting ratios are of great assistance in locating the weak spots in the business even though the overall performance may be quite good. Management can pay attention to the weakness and take remedial action. For example, if the firm finds that the increase in distribution expenses is more than proportionate to the results achieved, these can be examined in detail and depth to remove any wastage that may be there.
- vi. **Useful in Inter-firm and Intra-firm Comparison :** A firm would like to compare its performance with that of other firms and of industry in general. The comparison is called inter-firm comparison. If the performance of different units belonging to the same firm is to be compared, it is called intra-firm comparison. Such comparison is almost impossible without accounting ratios. Even the progress of a firm from year to year cannot be measured without the help of ratios. The accounting ratios are the best tools to compare the various firms and divisions of a firm.

12.5 LIMITATIONS OF ACCOUNTING RATIOS

Accounting ratios are very significant in analysing the financial statements. Through accounting ratios, it will be easy to know the true financial position and financial soundness of a business concern. However, despite the advantages of ratio analysis, it suffers from a number of limitations. The following are the main limitations of accounting ratios.

- **Ignorance of Qualitative Aspect :** The ratio analysis is based on quantitative aspect. It totally ignores qualitative aspect which is sometimes more important than quantitative aspect.
- **Ignorance of Price Level Changes :** Price level changes make the comparison of figures difficult over a period of time. Before any comparison is made, proper adjustments for price level changes must be made.
- **No Single Concept :** In order to calculate any ratio, different firms may take different concepts for different purposes. Some firms take profit before charging interest and tax or profit before tax but after interest tax. This may lead to different results.
- **Misleading Results if based on Incorrect Accounting Data :** Ratios are based on accounting data. They can be useful only when they are based on reliable data. If the data are not reliable, the ratio will be unreliable.

- **No Single Standard Ratio for Comparison :** There is no single standard ratio which is universally accepted and against which a comparison can be made. Standards may differ from industry to industry.
- **Difficulties in Forecasting :** Ratios are worked out on the basis of past results. As such they do not reflect the present and future position. It may not be desirable to use them for forecasting future events.

12.6 MEANING AND ITS CLASSIFICATION

The ratio is an arithmetical expression i.e. relationship of one number to another. It may be defined as an indicated quotient of the mathematical expression. It is expressed as a proportion or a fraction or in percentage or in terms of number of times. A financial ratio is the relationship between two accounting figures expressed mathematically. Suppose two accounting figures of a concern are sales Rs. 1,00,000 and profits Rs. 15,000. The ratio between these two figures will be

$$\frac{15,000}{1,00,000} = 3 : 20 \text{ or } 15\%$$

Ratios provide clues to the financial position of a concern. These are the indicators of financial strength, soundness, position or weakness of an enterprise. One can draw conclusions about the financial position of a concern with the help of accounting ratios.

Suppose one shopkeeper (X) earns a profit of Rs. 1,000 and another (Y) earns Rs. 20,000 which one is more efficient? We may say that the one who earns a higher profit is running his shop better. In fact to answer the questions, we must ask, how much is the capital employed by each shopkeeper? Let, X employ Rs. 1,00,000 and Y Rs. 4,00,000. We can work out the percentage of profit earned by each to the capital employed. Thus,

$$X = \frac{\text{Rs. } 10,000}{\text{Rs. } 1,00,000} \times 100 = 10\%$$

$$Y = \frac{\text{Rs. } 20,000}{\text{Rs. } 4,00,000} \times 100 = 5\%$$

These figures show that for every Rs. 100 of capital, X earns Rs. 10 and Y earns Rs. 5. X is obviously making a better use of the funds employed by him. He must be treated as more efficient of the two. The above example shows that absolute figures by themselves do not communicate the meaningful information.

Broadly accounting ratios can be grouped into the following categories:

(a) Liquidity ratios (b) Activity ratios (c) Solvency ratios

(c) Profitability ratios

Liquidity Ratios

The term liquidity refers to the ability of the company to meet its current liabilities. Liquidity ratios assess capacity of the firm to repay its short term liabilities. Thus, liquidity ratios measure the firms' ability to fulfil short term commitments out of its liquid assets. The important liquidity ratios are :

(i) Current Ratio

(ii) Quick Ratio

(i) **Current Ratio :** Current ratio is a ratio between current assets and current liabilities of a firm for a particular period. This ratio establishes a relationship between current assets and current liabilities. The objective of computing this ratio is to measure the ability of the firm to meet its short term liability. It compares the current assets and current liabilities of the firm. This ratio is calculated as under :

$$\text{Current ratio} = \frac{\text{Current Assets}}{\text{Current Liabilities}}$$

Current Assets are those assets which can be converted into cash within a short period i.e. not exceeding one year. It includes the following:

Cash in hand, Cash at Bank, Trade Receivables, Short term investment, Stock Prepaid expenses.

Trade Receivables include Bills Receivables and Sundry Debtors.

Current liabilities are those liabilities which are expected to be paid within a year. It includes the following:

Trade Payables, Bank overdraft, Provision for tax, Outstanding expenses.

Trade Payables include Sundry Creditors and Bills Payables.

Significance

It indicates the amount of current assets available for repayment of current liabilities. Higher the ratio, the greater is the short term solvency of a firm and vice-versa. However, a very high ratio or very low ratio is a matter of concern. If the ratio is very high it means

the current assets are lying idle. Very low ratio means the short term solvency of the firm is not good. Thus, the ideal current ratio of a company is 2: 1 i.e. to repay current liabilities, there should be twice current assets.

Illustration 1

Calculate current ratio from the following:

	Rs.
Sundry debtors	4,00,000
Stock	1,60,000
Marketable securities	80,000
Cash	1,20,000
Prepaid expenses	40,000
Bill payables	80,000
Sundry creditors	1,60,000
Debentures	2,00,000
Outstanding Expenses	1,60,000

Solution :

$$\text{Current ratio} = \frac{\text{Current Assets}}{\text{Current Liabilities}}$$

$$\begin{aligned} \text{Current Assets} &= \text{Sundry Debtors} + \text{Stock} + \text{Marketable Securities} + \text{Cash} + \\ &\quad \text{Prepaid Expenses} \\ &= \text{Rs. } (400,000 + 160,000 + 80,000 + 120,000 + 40,000) \\ &= \text{Rs. } 800,000 \\ \text{Current Liabilities} &= \text{Bill Payables} + \text{Sundry Creditors} + \text{Outstanding Expenses} \\ &= (80,000 + 160,000 + 160,000) = \text{Rs. } 400,000 \end{aligned}$$

$$\text{Current Ratio} = \frac{\text{Rs. 8,00,000}}{\text{Rs. 4,00,000}} = 2:1$$

(ii) **Quick Ratio :** Quick ratio is also known as Acid test or Liquid ratio. It is another ratio to test the short-term solvency of the concern. This ratio establishes a relationship between quick assets and current liabilities. This ratio measures the ability of the firm to pay its current liabilities. The main purpose of this ratio is to measure the ability of the firm to pay its current liabilities. For the purpose of calculating this ratio, stock and prepaid expenses are not taken into account as these may not be converted into cash in a very short period. This ratio is calculated as under :

$$\text{Liquid ratio} = \frac{\text{Liquid or Quick Assets}}{\text{Current Liabilities}}$$

where, liqui assets = current assets - (stock + prepaid expenses)

Significance

Quick ratio is a measure of the instant debt paying capacity of the business enterprise. It is a measure of the extent to which liquid resources are immediately available to meet current obligations. A quick ratio of 1:1 is considered good/favourable for a company.

Illustration 2

Taking the same information as given in illustrated 1 calculate the quick ratio.

Solution :

$$\text{Quick Ratio} = \frac{\text{Liquid or Quick Assets}}{\text{Current Liabilities}}$$

$$\begin{aligned} \text{Quick Assets} &= \text{Currents Assets} - (\text{Stock} + \text{Prepaid Expenses}) \\ &= \text{Rs. 8,00,000} - (\text{Rs. 1,60,000} + \text{Rs. 40,000}) = \text{Rs. 6,00,000} \end{aligned}$$

$$\text{Current Liabilities} = \text{Rs. 6,00,000}$$

$$\text{Quick Ratio} = \frac{\text{Rs. 6,00,000}}{\text{Rs. 6,00,000}} = 1 : 1$$

Illustration 3

Calculate liquidity ratios from the following information :

Total current assets	Rs. 9,00,000
Stock (included in current assets)	Rs. 3,00,000
Prepaid expenses	Rs. 30,000
Current liabilities	Rs. 6,00,000

Solution :

$$\begin{aligned} \text{A. Current Ratio} &= \frac{\text{Current Assets}}{\text{Current Liabilities}} = \frac{\text{Rs. 9,00,000}}{\text{Rs. 6,00,000}} \\ &= 3 : 2 \text{ or } 1.5 : 1 \end{aligned}$$

$$\begin{aligned} \text{B. Liquid Ratio} &= \frac{\text{Current Assets} - (\text{Stock} + \text{Prepaid Expenses})}{\text{Current Liabilities}} \\ &= \frac{\text{Rs. 5,70,000}}{\text{Rs. 6,00,000}} = 0.95 : 1.0 \end{aligned}$$

Illustration 4

The balance sheet of SRK Ltd. shows the following figures :

Total current assets	Rs. 152,000
Cash in hand and at Bank	Rs. 30,000
Fixed Assets	Rs. 113,000
Creditors	Rs. 20,000
5% Debentures	Rs. 24,000
Bill Payables	Rs. 4,000
Debtors	Rs. 18,000
Stock	Rs. 52,000

General reserve	Rs.	8,000
Profit and Loss A/c	Rs.	5,000

Calculate (i) current ratio and (ii) liquid ratio.

Solution :

$$(i) \text{ Current Ratio} = \frac{\text{Current Assets}}{\text{Current Liabilities}}$$

where,

$$\begin{aligned} \text{Current Assets} &= \text{Cash in hand and at bank} + \text{Debtors} + \text{Stock} \\ &= \text{Rs. } 30,000 + \text{Rs. } 18,000 + \text{Rs. } 52,000 \\ &= \text{Rs. } 1,00,000 \end{aligned}$$

$$\begin{aligned} \text{Current Liabilities} &= \text{Creditors} + \text{Bill Payable} \\ &= \text{Rs. } 20,000 + \text{Rs. } 4,000 \\ &= \text{Rs. } 24,000 \\ &= \frac{\text{Rs. } 1,00,000}{\text{Rs. } 24,000} = 4.26 : 1 \end{aligned}$$

$$(ii) \text{ Quick Ratio} = \frac{\text{Current Assets}}{\text{Current Liabilities}}$$

where,

$$\begin{aligned} \text{Quick Assets} &= \text{Current Assets} - \text{Stock} \\ &= \text{Rs. } 1,00,000 - \text{Rs. } 52,000 \\ &= \text{Rs. } 48,000 \end{aligned}$$

$$\text{Quick Ratio} = \frac{\text{Rs. } 48,000}{\text{Rs. } 24,000} = 2 : 1$$

Illustration 5

From the following information, if Rs. 1000 is paid to creditors what will be the effect (increase or decrease or no change) on current ratio, if before payment, balances are : Cash Rs. 15,000, Creditors Rs. 7,500 ?

Solution

$$\begin{aligned}\text{Current Ratio} &= \frac{\text{Current Assets}}{\text{Current Liabilities}} \\ \text{Before payment} &= \frac{\text{Cash}}{\text{Creditors}} = \frac{\text{Rs. 15,000}}{\text{Rs. 7,500}} = 2.1 \\ \text{After payment} &= \text{Rs. 1,000 to creditors} \\ \text{Current Ratio} &= \frac{\text{Cash}}{\text{Creditors}} = \frac{\text{Rs. 15,000} - \text{Rs. 1,000}}{\text{Rs. 7,500} - \text{Rs. 1,000}} \\ &= \frac{\text{Rs. 14,000}}{\text{Rs. 6,500}} = 2.15 : 1\end{aligned}$$

Hence, it increase the current ratio from 2 : 1 to 2.15 : 1

12.7 ACTIVITY OR TURNOVER RATIOS

Activity ratios measure the efficiency or effectiveness with which a firm manages its resources. These ratios are also called turnover ratios because they indicate the speed at which assets are converted or turned over in Revenue from operations (sales). These ratios are expressed as 'times' and should always be more than one. Some of the important activity ratios are:

- (i) Inventory turnover ratio (Stock turnover ratio)
- (ii) Trade Receivables turnover ratio (Debtors turnover ratio)
- (iii) Trade Payables turnover ratio (Creditors turnover ratio)
- (iv) Working capital turnover ratio

(i) Inventory Turnover Ratio (Stock Turnover Ratio)

Inventory turnover ratio is a ratio between cost of revenue from operation and the average inventory. Every firm has to maintain a certain level of inventory of finished goods. But the level of inventory should neither be too high nor too low. It evaluates the efficiency with which a firm is able to manage its inventory. This ratio establishes relationship between cost of revenue from operation and average inventory.

$$\text{Inventory Turnover Ratio} = \frac{\text{Cost of Revenue from Operations}}{\text{Average Inventory}}$$

$$\begin{aligned} \text{Cost of Revenue from Operation} &= \text{Opening Inventory} + \text{Net Purchases} \\ &\quad + \text{Direct expenses} - \text{Closing Inventory} \end{aligned}$$

$$\text{OR Cost of Revenue from Operation} = \text{Net Sales} - \text{Gross Profit}$$

$$\text{Average Inventory} = \frac{\text{Opening Inventory} + \text{Closing Inventory}}{2}$$

- (i) If cost of revenue from operation is not given, the ratio is calculated from revenue from operations (sales).
- (ii) If only closing inventory is given, then that may be treated as average inventory.

Significance

The ratio signifies the number of times on an average the inventory or stock is disposed off during the period. The high ratio indicates efficiency and the low ratio indicates inefficiency of stock management.

Illustration 6

Calculate inventory turnover ratio from the following information :

Opening inventory	Rs. 45000
Closing inventory	Rs. 55000
Net Purchases	Rs. 160000

Solution :

$$\text{Inventory Turnover Ratio} = \frac{\text{Cost of Revenue from Operations}}{\text{Average Inventory}}$$

$$\text{Average Inventory} = \frac{\text{Opening Inventory} + \text{Closing Inventory}}{2}$$

$$\text{Average Inventory} = \frac{\text{Rs } (45,000 + 55,000)}{2}$$

$$= \text{Rs. } 50,000$$

$$\begin{aligned} \text{Cost of Revenue from Operations} &= \text{Opening Inventory} + \text{Net} \\ &\quad \text{Purchases} - \text{Closing Inventory} \\ &= \text{Rs. } 45,000 + \text{Rs. } 1,60,000 - \text{Rs. } 55,000 \\ &= \text{Rs. } 1,50,000 \end{aligned}$$

$$\text{Inventory Turnover Ratio} = \frac{\text{Rs. } 1,50,000}{\text{Rs. } 50,000} = 3 \text{ times}$$

Illustration 7

Opening inventory Rs. 19,000

Closing inventory Rs. 21,000

Net Purchases Rs. 2,00,000

Gross Profit 25% of revenue from operations. Calculate inventory turnover ratio.

Solution :

$$\begin{aligned} \text{Cost of Revenue from Operations} &= \text{Revenue from Operations} - \\ &\quad \text{Gross profit} \\ &= \text{Rs. } 2,00,000 - 25\% \text{ of Rs. } 2,00,000 \\ &= \text{Rs. } (2,00,000 - 50,000) \\ &= \text{Rs. } 1,50,000 \end{aligned}$$

$$\text{Average Inventory} = \frac{\text{Opening Inventory} + \text{Closing Inventory}}{2}$$

$$\begin{aligned}
&= \frac{\text{Rs. } (19,000 + 21,000)}{2} \\
&= \text{Rs. } 20,000 \\
\text{Inventory turn over Ratio} &= \frac{\text{Cost of Revenue from Operations}}{\text{Average Inventory}} \\
&= \frac{\text{Rs. } 1,50,000}{\text{Rs. } 20,000} = 7.5 \text{ times}
\end{aligned}$$

Illustration 8

Annual sales	Rs. 4,00,000
Gross Profit 20% on sales	
Opening Inventory	Rs. 38,500
Closing Inventory	Rs. 41,500

Calculate inventory turnover ratio.

Solution :

$$\begin{aligned}
\text{Inventory turn over Ratio} &= \frac{\text{Cost of Revenue from Operations}}{\text{Average Inventory}} \\
\text{Costs of revenue from Operations} &= \text{Sales - Gross Profit} \\
&= \text{Rs. } 4,00,000 - (20\% \text{ on Rs. } 4,00,000) \\
&= \text{Rs. } 4,00,000 - \text{Rs. } 80,000 \\
&= \text{Rs. } 320,000 \\
\text{Average Inventory} &= \frac{\text{Opening Inventory} + \text{Closing Inventory}}{2} \\
&= \frac{38,500 + 41,500}{2} = \frac{80,000}{2} \\
&= \text{Rs. } 40,000 \\
\text{Inventory turnover Ratio} &= \frac{\text{Rs. } 3,20,000}{\text{Rs. } 40,000} = 8 \text{ times}
\end{aligned}$$

Illustration 9

From the following information calculate opening inventory and closing inventory :

Revenue from operations (sales) during the year	=	Rs. 2,00,000
Gross Profit on Sales	=	50%
Inventory turnover ratio	=	4 times

If closing inventory was Rs. 10,000 more than the opening inventory what will be the amount for the opening inventory and closing inventory ?

Solution :

Revenue from Operations (Sales)	=	Rs. 2,00,000 (given)
Gross profit on sales	=	50% (given)

$$\text{Gross Profit} = 2,00,000 \times \frac{50}{100} = 1,00,000$$

$$\begin{aligned}\text{Cost of Revenue from operation} &= \text{Sales} - \text{Gross Profit} \\ &= \text{Rs. } 2,00,000 - \text{Rs. } 1,00,000 \\ &= \text{Rs. } 1,00,000\end{aligned}$$

$$\text{Inventory Turnover Ratio} = \frac{\text{Cost of Revenue from Operations}}{\text{Average Inventory}}$$

$$4 = \frac{1,00,000}{\text{Average Inventory}}$$

By cross multiplying

$$\text{Average Inventory} = \frac{\text{Rs. } 1,00,000}{4} = \text{Rs. } 25,000$$

$$\text{Average Inventory} = \frac{\text{Opening Inventory} + \text{Closing Inventory}}{2}$$

Let opening inventory be x

$$\text{Closing Inventory} = x + 10,000$$

$$\text{Average Inventory} = \frac{x + x + 10,000}{2} = 25,000 \text{ (given)}$$

$$\begin{aligned}
\text{or } x + x + 10,000 &= 50,000 \\
\text{or } 2x &= 50,000 - 10,000 \\
\text{or } 2x &= 40,000 \\
\text{or } x &= 20,000 \\
\text{Hence, Opening Inventory} &= \text{Rs. } 20,000 \\
\text{Closing Inventory} &= \text{Rs. } 20,000 + \text{Rs. } 10,000 \\
&= \text{Rs. } 30,000
\end{aligned}$$

(ii) Trade Receivable Turnover Ratio (Debtors Turnover ratio)

This ratio establishes a relationship between cost of revenue from operations and average trade receivables ie average trade debtors and bill receivables. The objective of computing this ratio is to determine the efficiency with which the trade receivables are managed. This ratio is also known as Ratio of Revenue from Operations (Net Sales) to Average Trade Receivables. It is calculated as under

$$\text{Trade Receivable Turnover Ratio} = \frac{\text{Credit Revenue from Operations (Net Credit Sales)}}{\text{Average Trade Receivables}}$$

In case, figure of credit revenue from operations (net credit sale) is not available then the sales are treated as credit sales :

Average Trade Receivables =

$$\frac{\text{Opening Debtors \& Bills Receivable} + \text{Closing Debtors \& Bills Receivable}}{2}$$

Note : If opening trade receivables are not available, then closing trade receivables are taken as average trade receivables.

Significance

Debtors turnover ratio is an indication of the speed with which a company collects its debts. The higher the ratio, the better it is because it indicates that debts are being collected quickly. In general, a high ratio indicates the shorter collection period which implies prompt payment by debtor and a low ratio indicates a longer collection period which implies delayed payment for debtors

Illustration 10

Find out trade receivable turnover from the following information for one year ended 31st March 2023.

	31st March 2023
Annual credit revenue from operations	500000
Trade receivable in the beginning	80000
Trade receivable at the end	100000

Average Trade Receivables =

$$\frac{\text{Opening Debtors \& Bills Receivable} + \text{Closing Debtors \& Bills Receivable}}{2}$$

$$\text{Trade Receivable Turnover} = \frac{\text{Credit Revenue from Operations}}{\text{Average Trade Receivables}}$$

$$\text{Average Trade Receivables} = \frac{80,000 + 1,00,000}{2} = \text{Rs. } 90,000$$

$$\text{Trade Receivable Turnover Ratio} = \frac{5,00,000}{90,000} = 5.56 \text{ times}$$

(iii) Trade Receivable Turnover Ratio (Debtors Turnover ratio)

It is a ratio between net credit purchases and average trade payables (i.e creditors and Bill payables). In the course of business operations, a firm has to make credit purchases. Thus a supplier of goods will be interested in finding out how much time the firm is likely to take in repaying the trade payables. This ratio helps in finding out the exact time a firm is likely to take in repaying to its trade payables. This ratio establishes a relationship between credit purchases and average trade payables.

$$\text{Trade Payables Turnover Ratio} = \frac{\text{Net Credit Purchases}}{\text{Average Trade Payables}}$$

Average Trade Receivables =

$$\frac{\text{Opening Debtors} + \text{Opening Bills Payables} + \text{Closing Creditors} + \text{Closing Bills Payables}}{2}$$

Significance

Trade Payables turnover ratio helps in judging the efficiency in getting the benefit of credit purchases offered by suppliers of goods, A high ratio indicates the shorter payment period and a low ratio indicates a longer payment period.

Illustration 11

Calculate trade payables turnover ratio from the following information :

	Rs.		Rs.
Cash purchases	1,00,000	Total Purchases	4,07,000
Opening creditors	25,000	Closing creditors	50,000
Closing bill payables	25,000	Opening bill payables	20,000
Purchase returns	7,000		

Solution :

$$\text{Trade Payables Turnover Ratio} = \frac{\text{Net Credit Purchases}}{\text{Average Trade Receivables}}$$

$$\begin{aligned}\text{Net Purchases} &= \text{Total Purchase} - \text{Purchase Returns} \\ &= \text{Rs. } 407000 - \text{Rs. } 7000 = \text{Rs. } 400000 \\ &= \text{Rs. } 3,00,000\end{aligned}$$

Average Trade Payables

Opening Debtors + Opening Bills Payables + Closing Creditors + Closing Bills Payables

$$\begin{aligned}& \frac{\text{Rs. } 25,000 + \text{Rs. } 20,000 + \text{Rs. } 5,000 + \text{Rs. } 25,000}{2} \\ &= \frac{\text{Rs. } 1,20,000}{2} = \text{Rs. } 60,000\end{aligned}$$

$$\text{Trade Payables Turnover Ratio} = \frac{\text{Rs. } 3,00,000}{\text{Rs. } 60,000} = 5 \text{ times}$$

Illustration 12

Calculate trade payables turnover ratio

Credit purchase during the year	Rs. 14,40,000
Closing creditors	Rs. 1,44,000
Closing Bill Payables	Rs. 96,000

Solution :

$$\begin{aligned}\text{Trade Payables Turnover Ratio} &= \frac{\text{Net Credit Purchases}}{\text{Average Trade Receivables}} \\ &= \frac{\text{Rs. 14,40,000}}{\text{Rs. 1,44,000} + \text{Rs. 96,000}} \\ &= \frac{\text{Rs. 14,40,000}}{\text{Rs. 2,40,000}}\end{aligned}$$

Note : Where opening creditors and opening bill payables are not given then closing creditors and bill payables are taken as average trade payables.

Working Capital Turnover Ratio

Working capital of a concern is directly related to revenue from operations (sales). The current assets like debtors, bill receivables, cash, stock etc, change with the increase or decrease in revenue from operations.

$$\text{Working Capital} = \text{Current Assets} - \text{Current Liabilities}$$

Working capital turnover ratio indicates the speed at which the working capital is utilised for business operations. It is the velocity of working capital ratio that indicates the number of times the working capital is turned over in the course of a year. This ratio measures the efficiency at which the working capital is being used by a firm. A higher ratio indicates efficient utilisation of working capital and a low ratio indicates the working capital is not properly utilised.

This ratio can be calculated as

$$\text{Working Capital Turnover Ratio} = \frac{\text{Cost of Revenue from Operations}}{\text{Average Working Capital}}$$

$$\text{Average Working Capital} = \frac{\text{Opening Working Capital} + \text{Closing Working Capital}}{2}$$

If the figure of cost of revenue from operations is not given, then the figure of revenue from operations (sales) can be used. On the other hand if opening working capital is not given then working capital at the year end will be used.

Illustration 13

Find out working capital turnover ratio for the year 2023.

	Rs.
Cash	10,000
Bills Receivable	5,000
Sundry debtors	25,000
Inventory	20,000
Sundry creditors	30,000
Cost of Revenue from Operations	1,50,000

Solution :

$$\text{Working Capital Turnover Ratio} = \frac{\text{Cost of Revenue from Operations}}{\text{Average Working Capital}}$$

$$\begin{aligned} \text{Current Assets} &= \text{Rs. } 10,000 + \text{Rs. } 5,000 + \text{Rs. } 25,000 + \text{Rs. } 20,000 \\ &= \text{Rs. } 60,000 \end{aligned}$$

$$\text{Current Liabilities} = \text{Rs. } 30,000$$

$$\begin{aligned} \text{Net working capital} &= \text{CA} - \text{CL} = \text{Rs. } 60,000 - \text{Rs. } 30,000 \\ &= \text{Rs. } 30,000 \end{aligned}$$

$$\text{So, Working Capital Turnover Ratio} = \frac{\text{Rs. } 1,50,000}{\text{Rs. } 30,000} = 5 \text{ times}$$

12.8 SOLVENCY RATIOS

The term 'solvency' refers to the ability of a concern to meet its long term obligations. The long-term liability of a firm is towards debenture holders, financial institutions providing medium and long term loans and other creditors selling goods on credit. These ratio indicate firm's ability to meet the fixed interest and its costs and repayment schedules associated with its long term borrowings.

The following ratios serve the purpose of determining the solvency of the business firm.

- Debt equity Ratio
- Interest coverage Ratio
- Proprietary Ratio.

Debt-equity Ratio

It is also otherwise known as external to internal equity ratio. It is calculated to know the relative claims of outsiders and the owners against the firm's assets. This ratio establishes the relationship between the outsiders funds and the shareholders funds. Thus,

$$\text{Debt-equity Ratio} = \frac{\text{Outsiders' Funds}}{\text{Shareholders' Funds}}$$

The two basic components of the ratio are outsiders' funds and shareholders' funds. The outsiders' funds include all debts/liabilities to outsiders i.e. debentures, long term loans from financial institutions, etc. Shareholders' funds mean preference share capital, equity share capital, reserves and surplus and fictitious assets like preliminary expenses. This ratio indicates the proportion between shareholders' funds and the long-term borrowed funds. In India, this ratio may be taken as acceptable if it is 2: 1. If the debt- equity ratio is more than that, it shows a rather risky financial position from the long term point of view.

Significance

The purpose of debt equity ratio is to derive an idea of the amount of capital supplied to the concern by the proprietors. This ratio is very useful to assess the soundness of long term financial position of the firm. It also indicates the extent to which the firm depends upon outsiders for its existence. A low debt equity ratio implies the use of more equity than debt.

Illustration 1

From the following, calculate the debt-equity ratio

	Rs.
Equity Shares Capital	1,00,000
General Reserve	45,000
Accumulated Profits	30,000
Debentures	75,000
Sundry trade creditors	40,000
Outstanding expenses	10,000

Solution :

$$\begin{aligned}\text{Debt-equity Ratio} &= \frac{\text{Debt (Total Long term Loans)}}{\text{Equity (Shareholders Funds)}} \\ &= \frac{\text{Rs. 75,000}}{\text{Rs. 1,75,000}} = 3 : 7\end{aligned}$$

Working Notes : Shareholders' Fund = Equity Share Capital + Reserves + Accumulated Profits

(i) Rs. 1,00,000 + Rs. 45,000 + Rs. 30,000 = Rs. 1,75,000

(ii) Long term debt = Debentures = Rs. 75,000

Illustration 2

Calculate the debt-equity ratio from the following data :

Total Assets Rs. 1,20,000. Total debts Rs. 1,00,000 current liabilities Rs. 60,000.

Solution :

Calculation of debt-equity ratio

$$\begin{aligned}\text{Long Term Debt} &= \text{Total debt - current liabilities} \\ &= \text{Rs. 1,00,000 - Rs. 60,000}\end{aligned}$$

$$\begin{aligned}
 &= \text{Rs. } 40,000 \\
 \text{Shareholders' Fund} &= \text{Total Assets} - \text{total debt} \\
 &= \text{Rs. } 1,20,000 - \text{Rs. } 1,00,000 \\
 &= \text{Rs. } 20,000 \\
 \text{Debt-equity Ratio} &= \frac{\text{Debt (Total Long term Loans)}}{\text{Equity (Shareholders Funds)}} \\
 &= \frac{\text{Rs. } 45,000}{\text{Rs. } 20,000} = 2
 \end{aligned}$$

Proprietary Ratio

It is also known as equity ratio. This ratio establishes the relationship between shareholders' funds to total assets of the firm. The shareholders' funds is the sum of equity share capital, preference share capital, reserves and surpluses. Out of this amount, accumulated losses should be deducted. On the other hand, the total assets mean total resources of the concern. The ratio can be calculated as under:

$$\text{Proprietary Ratio} = \frac{\text{Shareholder's Funds}}{\text{Total Assets}}$$

Significance

Proprietary ratio throws light on the general financial position of the enterprise. This ratio is of particular importance to the creditors who can ascertain the proportion of shareholders' funds in the total assets employed in the firm. A high ratio shows that there is safety for creditors of all types. Higher the ratio, the better it is for concern

A ratio below 50% may be alarming for the creditors since they may have to lose heavily in the event of company's liquidation on account of heavy losses.

Illustration 3

From the following, calculate the proprietary ratio :

Rs.

Equity share capital	1,00,000
Preference share capital	50,000
Reserves and surpluses	25,000
Debentures	60,000
Creditors	15,000
Total	2,50,000
Fixed assets	1,25,000
Current Assets	50,000
Investment	75,000
Total	2,50,000

Solution :

$$\begin{aligned}
 \text{Proprietary Ratio} &= \frac{\text{Shareholders' Funds}}{\text{Total Assets}} \\
 &= \frac{\text{Equity Share Capital} + \text{Preference Share Capital} + \text{Reserve \& Surpluses}}{\text{Total Asset}} \\
 &= \frac{\text{Rs. 1,75,000}}{\text{Rs. 2,50,000}} = 0.7 \text{ or } 70\%
 \end{aligned}$$

Interest Coverage Ratio

This ratio establishes the relationship between Net Profit before Interest and Tax and Interest on long-term debts. It is calculated as follows :

$$\text{Interest Coverage Ratio} = \frac{\text{Net Profit before Interest and Tax}}{\text{Interest on Long-term Debts}}$$

Illustration 4

X Ltd. has a 10% long-term loan of Rs. 20,00,000. Its net profit before interest and tax was Rs. 9,00,000. Calculate interest coverage ratio.

$$\text{Interest Coverage Ratio} = \frac{\text{Net Profit before Interest and Tax}}{\text{Interest on Long-term Debts}}$$

Net profit before interest and tax = 9,00,000

$$\text{Interest on long term loan} = \frac{10}{100} \times 20,00,000 = 2,00,000$$

$$\text{Interest Coverage ratio} = \frac{9,00,000}{2,00,000} = 4.5 \text{ times}$$

Significance

This ratio is very useful to the long term lending agencies like debenture holders and lenders of long term funds as it indicates the number of times the interest on long term funds is covered by profits. A high ratio is considered better for the lenders because provides higher safety margin.

32.5 PROFITABILITY RATIOS

The main aim of an enterprise is to earn profit which is necessary for the survival and growth of the business enterprise. It is earned with the help of amount invested in business. It is necessary to know how much profit has been earned with the help of the amount invested in the business. This is possible through profitability ratios. These ratios examine the current operating performance and efficiency of the business concern. These ratios are helpful for the management to take remedial measures if there is a declining trend. The important profitability ratios are :

- (i) Gross Profit Ratio
 - (ii) Net Profit Ratio
 - (iii) Operating Profit Ratio
 - (iv) Return on Investment Ratio
- (i) Gross Profit Ratio**

It expresses the relationship of gross profit to revenue from operations (net sales). It is expressed in percentage. It is computed as

$$\text{Gross Profit Ratio} = \frac{\text{Gross Profit}}{\text{Revenue from Operations (Net Sales)}} \times 100$$

Where,

Net Sales = Total sales - (sales returns + excise duty)

Gross Profit = Revenue from operations - Cost of revenue from operations

Gross profit ratio shows the margin of profit. A high gross profit ratio is a great satisfaction to the management. It represents the low cost of revenue from operations. Higher the rate of gross profit, lower the cost of revenue from operations.

Illustration 5

From the following detail of a business concern ascertain the gross profit ratio :

Details	2022	2023
	(Rs.)	(Rs.)
Revenue from operations (sales)	1,20,000	1,60,000
Gross Profit	40,000	60,000

Solution :

$$2022 \quad \text{Gross Profit Ratio} = \frac{\text{Rs. } 40,000}{\text{Rs. } 1,20,000} \times 100 = 33.33\%$$

$$2023 \quad \text{Gross Profit Ratio} = \frac{\text{Rs. } 60,000}{\text{Rs. } 1,60,000} \times 100 = 37.5\%$$

Illustration 6

Calculate the gross profit ratio from the following data :

Sales Rs. 3,25,000 sales returns Rs. 25,000 and cost of revenue from operations Rs. 2,40,000.

Solution :

$$\text{Gross Profit Ratio} = \frac{\text{Gross Profit}}{\text{Revenue from Operations (Net Sales)}} \times 100$$

$$\begin{aligned} \text{Gross Profit} &= \text{Net sales} - \text{Cost of revenue from operations} \\ &= 300,000 - 2,40,000 = 60,000 \end{aligned}$$

$$\text{Gross Profit Ratio} = \frac{\text{Rs. } 60,000}{\text{Rs. } 3,00,000} \times 100 = 20\%$$

Note : Net Sales = Sales - Sales return = 3,25,000 - 25,000 = Rs. 3,00,000

(ii) Net Profit Ratio

A ratio of net profit to revenue from operations (sales) is called Net Profit

WHAT YOU HAVE LEARNT

- Analysis of financial statements means establishing meaningful, relationship between various items of the two financial statements i.e. income statement and position statement.
- Limitations of Financial Analysis
 - (i) Affected by window dressing
 - (ii) Do not reflect changes in price level.
 - (iii) Different Accounting policies.
 - (iv) Difficulty in forecasting.
 - (v) Limitations of financial statements.
- The main parties interested in analysis of financial statements are

(i) Investors	(ii) Management
(iii) Trade unions	(iv) Lenders
(v) Trade creditors	(vi) Employees
(vii) Tax authorities	(viii) Government
(ix) Stock exchange	(x) Researchers
- The major tools for financial statement analysis are :
 - (i) Comparative Statement
 - (ii) Common Size Statement

(iii) Ratio and analysis

(iv) Funds flow analysis

(v) Cash flow analysis

- Comparative study of financial statements is the comparison of the financial statements of the business with the previous years financial statements.
- Comparative Balance Sheet shows the different assets and liabilities of the firm on different dates to make comparison of balances from one date to another.
- Common size balance sheet items are expressed in the ratio of each asset to total assets and the ratio of each liability is expressed in the ratio of total liabilities.
- The term ratio means an arithmetical relationship between two numbers.
- Advantages and uses of Ratio Analysis
 - (i) Useful in Analysis of Financial Statements.
 - (ii) Useful in Simplifying Accounting Figures.
 - (iii) Useful for Forecasting.
 - (iv) Useful in Locating the Weak spots.
- Liquidity ratios assesses the capacity of the firm to repay short term liability. It measures the ability to fulfil short term commitments out of liquid assets.

The important liquidity ratios are :

- (i) Current Ratio : It measures the short term solvency of a business

$$\text{Current Ratio} = \frac{\text{Current Assets}}{\text{Current Liabilities}}$$

- (ii) Liquid Ratio : It measures the ability of the firm to pay current liabilities immediately

$$\text{Liquid Ratio} = \frac{\text{Liquid Assets}}{\text{Current Liabilities}}$$

$$\text{Liquid assets} = \text{Current assets} - (\text{Inventory} + \text{Prepaid expenses})$$

- Activity or turnover ratios measures the effectiveness with which a concern uses resources at its disposal.

- The important activity ratios are

- (i) Inventory turnover ratio : It measures the efficiency with which the Inventory is managed.

$$\text{Inventory Turnover Ratio} = \frac{\text{Cost of Revenue from Operations}}{\text{Average Inventory}}$$

- (ii) Trade Receivable turnover ratio : It is calculated to indicate the efficiency of the company to collect its debts.

$$\text{Trade Receivable Turnover Ratio} = \frac{\text{Revenue from Operations}}{\text{Average Trade Receivable}}$$

- (iii) Trade Payable turnover ratio : It indicates the efficiency with which suppliers are paid.

$$\text{Trade Payable Turnover Ratio} = \frac{\text{Net Credit Purchases}}{\text{Average Trade Payables}}$$

Terminal Exercise

Section - A

1. Financial Statement Analysis
2. Ration Analysis
3. Common Size Statement
4. Current Ratio
5. Liquid Ratio
6. Inventory Turnover Ratio
7. Debt Equity Ratio
8. Proprietary Ratio
9. Gross Profit Ratio
10. Net Profit Ratio
11. Operatig Profit Ratio

Section - B

1. State any four tools which are commonly used for analysing and interpreting financial statements.
2. What are the main limitations of financial Analysis ? Explain in detail.
3. What are the main techniques of financial statement analysis ?
4. Briefly explain the parties interested in analysis of financial statements.
5. What are the Advantages and use of ratio analysis ? Explain in detail.
6. Explain the significance of trade receivable turnover ratio and liquid ratio.
7. Explain the meaning and significance of the following ratios.
 - (a) Current ratio
 - (b) Trade Payables turnover ratio
 - (c) Inventory turnover ratio

Section - C

1. Write a brief note on comparative statement, common size statement and trend analysis.
2. Following are the Balance Sheets of Rama Ltd. as at 31st March, 2023 and 2022.

<i>Particulars</i>	<i>31st March 2023 (Rs)</i>	<i>31st March 2022 (Rs)</i>
I. Equity and Liabilities		
1. Shareholder's Funds		
(a) Share Capital	9,00,000	7,50,000
(b) Reserves and Surplus	3,30,000	2,85,000
2. Non-Current Liabilities		
Long-term Borrowings		
12% Debentures, Secured	3,00,000	4,50,000

3. Current Liabilities		
(a) Short-term Borrowings	1,40,000	1,70,000
(b) Trade Payables	2,00,000	1,50,000
(c) Other Current Liabilities	60,000	45,000
(d) Short-term Provisions	20,000	10,000
Trade Payables	5,00,000	3,00,000
Total	19,50,000	18,60,000
II. ASSETS		
1. Non-Current Assets		
(a) Fixed Assets	9,55,000	10,45,000
(b) Non-Current Investments	2,00,000	2,00,000
2. Current Assets		
(a) Inventories	2,50,000	2,00,000
(b) Trade Receivables	2,50,000	2,25,000
(c) Cash and Cash Equivalents	1,95,000	1,10,000
(d) Other Current Assets	1,00,000	80,000
	19,50,000	18,60,000

You are required to prepare Comparative Balance Sheet on the basis of the information given in the above Balance Sheets.

10. From the following Statements of Profit and Loss, prepare Comparative Statement of Profit and Loss (Income Statement) :

<i>Particulars</i>	<i>31st March 2023 (Rs)</i>	<i>31st March 2022 (Rs)</i>
I. Income		
Revenue from Operations (Sales)	19,20,000	16,00,000
II. Expenses		
Purchases of Stock-to-Trade	11,70,000	9,50,000
Change in Inventories of Stock-in-Trade	(10,000)	50,000
Employees Benefit Expenses	3,80,000	2,80,000
Other Expenses	1,50,000	2,00,000
Total	16,90,000	14,80,000
III. Net Profit (I-II)	2,30,000	1,20,000

11. Prepare Comparative Balance Sheet of RSR Ltd. :

<i>Particulars</i>	<i>31st March 2023 (Rs)</i>	<i>31st March 2022 (Rs)</i>
I. Equity and Liabilities		
1. Shareholder's Funds		
(a) Share Capital	15,00,000	10,00,000
(b) Reserves and Surplus	10,00,000	10,00,000
2. Non-Current Liabilities		
Long-term Borrowings	8,00,000	2,00,000
3. Current Liabilities		
Trade Payables	5,00,000	3,00,000
Total	38,00,000	25,00,000
II. ASSETS		
1. Non-Current Assets		
Fixed Assets :		
(i) Tangible Assets	25,00,000	15,00,000
(ii) Intangible Assets	5,00,000	5,00,000
2. Current Assets		
(a) Trade Receivables	6,00,000	3,50,000
(b) Cash and Cash Equivalent	2,00,000	1,50,000

12. From the following compute current ratio and quick ratio :

	Rs.
Fixed Assets	1,50,000
Inventory	45,000
Debtors	30,000
Cash	60,000
Prepaid Expenses	15,000
Creditors	45,000
Reserves	15,000

13. Following figures have been extracted from the books of PRS Ltd. as on 31st December 2022 is

	Rs.		Rs.
Equity share capital	1,00,000	Cash in hand	20,000
7% debentures	1,00,000	Cash at Bank	20,000
Bank Overdraft	40,000	Bill receivables	1,00,000
Creditors	40,000	Investment	10,000
Debtors	50,000	General Reserve	30,000
Inventory	1,50,000		

Cost of Revenue from operations during the year 2014 were Rs. 4,70,000. Calculate inventory turnover ratio.

14. Given : Current ratio 5 : 2
Liquidity ratio 3 : 2
working capital Rs. 90,000

Calculate (a) Current liabilities (b) Current Assets (c) Liquid assets (d) Stock

15. XYZ Ltd. supplies you following information regarding the year ending 31st, December 2022.

Cash sales	Rs. 80,000
Credit sales	Rs. 2,00,000
Return inward	Rs. 10,000
Opening inventory	Rs. 25,000
Closing inventory	Rs. 30,000