CHARTERED ACCOUNTANCY PROFESSIONAL (CAP) -I

STUDY MATERIAL

Fundamentals of Accounting

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Study Material

Fundamentals of Accounting

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The Institute of Chartered Accountants of Nepal

Satdobato, Lalitpur

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Preface

This Study material on the subject "Fundamentals of Accounting" has been prepared for the students of Chartered Accountancy Professional (CAP I) New Course with an objective to provide basic and conceptual understanding of the fundamental of financial accounting system, to apply the theory to basic financial accounting issues and process financial transactions, and to prepare accounting statements of proprietorship, partnership as well as not for profit entities.

This study material has been divided into eight chapters and each chapter has been divided into units, each unit deals with the detailed contents of the syllabus and concepts on the topic more comprehensively. Therefore, students are requested to familiarized with the syllabus of the subject, read each topic thoroughly, and solve problems independently to evaluate their understanding on the topic. After reading the material and solving the illustrations independently this will help them to solve the questions given at the end of each unit in an examination condition to generate self-confidence.

Adequate number of objective questions practical problems with solutions has been incorporated in the material to clarify fundamental concepts of Accounting. Further, at the end of each unit, gives summary of the topic has been incorporate to make the subject interesting and comprehensible.

We believe, this material will be of great help to students of CAP –I . However, they are advised to study and practice number of problems from the other recommended reference books given in the chartered Accountancy professional scheme and syllabus. Last but the most, we acknowledge the efforts of CA. Dinesh K.C., who has meticulously assisted for updating this study material. Likewise, CA. Sachet Lal Shrestha, who has reviewed this study material for building in this comprehensive shape.

Due care has been taken to make every chapter simple, comprehensive and relevant for the students while preparing this material. In case students need any clarification or have any suggestions to make the material for further improvement, they may be forwarded to Education Division at the institute

Education Division

The Institute of Chartered Accountants of Nepal

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CHAPTER- 1

Fundamentals of Accounting: Introduction

UNIT 1:

Types of Business

Learning Objectives

1. Acquire general knowledge of business;
2. Be familiar with profit making and not for profit organizations;
3. Identify various types of business set up and their legal forms; and
4. Understand the capital structure of different business set ups.

1 INTRODUCTION

The term "business" relates to the state of being busy doing commercially viable and profitable activities. It refers to a legally recognized organization designed to provide goods and/or services to the consumers. The world today and all its economic activities are carried out under different forms of business set up. We can see various types of business organizations that are primarily established with an objective to earn profit with a notable exception not to earn profit. Such organizations are incorporated under various legal forms prescribed in the laws of the nation. As such the most commonly established business organizations in the context of our country are discussed in following paragraphs.

1.1 Sole Proprietorship

Sole proprietorships are businesses that are owned by one individual and usually operated by that individual. Most often, the owner, who is also called the “proprietor”, manages the overall activities of the business. Therefore, sole proprietorship tend to be small retail establishments and individual professional business, such as neighborhood restaurants and dispensary, law firm, accounting or other services firm etc. The capital required for to the conduct of the business is invested solely by the owner himself/herself. The major disadvantage of the sole proprietorship is the unlimited legal liability. Because owners are not legally distinct from their businesses, any claims against sole proprietorships are also claims against the owners’ personal assets

1.2 Partnership

The partnership is association of two or more person who comes together with a common object of conducting the business and sharing the profit and loss as per the agreed terms and conditions. Partnerships are very similar to sole proprietorships, except that partnerships have more than one owner. The partnership business are formed in accordance with the prevailing laws that prescribes the ceiling of the partners based on the types and the nature of the business activities. The capital required for to the conduct of the business is contributed by the partners as per the partnership deed. Partnerships are not separate legal entities apart from their owners, but they are separate accounting entities. The liabilities of partners are unlimited so each partner may be held liable for all the debts of the partnership and for the actions of each partner within the scope of the business.

1.3 Company

According to Haney, “ A company is an incorporated association which is an artificial person created by law, having a separate entity, with a perpetual succession and a common seal.

According to Chief Justice Marshall, “Company is a person, artificial, invisible, intangible and existing only in the eyes of the law. It has no physical existence but exits only in contemplation of law.”

A company is a body corporate consisting of aggregation of person with capital divided into numerous transferable shares formed to carry out a particular purpose. It is considered as an artificial person created by law to achieve the objective for which it is formed. A company is incorporated under the Companies Act of the country. Companies differ substantially from sole proprietorships and partnerships because they are separate legal entities. A company must develop bylaws governing its operation, issue shares to its owners to represent their ownership interests, elect a board of directors who are responsible for the management of the company, pay taxes, and adhere to a variety of laws and regulations. e

Type of Companies

a. On the basis of the Ownership

i. Public Limited Companies

It is a company which by its Article of Association

- Must have at least seven member
- Free to make an invitation to the general public to subscribe to its shares and debenture
- Puts no restriction on the right of member to transfer their share
- Must use the words " Limited" in its name

ii. Private Limited Companies

It is a company which by its Article of Association

- Limits the number of its member to 101
- Prohibits any invitation to the public to subscribe any shares or debentures
- Restricts the rights of its member to transfer its share to general public
- Must use the words " Private Limited " in its name

b. On the basis of the Functions

i. Manufacturing Company

The company which is involved in production of any kind of goods is called manufacturing company. This type of companies processes the raw material in factory and produces the goods. So this type of company should have processing unit (factory). For example Cement Factory, Sugar Mills, Paper Mills etc.

ii. Trading Company

The company which doesn't produce goods itself but involve in buying and selling activity (trading activity) of goods produced by other companies is called trading company. This type of company buys goods from the manufacturer and sells to the customers. So, this type of company doesn't have factory for processing. For example Nepal Oil Corporation, Morang Auto Works, Salt Trading Corporation etc.

iii. Service Oriented Company

The company whose activity is only to provide services to customers is called service oriented company. These companies don't deals with goods. So, this type of companies also don't need factory for processing. For example, Banks, Insurance Companies, Airlines etc.

1.4 Cooperatives

The cooperatives are similar to the companies in terms of legal status except that they are incorporated under the Cooperative Societies Act of the country and are an autonomous association of persons united voluntarily to meet their common economic, social and cultural needs and aspirations through a jointly-owned and democratically-controlled enterprise. It is a business organization owned and operated by a group of individuals for their mutual benefit.

Cooperatives are based on the values of self-help, self-responsibility, democracy and equality. According to the tradition of their founders, cooperative members believe in the ethical values , honesty, openness, social responsibility and caring for others. Such legal entities have a range of unique social characteristics. Membership is open to anyone who satisfies certain non-discriminatory conditions. Economic benefits are distributed proportionally according to each member's level of participation in the cooperative, for instance distribution based on sales or purchases, rather than capital invested. Cooperatives may be generally classified as either consumer cooperatives or producer cooperatives. Cooperatives are closely related to collectives, which differ only in that profit-making or economic stability is placed secondary to adherence to social-justice principles. There are various types of cooperative organizations which is governed by their specific objective and area of services. These are housing cooperative, building cooperative, retailers' cooperative, utility cooperative, worker cooperative, business and employment cooperative, social cooperative, consumer cooperative, agricultural cooperative, cooperative banking (credit unions and cooperative savings banks) etc.

1.5 Trust

A trust is a written arrangement between an owner and the trustees. The owner hands over property and/or funds to a group of people (called trustees) who look after the property and funds and uses it for the benefit of the other people (called beneficiaries) for a specific objective. A trust is operated by a Board of Trustees and a Deed of Trust will state the powers and duties of a trust. Trustees can be paid for the work they do for the trust.

Trust can be a private or public charitable trust. In a private trust, the beneficiaries are one or more ascertainable individuals. In a public trust, the beneficiaries are a body of uncertain or fluctuating individuals and may consist of a class of the public or the whole public. Generally, a private trust is not permanent one. But a public trust is of a permanent nature.

Any person competent to contract and competent to deal with property can form charitable trust. Besides individuals, a body of individuals or an artificial person such as an association of persons, an institution, a limited company can also form trust. Every person capable of holding property can become a trustee.

The trust deed is the founding document of a trust. A notary public must write and attest trust deed and the trust must be registered. Any changes to trust deed at any stage should be notified.

Legal title of the property of a public charitable trust vests with the trustees. Trustees of a public charitable trust may not, however, in any way use trust property or their position for their own interest or private advantage. Trustees may not enter into agreements in which they may have a personal interest that conflicts or may possibly conflict with the interests of the beneficiaries of the trust (whose interests the trustees are bound to protect). Trustees may not delegate any of their duties, functions or powers to a co-trustee or any other person, except that trustees may delegate managerial acts. In essence, trustees may not delegate authority with respect to duties requiring the exercise of discretion.

1.6 Social Club

A social club may refer to a group of people, generally formed around a common interest, occupation or activity (e.g. hunting, fishing, recreation, politics or charity work). Generally, social club is required to register under prevailing laws. Many social clubs are democratically organized just like a company and the member or beneficiaries get information similar to that provided to a shareholder. But the surplus of these organizations is not distributed among its members by way of dividend as it is done in case of a company. These clubs are centered on the activities available to the club members in the city or area in which the club is located. Some have a traditional club house, bar or restaurant where members gather, others do not.

Events can include a broad range of activities from sporting events and social parties to the Ballet, the arts or book clubs. Unlike traditional clubs they are not limited to one kind of event or special interest, but include a broad range of events in their monthly calendars. The members choose which events the club is going to take part in based upon the changing interests of the members. The members themselves determine which events, of those offered, they will attend.

Membership of these clubs can be limited or open to the general public, as can the events. Most clubs have a limited membership based upon specific criteria, and restrict the events to the members to increase their feeling of security, creating an increased sense of camaraderie and belongingness. Financing of these organizations are dependent on the donations given by members or outsider. A substantial portion of the resources of an organization are donated, the organization must account for the resources and to spend the funds of the organization in such a fashion that provides maximum benefit to the members.

1.7 Not-for-profit Organization

A Not-for -Profit organization is any organization that does not aim to make a profit or an organization that does not have financial profit as a main strategic objective, and which is not a public body. These organizations are not situated in either the public or private sectors, but in what has been called the third sector. Profit organizations exist to earn and distribute taxable business earnings to its shareholders, the Not-for-Profit organizations exist solely to provide program and services that are of public benefit. Often these program and services are not otherwise provided by local, state or other government entities. Not-for-Profit organization may have paid staff and working capital but their fundamental purpose is to serve people for noble cause. They are led by values rather than financial commitment to the stakeholders. While they are able to earn profit, more accurately called a surplus, such earning are retained by the organization for its future provision of program and services. Not-for-Profit organizations include charities, professional association, labour union, religious, arts, community and service organization. They may be organized as a non-for-profit entity or as a trust, a cooperative, or they may be purely informal.

Summary

In this unit we have discussed on the topic of business and its various types. We are able to understand that the business activities are carried out under many different legal forms with a primary objective of earning profit in general. Besides, we are also familiar with those Not-for-Profit organizations that are dedicated towards providing services to the society. Further, we have a brief idea on the capital structure of those various business organizations as well.

Self-Examination Questions

I. Multiple Choice Questions (MCQs)

1. Business run by a single person is called

(a) Partnership (b) Company
(d) Sole Proprietorship (d) None of the above

2. Which of the company cannot issue shares to general public?

(a) Public Limited company (b) Private Limited Company
(d) Co-operatives (d) All of the above

3. Co-operatives are registered under ;

(a) Companies Act (b) Co-operative Societies Act
(d) Partnership Act (d) None of the above

II. Short Descriptive Questions (SDQs)

1. Discuss briefly the term business and its objectives.
2. Is it necessary that the business should only be established with an objective of earning financial returns?
3. Discuss the different forms of business organizations in light with their capital structure (ownership investment).

ANSWER

Multiple Choice Questions (MCQs)

1	**c**	**2**	**b**	**3**	**b**

CHAPTER- 1

Fundamentals of Accounting: Introduction

UNIT 2:

Definition and Scope of Accounting

Learning Objectives:

1. *Try to learn the meaning of 'transaction and events'.*
2. *Be familiar with the various definitions of accounting and understand its meaning.*
3. *Understand the concept of accounting as language of business.*
4. *Try to learn the functions or purposes of accounting information.*
5. *Understand the various branches of accounting.*
6. *Identify the various user groups whom are dependent upon the accounting information.*
7. *Analyze the relationship of accounting with Economics, Statistics, Mathematics, Law and Management.*

2.1 INTRODUCTION

From an individual to the business organizations, everyone enters to some kind of economic activities in their day to day life. For instance, a trader purchases trading goods and sells it in the market to earn profit, a salaried person gets monthly pay and spends it in his household needs etc. are all some kinds of economic activities. All such activities are performed through **'transactions and events',** where transaction means 'a business, performance of an act, an agreement' while **event** means 'a happening, as a consequence of transaction(s), a result.'

Illustration 1

A business house invests Rs. 10 million for establishing a garment factory. During the year it purchased cloth worth Rs. 5 million, spent additional Rs. 2 million for stitching the cloth into readymade garment and finally sold the ready-made garment in the market for Rs. 8 million. The business house paid factory rent of Rs.0.5 million and finds that there still is stock worth Rs. 1 million in hand. Here the business house performed economic activities through a series of transactions and encountered with some events. Hence, is it not logical that the business house wants to know the result of its activities.

The result of the above activities of the business house is given below:

Particulars	**Rs. in million**	
Sales of Readymade Garment		8
Stock in hand		1
		9
Less:		
Cloth purchased	5	
Stitching cost	2	
Rent paid	0.5	**7.5**
Profit		**1.5**

In the above case, earning profit Rs. 1.5 million is an event; also having stock in hand is another event, while purchasing cloth, stitching, selling readymade garments and payment of rent are the transactions.

Hence it is well understood that everybody has an interest in keeping records of all the transactions and events so as to derive adequate information about the economic activity to aid in their decision making. Accordingly, accounting discipline has been developed to serve that very purpose of recording the transactions and events so as to extract suitable information to aid decision making regarding any type of economic activity ranging from personal to corporate affairs.

2.2 BOOK-KEEPING

"***Book-keeping is the art of recording business transactions in a systematic manner***". A.H.Rosen kamph.

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

Book- keeping includes recording of journal, posting in ledgers and balancing of accounts. All the records before the preparation of trail balance is the whole subject matter of book- keeping. Thus, book- keeping many be defined as the science and art of recording transactions in money or money's worth so accurately and systematically, in a certain set of books, regularly that the true state of businessman's affairs can be correctly ascertained. Here it is important to note that only those transactions related to business are recorded which can be expressed in terms of money.

Advantages of Book- keeping

i) Book- keeping provides a permanent record of each transactions.
ii) Soundness of a firm can be assessed from the records of assets and abilities on a particular date.
iii) Entries related to incomes and expenditures of a concern facilitate to know the profit and loss for a given period.
iv) It enables to prepare a list of customers and suppliers to ascertain the amount to be received or paid.
v) It is a method which gives opportunities to review the business policies in the light of the past records.
vi) Amendment of business laws, provision of licenses, assessment of taxes etc., are based on records.

2.3 ACCOUNTING

Merely 'account' means a record and 'accounting' means the way of keeping record. But in standard term 'accountancy' or 'accounting', is the process of communicating information about a business entity to users. Accounting is often called language of the business. The basic function of the language is to communicate business related information.

Accounting has been defined by the American Institute of Certified Public Accountants (AICPA) in 1961 as ***"Accounting is the art of recording, classifying, and summarizing in a significant manner and in terms of money, transactions and events which are, in part at least, of a financial character, and interpreting the result thereof".***

This definition is regarded as traditional view of accounting, where accounting is simply an art of record keeping. Every good record keeping system includes suitable classification of transactions and events as well as their summarization for ready reference. Essentially the transactions and events are to be measured in terms of money. Measurement in terms of money means measuring at the ruling currency of the country. For example, rupees in Nepal, dollar in USA, pound in UK etc. The transactions and events must have at least in part, financial characteristics. The appointment of a CEO in a company is an event without having financial character, while the revenue generated in the business under his leadership is an event having financial character. Accounting also interprets the recorded, classified and summarized transactions and events.

However, the above mentioned definition does not reflect the present day accounting function. The dimension of accounting is much broader than that described in the above definition.

A widely accepted definition of accounting is given by the American Accounting Association as: ***"The process of identifying, measuring and communicating economic information to permit informed judgment and decisions by the users of accounting information"***

The study of the various elements of the above definition shows the role of accounting although many of its implications may become clear as the course advances.

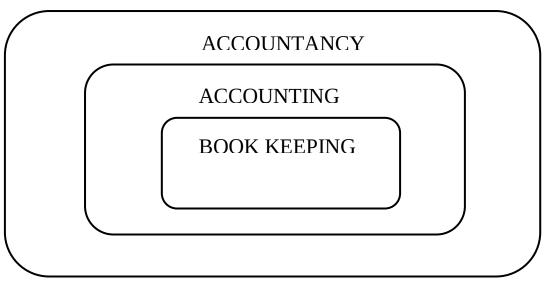
(1) There are certain users of accounting information. Earlier it was viewed that accounting is for the proprietor or owner of the business, but changing social relationships diluted the earlier thinking. It is now believed that users of accounts include the investors, employees, lenders, suppliers and other trade creditors, customers, government and other agencies and the public at large.

(2) The users need information for making decisions and other economic judgments. The data provided by accounting system should be relevant and reliable to make the decisions.

(3) Accounting is a process of identifying, generating, recording and communicating such information to the users. Transactions and events are measured by common measurement unit, i.e. money and communicated to the users of accounts through accounting. Communication does not mean haphazard presentation of information. Accounting provides the art of presenting information systematically to the users of accounts.

So, accountancy, or accounting, is the production of information about an enterprise economic activities and the communication of that information from those who have it to those who need it. The communication is generally in the form of financial statements that show in money terms, the economic resources under the control of management;

RELATIONSHIP BETWEEN ACCOUNTANCY, ACCOUNTING & BOOK KEEPING



From above chart it is clear that Book keeping is part of Accounting & Accounting is itself a part of Accoutancy Subject.

2.4 DISTINCTION BETWEEN BOOK-KEEPING AND ACCOUNTING

The difference between book-keeping and accounting can be summarized in a tabular from as under:

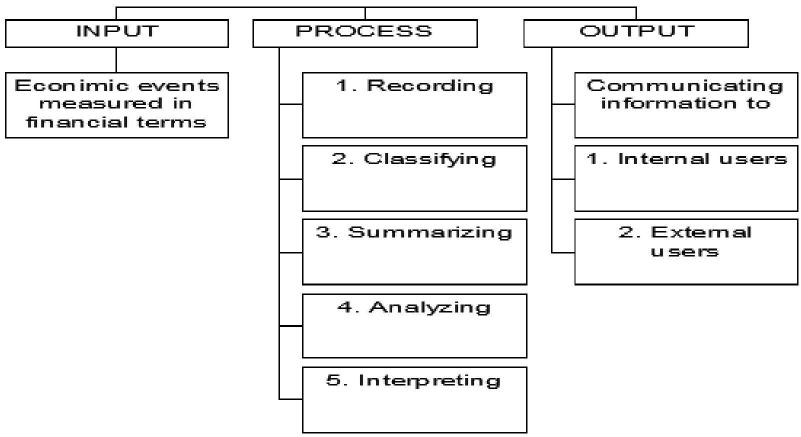
Basis of Difference	Book-keeping	Accounting
Transactions	Recording of transactions in books of original entry	To examine these recorded transactions in order to find out their accuracy.
Posting	To make posting in ledger	To examine this posting in order to ascertain its accuracy.
Total and Balance	To make total of the amount in journal and accounts of ledger.	To ascertain balance in all the accounts. To prepare trial balance with the help of balances of ledger accounts.
Income Statement and Statement of Financial Position	Preparation of trading, Profit & loss account and Statement Of Financial Position is not book keeping	Preparation of trading, profits and loss account and Statement Of Financial Position is included in it.
Rectification of errors	These are not included in book-keeping	These are included in accounting.
Special skill and knowledge	It does not require any special skill and knowledge as in advanced countries this work is done by machines.	It requires special skill and knowledge.
Liability	A book-keeper is not liable for accountancy work.	An accountant is liable for the work of book- keeper.

2.5 ACTIVITIES COVERED UNDER ACCOUNTING

The first part of the definition of accounting related to collecting and recording transactions refers to double-entry bookkeeping, which consists of maintaining a record of the nature and money value of the transactions of an enterprise. The second part of the definition, relating to communicating the results, refers to preparing final accounts and statements from the books of account (or any other system of recording), showing the profit earned during a given period and the financial state of affairs of a business at the end of that period.

These two activities of accounting may be broken down further as described below.

ACTIVITIES COVERED UNDER ACCOUNTING INFORMATION SYSTEM



i. Identifying – The first step in accounting is to identify the transactions and events that hosts a financial characteristics. As already discussed in the introductory paragraph transaction means 'a business, performance of an act, an agreement' while event means a 'happening, as a consequence of transaction(s), a result.'

ii. Measuring – The identified financial transactions and events are then measured in monetary terms. Measurement in terms of monetary terms means measuring at the ruling currency of the country. For example, rupees in Nepal, dollar in USA, pound in UK etc.

iii. Recording- The identified and measured financial transactions and events are systematically recorded in the books of account. The systematic recording of the transactions is made in a book called ***"Journal Book***".

iv. Classifying- The recorded transactions and events are classified so as to group the transactions of identical nature to one place . Mere recording of transaction may not provide useful and relevant information so classification of transaction is required to draw meaningful facts by grouping the transactions in usable form. This function is done by maintaining the ***"Ledger"*** in which different accounts are opened and transactions of similar nature are brought to one place by posting.

v. Summarizing- The classified transactions and events are summarized into various heads to explain the transaction meaningfully. This function involves the preparation of following financial statements.

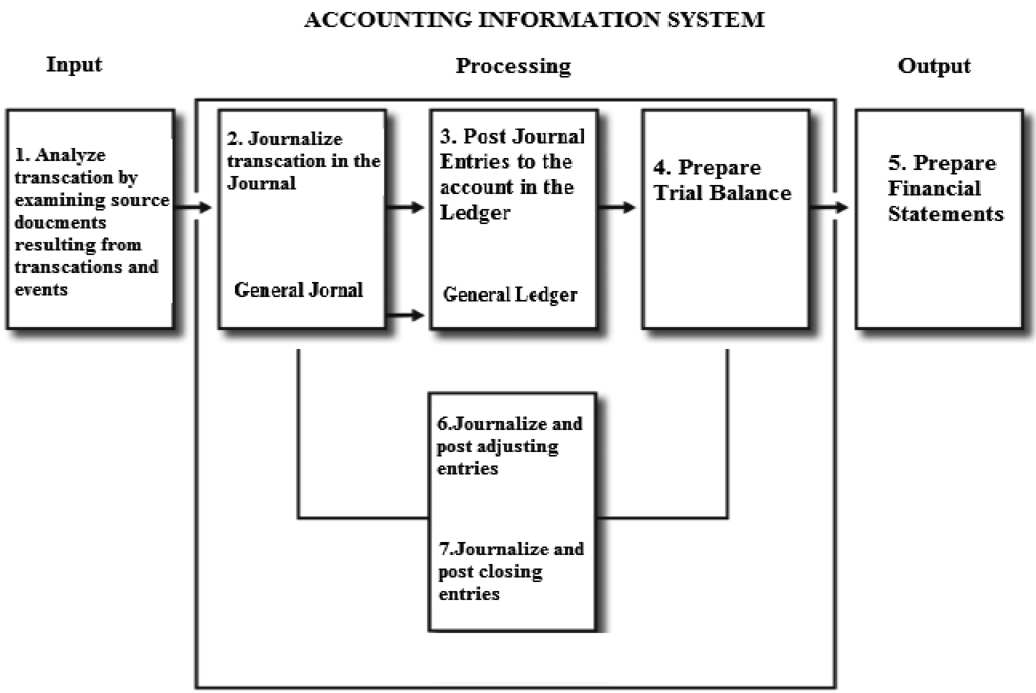
- Trial Balance
- Statement of Profit or Loss
- Statement Of Financial Position
- Cash Flow Statement

vi. Analyzing- Once the financial statements are prepared, then the information received from those financial statements are compared and analyzed to extract meaningful facts by establishing relation between various items of the Statement Of Financial Position, Statement of Profit or Loss, cash flows etc.

vii. Interpreting- It is concerned with explaining the meaning and significance of the relationship so established by the analysis. The interpretation of statements enables the user to make appropriate decisions out of alternative course of action. The preparer of the financial statements should explain not only what happened but also why it happened and what is likely to happen under specified conditions.

viii. Communicating- It is concerned with dissemination of summarized, analyzed and interpreted information to the user to enable them to make reasoned decisions. The ultimate aim of accounting is to communicate necessary information to user which could be relevant for making rational decision. Because accounting is the language of business whatever information is communicated, should have a definite meaning and helpful for assessing financial status as well as performance of enterprises. It is an information system which communicates the accounting information to the user (whether insider or outsider) to enable them to make economic decisions.

As an information system, accounting may be viewed as under:



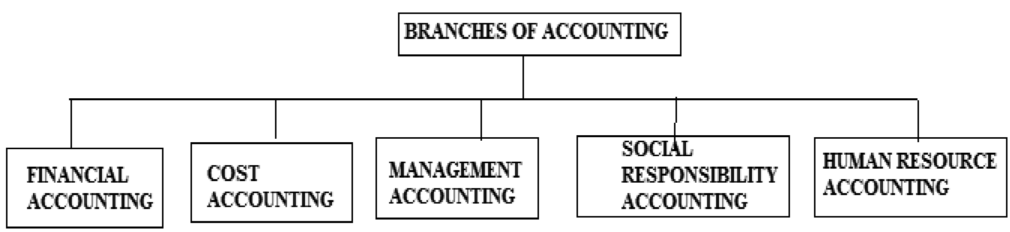
2.6 FUNCTIONS OF ACCOUNTING INFORMATION

The main functions of accounting information are as per below:

i. **Measurement:** Measurement of past performance of the organization and depicting its current financial position.
ii. **Forecasting:** Forecasting is a planning tool that helps management in its attempts to cope with the uncertainty of the future, relying mainly on data from the past and present and analysis of trends. Forecasting starts with certain assumptions based on the managements experience, knowledge and judgments. These estimates are projected into the coming months or years. Since any error in the assumptions will results in a similar or magnified error in forecasting, the techniques of sensitivity analysis is used which assigns a range of values to the uncertain factor (variables).
iii. **Decision-making:** Providing relevant information to the users of accounts to aid decision making.
iv. **Evaluation:** Assessing performance achieved in relation to targets.
v. **Control:** Identifying weaknesses of the operational system and providing feedback on effectiveness of measures adopted to check such weaknesses.
vi. **Stewardship:** Accounting for the uses of owner's funds wherein the management and owners are separated. For instance: Public Companies.
vii. **Government Regulation and Taxation:** Facilitates government to exercise control on the entity as well as collection of tax revenue.

2.7 SUB-FIELD/BRANCHES OF ACCOUNTING

Accounting communicates the financial information to variety of user by developing financial report and statements. To satisfy the needs of information to variety of user, various types/branches of accounting come into existence such as Financial Accounting, Cost Accounting, Management Accounting , Social Responsibility Accounting and Human Resource Accounting



i. **Financial Accounting:** Financial accounting is the part of accounting which is mainly concerned with the historical, custodial and stewardship aspects of external reporting to the shareholders, government and the other users of accounting information external to the business entity. It is process of identifying, measuring, recording, classifying, summarizing, analyzing, interpreting and communicating the financial transactions and events. The purpose of this branch of accounting is to keep systematic records, to ascertain financial position and performance and to communicate to the interested internal and external users. Thus, financial accounting emphasizes the stewardship aspect of accounting rather than the control or decision-making aspect of accounting.

*ii***. Cost Accounting:** Cost accounting is the part of accounting which is concerned with the accumulation and assignment of historical cost to the units of product and departments, primarily for the purpose of valuation of stock and measurement of profit. It is the process of recording and controlling the cost of product, operation or function. Cost accounting seeks to ascertain the cost of unit produced and sold or services rendered by the business unit with a view to exercising control over these costs to assess the profitability and efficiency of the entity.

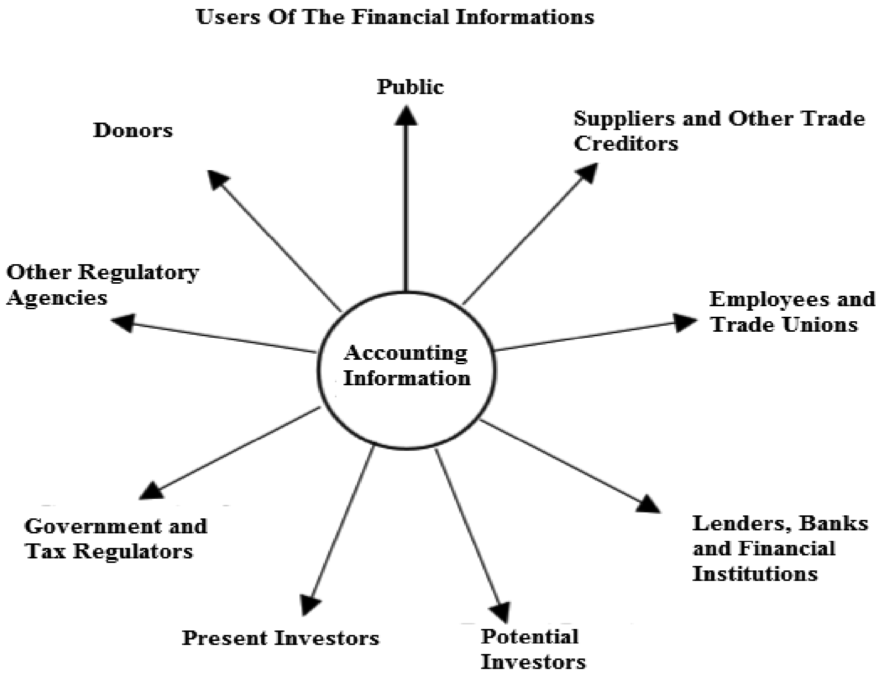
iii. **Management Accounting:** Management accounting is the part of accounting which is concerned, mainly with the internal reporting to the manager of all level of an entity. It is the application of accounting techniques for providing information designed to help management in planning , controlling and decision making activities of an entity. It is not only confined to the area of cost control but also covers other areas like capital expenditure decision, choosing the product line and capital structure decision.

iv. **Social Responsibility Accounting***:* It is the process of identifying, measuring and communicating the social effects of the business decision to permit informed judgments and decision by the users of the information. It is an accounting of social costs and social benefits. Accounting for environment and ecology is a part of the social responsibility accounting.

v. **Human Resource Accounting***:* Human resource accounting is an attempt to identify, quantify and report investments made in human resources of an organization that are not presently accounted for under conventional accounting practice.

2.8 USERS OF ACCOUNTING INFORMATION

The basic objective of accounting is to provide information which is useful for persons and groups inside and outside the organization. Various users of the financial information are given below:



i. Owners or Investors: Owners and Investor are the person or group of person who supply the risk capital for running the business. They can be present investor or potential investor of the organizations. Since ownership is separated from management, owners are interested in the financial information, to know about the safety of amount invested and return on amount invested. Similarly, they also need information to assess whether to buy or sell their investment. Besides that, they are interested to know the ability of the business to survive, prosper and to pay dividend. In non-corporate sector where ownership and management are not essentially separated, the owner(s) still need(s) information about performance of the business and its financial position to decide whether to continue or shut down. Thus, financial information helps them to decide about making investment, quantum of investment and holding on to equities they own.

ii. Lenders and Other Trade Creditors: They provide the required fund as a loan or supply required material and services on credit to organization. So, they need information to assess the financial soundness and profitability of the business firm which assured them to recovery of interest and principal when it dues.

iii. Government and its Agencies: Governments and their agencies are interested in the allocation of resources and, therefore, the activities of entities. They also require information that assists them in regulating the activities of entities, assessing taxation and providing a basis for national statistics. Furthermore, the government needs information to estimate the effects of existing and proposed levies and other financial and economic measures, to estimate economic trends including balance of payments figures and to promote economic efficiency. Their main concern is that whether prevailing laws and regulation are complied by business enterprises. Similarly, they also want to know whether business organizations are paying taxes and other duties according to applicable laws. Therefore, government policies related to taxation, subsidies, grants are guided by the relevance of the financial information provided by the organizations.

iv. Employees and Trade Unions: Employees are interested to know the stability, continuity and growth of the enterprises because both, their present job security and future prospects are tied with the company's fortunes. The main concern of employees are to assess whether company has ability to provide remuneration, retirement and other benefits and to enhance employment opportunities.

***v.* Customers:** They are composite group consisting of (a) producers at every stage of processing, (b) wholesalers and retailers and (c) the final consumers. They are also concerned with the stability and profitability of the enterprises because their functioning is more or less dependent in a vertical chain. Producer at the next stage of processing must be assured of the input which they obtain from the concern in question. The wholesalers and retailers must also be sure about uninterrupted supply of material and continuous availability of the product. In all these relative decisions, accounting information has a significant role to play.

vi Public: The public at large is interested in the functioning of the enterprise because it may make a substantial contribution to the whole economy in many ways including the number of people employed to their supplies. Some members of the public may be concerned about the employment policies of the organization and therefore want information relating to local employment levels or discrimination in employment. Other members of the public may be interested in any plans that the organization has that affect the environment, including issues relating to conservation and pollution. Other matters of a political or moral nature may also be of particular concern to some sections of the community, such as contributions to political organizations, pressure groups or charities, and whether the reporting entity is trading with countries having repressive political regimes. Some of this information must be disclosed under the Companies Acts (i.e. donations to political parties and charities), which implies that the organization has a responsibility to make public any matters that might be regarded as material

vii. Donors: Donors of aid are interested in information that enables them to ensure that they can assess the need for, and effects, of aid upon recipient entities and of the financial position and performance of entities carrying out work on their behalf.

The modern day accounting system is thus expected to provide detailed information to satisfy all the interested groups. Thus, the aim of financial accounting is to provide financial information to the various user groups to permit informed judgments and decisions. Various groups may have diversified interest, either conflicting or complementary but it is not possible to provide information separately to all such user group. Instead financial accounting aims at providing general purpose financial statement which consist income statement, Statement Of Financial

Position, cash flow statement, statement of changes in equity and other disclosures which is require to understand financial statement in better way.

2.9 RELATIONSHIP OF ACCOUNTING WITH OTHER DISCIPLINES

Systematic recording of financial activities will help to disseminate relevant information about the financial position and performances of an entity to the concerned parties. To understand and analyze the information and its financial effects , knowledge of an accounting and its related disciplines are necessary. Thus accounting is closely related with several other disciplines and to acquire a good knowledge in accounting one should be conversant with the relevant portion of such discipline.

Accounting and Economics:

Economics is viewed as a science of rational decision-making about the use of scarce resource. It is concerned with the analysis of efficient use of scarce resources for satisfying human wants. This may be viewed either from the perspective of a single firm or of the country as a whole.

Accounting is viewed as a system which provides data to the users to permit informed judgment and decisions. Some non-accounting data are also relevant for decision-making. Still, accounting provides a relevant and reliable information in improving the management decision-making process. However, economic theories influenced the development of the decision-making tools used in accounting.

Accountants got the ideas of value, income and capital maintenance from economists, but brushed suitably to make them usable in practical circumstances. Accountants developed the valuation, measurement and decision making techniques which may owe to the economic theorems for original but these are molded in the work environment and suitably tempered with reference to relevance, verifiability, freedom from bias, timeliness, comparability, reliability and understandability.

Economists think that value of an asset is the present value of all future earnings which can be derived from such assets. If the useful life of an asset is too long say more than hundred years, estimating the future stream of earnings becomes difficult So accountants developed the workable valuation base as the acquisition cost i.e. the price paid to acquire the assets.

Take another example, Economists classify cost as fixed and variable; but they are very sensitive about the cost behavior pattern. They accept that variable costs vary in direct proportion to revenue. Truly speaking, the linear relationship between variable cost and revenue is a myth. It is not easy to establish the exact functional relationship between variable cost and sales. So, accountants accept the linear relationship while finding break-even point. There are many other examples of such types of acclimatization of economic thoughts in the practical decision environment.

At the macro level, accounting provides the database over which the economic decision models have been developed All the micro level data are arranged by the accounting system and summed up to get macro level database.

Non-overlapping zone of accounting are not negligible, development of the systems of recording, classifying and summarizing transactions and events, harmonizing the systems by uniform rules and communicating the data is essentially a non-overlapping area of accounting.

Accounting and Statistics:

Though accounting system maintains the financial records on the basis of historical events and transactions in their monetary value. The use of statistics in accounting can be appreciated better in the context of the nature of accounting records. Accounting information is very precise, it is exact to the nearest figure i.e. two decimal. But, for decision making purposes such precision is not necessary and hence, the statistical approximations are sought.

In accounts, all values are important individually because they relate to business transactions. As against this, statistics is concerned with the typical value, behaviour or trend over a period of time or the degree of variation over a series of observations. Therefore, whenever a need arises for only broad generalizations or the average of relationships, statistical methods have to be applied in accounting data. Further, in accountancy, the classification of assets and liabilities as well as the heads of income and expenditure has been done as per the needs of financial recording to ascertain financial results of various operations. Other types of classifications like the geographical and historical classification, ones and ad hoc classification are done depending on the purpose to make such classification meaningful.

Accounting records generally take a short-term view of the events and are generally confined to a year while statistical analysis is more useful when long-term view of the events are taken for the purpose. For example, trend line over the long period aids in depicting relevant and reliable information . However, statistical methods do use past accounting records maintained on a consistent basis.

Accounting records are based on historical costs of permanent assets, while the current assets are automatically valued at the current values. This creates some anomalous situations when prices are not stable over a period of time. The new methods of inflation accounting are an attempt to correct this situation. The correction of values is made on the basis of the current purchasing power of money or the current value of the concerned assets revalued from the date of purchase till the day of recoding, charging depreciation on the current value, so that the present value of the asset aligns with the current value of money. All this would require the use of price indices or the price deflators which are based on statistical calculations of price changes.

The functional relations showing mathematical relations of one variable with one or more other variables are based on statistical work. These relations are used widely in making cost or price estimates for some estimated future values assigned to the given independent variables. For example, given the functional relation of total cost to the price of an input, the effect of changes in future prices on the cost of production can be calculated.

In accountancy, a number of financial and other ratios are based on statistical methods, which help in averaging them over a period of time. Several accounting and financial calculations are based on statistical formulae. Statistical methods are helpful in developing accounting data and in their interpretation. For example, time series and cross-sectional comparison of accounting data is based on statistical techniques. Regression analysis is most useful in forecasting, budgeting and cost control; significance tests can be used in the analysis of budget and standard cost variances. Therefore, the study and application of statistical methods would add extra edge to the accounting data.

Accounting and Mathematics:

Double Entry bookkeeping can be converted into algebraic form, in fact the first known book on this subject was part of a treatise on algebra. Knowledge of arithmetic and algebra is a pre-requisite for accounting computations and measurements. Calculations of interest and annuity are the examples of such fundamental uses. While computing depreciation on fixed asset, amortization amount for intangible assets, installments amount in hire purchase, repayment schedule of loan, , replacement of assets and setting lease rentals, mathematical techniques are frequently used.

With the advent of the computer, mathematics is becoming a vital part of accounting. Now-a-days statistics and econometric models are largely used for developing decision models for the users of accounts. Also, Operations Research Techniques provide lot of decision models. Since accounting is meant for providing information to the users, to be effective, accounting data should feed the information requirements of such statistical, econometric and operations research models. Understanding mathematics has become important to obtain the decision models framed by statisticians, econometricians and the Operational Research experts.

Presently graphs and charts are being extensively used for communicating accounting information. In addition to statistical knowledge, knowledge in geometry and trigonometry seems to be essential to have a better understanding about the accounting information.

Accounting and Law:

An economic entity operates within a legal environment. All transactions with suppliers and customers are governed by the Contract Act, the Negotiable Act, etc. The entity itself is created and controlled by laws such as, Partnership Act, Company Act.

Similarly, every country has a set of economic, fiscal and labour laws. Transactions and events are always guided by the laws of the land. Very often the accounting system to be followed has been prescribed by the law. For example, the Companies Act has prescribed the format of financial statements. Banking, insurance and other corporate bodies are required to publish their financial statement as prescribed by the respective legislations controlling such entities. However, legal prescription about the accounting system is the product of developments in accounting knowledge. That is to say, legislation about accounting system cannot be enacted unless there is a corresponding development in the accounting discipline. In that way accounting influences law and is also influenced by law.

Accounting and Management:

Management is a broad occupational field which comprises many functions and encompasses application of many disciplines including those mentioned above. Accountants are well placed in the management and play a key role in the management team. A large portion of accounting information is prepared for management decision- making. Although management relies on other data source, accounting data are used as basic source documents. In the management team, an accountant is in a better position to understand and use such data. In other words, since an accountant plays an active role in management, information provided by the accounting system helps to make various important decisions in relation to production, sales, budget allocation and control of overhead expense of the organization. So the accounting system can be molded to serve the management purpose. Thus, accounting is an essential service function of management.

Summary

In this unit we were able to understand the basic concepts of accounting. We could see that the accounting has evolved as a process of identifying, measuring and communicating economic information to allow the users in making various decisions. We have seen that the users of the accounts are not only the owners or the partners or the investors of business enterprises. Instead the broad users/groups include employees, lenders, suppliers and other creditors, customers, Governments and other agencies and public at large who uses the accounting information for measurement, forecasting, decision making, evaluation, control, stewardship and government regulations and taxation. Further, we have acquired knowledge regarding the relationship of Accounting with various other disciplines such as Economics, Statistics, Mathematics, Law and Management. Although, there are many other disciplines which does not have any relationship with accounting, the students are expected to have an adequate knowledge with respect to the disciplines that have relationship with accounting to understand the accounting discipline properly.

Self-Examination Questions

I. Multiple Choice Questions (MCQs)

1. Which of the following is not a subfield of Accounting?
   (a) Management Accounting (b) Cost Accounting
   (c) Financial Accounting (d) Book Keeping

2. Users of accounting information includes
   (a) Creditors (b) Customers
   (c) Public (d) All of the above

3. All of the following are functions of Accounting except;
   (a) Decision Making (b) Measurement
   (c) Forecasting (d) Ledger Posting
4. Components of financial statements don't include;
   (a) Cash Flow Statement (b) Statement of Financial Position
   (c) Trial Balance (d) Statement of Profit or Loss

5. Financial Statements do not consider
   (a) Assets expressed in monetary terms
   (b) Liabilities expressed in monetary terms
   (c) Only Assets expressed in non-monetary terms
   (d) Assets and liabilities expressed in non-monetary terms

6. Financial Statements are part of
   (a) Book Keeping (b) Accounting
   (c) All of Above (d) None of the above

7. On Kartik 16, Sumina paid repair of Rs. 1,250. This can be classified as
   (a) An event (b) A transaction
   (c) Both event and transactions (d) None of the above

8. Sale of goods to Ram for Rs. 2,450 is
   (a) Cash Transaction (b) Credit Transaction
   (c) Barter (d) Internal Event

9. Internal users of accounting information include -
   (a) Short-term creditors (b) Customers
   (c) Long-term lenders (d) Shareholders

10. External users of accounting information include –
   (a) Shareholders (b) Customers
   (c) Management (d) None of these

11. Expenses are reflected in the form of –
   (a) Inflow of assets or incurrence of liabilities
   (b) Outflow of assets or decrease of liabilities
   (c) Inflow of assets or decrease of liabilities
   (d) Outflow of assets or incurrence of liabilities

II. Short Descriptive Questions (SDQs)

1. What is accounting? What are the activities covered under accounting?
2. Define transactions and events with suitable examples.
3. Discuss accounting as a language of business.
4. How would you use the accounting information in various capacity?
5. Accounting has many branches. Explain.
6. Describe the relationship of accounting with various other disciplines.

ANSWER

Multiple Choice Questions (MCQs)

1	d	5	d	9	d
2	d	6	b	10	b
3	d	7	b	11	d
4	c	8	B		

CHAPTER- 1

Fundamentals of Accounting: Introduction

UNIT 3:

Role of Accountant in the Society

Learning Objectives

1. *Acquire general knowledge of business;*
2. *Be familiar with profit making and not for profit organizations;*
3. *Identify various types of business set up and their legal forms; and*
4. *Understand the capital structure of different business set ups.*

3.1 AREAS OF SERVICE

There are only a few types of profession in world which are held in high esteem in public eyes and there is no denying the fact that the accounting profession is one of them. *Goethe* had called the accountant's profession as "the fairest invention of the human mind". By the use of the science of accountancy and under the spell of its art, a dynamic pattern which assists business in planning its future is woven by accountants out of the inert mass of non-speaking silent figures. This is what makes their profession an instrument of socio-economic change and welfare of the society.

An accountant with his education, training, analytical mind and experience is best qualified to provide multiple need-based services to the ever-growing society. The accountants of earlier eras were more concerned with the maintenance and audit of books of account and the immediate possibilities provided by other spheres of activity did not then exist. The accountants of today can do full justice not only to matters relating to taxation, costing, management accounting, financial lay-out, company legislation and procedures but they can delve deep into the fields relating to financial policies, budgetary policies and even economic principles. The area of activities which can be undertaken by the accountants is not limited but it can also cover many additional facets.

In discharging the duties and while performing the various functions, the paramount consideration which should weigh with accountants is that they are not merely performing particular duties to earn emoluments but that they have to discharge a wider function and their obligation, a moral one is to function in such a way that they are above suspicion and as members of the learned and an honorable profession. They provide service to the entire community.

Some of the services rendered by accountants to the society are briefly mentioned here under:

3.1.1 Maintenance of Books of Accounts

An accountant is able to maintain a systematic record of financial transactions in order to establish the net result of the transactions entered into during a period and to state the financial position of the concern as at a particular date. For the fulfillment of this twin objective- ascertaining the financial performance and the financial position it is necessary that all transactions be recorded in a systematic manner which can be done only by an accountant. The following advantages are available from these records:

(a) Assistance to management: In modern times in addition to ascertaining the financial results of operations, accounting also performs other significant functions. It provides such information to the management as will enable it to do its work properly. Such information helps in the following:

(i) **Planning:** Management would like to know the sales, out-put, expenses, etc, relating to the next year and also the flow of cash; for this purpose accounting would be able to collect the necessary information and make the necessary estimates.

(ii) **Decision-making:** Management is faced with a number of problems requiring a decision, for example, what should be the selling price of goods produced? Should concession be offered to a special customer and if so, how much? Should a part be made in the factory or purchased from outside? For making such decisions, accounting collects the relevant information.

(iii) **Controlling:** Management would like to see that (1) the work done is according to the plan, and (2) the cost incurred is reasonable. Accounting collects information to help management in this regard. For instance management would be able to know which department is over-spending.

(b) Replacement of memory: No businessman can remember everything about his business since human memory has limitations. It is necessary to record transactions in the books of account promptly. This will obviate the necessary of remembering the various transactions since books of account will furnish the necessary information when necessary.

(c) Comparative study: A systematic record will enable a business to compare one year's results with the results of other years and locate significant factors leading to the change if any.

(d) Settlement of taxation liabilities: If books of accounts are maintained properly, they will be of great assistance when the firm is assessed to income tax or any other tax i.e. VAT, Property Tax, Business tax, TDS etc.

(e) Evidence in court: Systematic record of transactions is often treated by the courts as good evidence.

(f) Sale of business: Accurate and complete records enable to identify business assets, liabilities, income and expenses. Such information enable the ascertainment of proper purchase price at the time of selling the business

(g) Assistance to an insolvent person: In case one becomes insolvent he has to explain many things about the past. Proper accounting helps him to do that.

3.1.2 Statutory Audit:

Any business entity is established in society as per prevailing laws. It requires to provide the information regarding their activities to concerned authority and general public. For that purpose, entity's activities should be evaluated or reviewed independently by third party. So, every limited company is required to appoint a qualified accountants as an auditor who has statutory duty to report each year whether in his opinion the Statement Of Financial Position shows a true and fair view of the state of affairs on the Statement Of Financial Position date, and the Statement Of Profit or Loss shows a true and fair view of the profit or loss for the year. Auditing is not confined to the accounts of companies rather includes the overall assessment of the risk in the organization;

3.1.3 Internal Audit:

It is a management tool whereby an internal auditor thoroughly examines the accounting transactions and also the system, according to which these have been recorded with a view to reassuring the management that the accounts are being properly maintained and the system contains adequate safeguards to check any leakage of revenue or misappropriation of property of assets and the operations have been carried out in conformity with the plans of the management. The growing demand and greater initiative of the internal auditor for constructive contribution towards improving the operational efficiency of the business through an independent review and appraisal of all business operations have developed internal auditing into an important service to the management.

3.1.4 Taxation:

An accountant with their technical expertise, professional and ethical training plays a key role in assisting client, employer and other taxpayer regarding tax obligation.. Many individuals and most businesses need assistance in dealing with the complex domestic and international tax laws. This complexity also provides tremendous tax planning opportunities. As a tax specialist, accountant will show individual clients how to reduce their taxes while simultaneously helping them make decisions about investing, buying a house, funding their children's education, and planning their retirement. For business clients, careful planning and structuring of business investments and transactions can save millions of Rupee in taxes. In fact, it is safe to say that very few significant business transactions take place without the careful guidance of a tax specialist.. Many companies offer deferred compensation or stock bonus plans to their executives. Nearly all companies provide some sort of pension or other retirement plan for their employees, as well as health care benefits. Significant tax savings can be generated for both the company and their employees if these benefits are structured correctly.

3.1.5 Management Accounting:

Management accounting performs an advisory function. He is largely responsible for internal reporting to the management for planning and controlling current operations, decision making on special matters and formulating long-range plans. His job is to collect, analyze, interpret and present accounting information which is useful to the management.

3.1.6 Financial Advice:

Many people need help and guidance in planning their personal financial affairs, whether or not they also have business problems. An accountant who knows about finances, taxation and family problems, is placed to give such advice. Some of the areas are which an accountant can render financial advice are:

a. ***Investment**:* An accountant can explain the significance of the formidable documents which share-holders receive from companies and help in making decisions relating to their investments.

b. ***Insurance:*** An accountant can provide information to his clients on various insurance policies and helps in choosing appropriate policy.

c. ***Business Expansion:*** As business grow in size and complexity in transactions increase especially in the case of merger and acquisition of businesses , accountants are in the forefront position in interpreting accounts, making suggestions as to the form of schemes and the fairness or otherwise of proposals considering cost, benefits and financial consequences . When the time comes to invite the public to subscribe for shares, the advice of accountants is needed in relation to legal compliance, capital structure and leverage positions. They also advise on how to solve the problem of borrowing money where alternative source of finance are available. Accountants can render extremely useful service in connection with negotiations with foreign collaborators.

d. ***Investigations:*** Financial investigation are required for a variety of purposes, such as ascertain the financial position of a business, obtain the relevant information of interested parties in connection with an issue of capital, assessment for the purchase or sale of the business or a reconstruction or amalgamation of business entity. Similarly, Investigations help the management to decide whether it is cheaper to manufacture an article or to buy out, to ascertain why profit have fallen, to achieve greater efficiency in management, to ascertain whether fraud has occurred and if so its nature and extent and to made suggestions which will help to prevent from recurrence and to value businesses and shares in private companies for purposes such as purchase, sale, estate duly or wealth tax etc.

The task of an account as an independent professional is to establish the fact fairly and clearly for the benefit of those who have to make decisions and to give advice in many areas in which he has competence and experience.

e. ***Pension Schemes:*** Specialist advice from actuaries, insurance agents or insurance company is needed before launching or amending a provident fund or pension scheme in a business. But before making a final decision, an accountant has to be consulted. Later on his help may be needed for managing the schemes or obtaining tax relief.

f. ***Mechanical Aids:*** There is a great variety of office equipment and machines in market ranging from the very simple and inexpensive to the highly complicated and costly ones. An accountant can often advise as to the type best suited.

3.1.7 Management Consultancy Services:

The services that can be rendered by accountants doing management consultancy services are as follows:

a ***Management Information Systems:***

- Rationalization of management information for the needs of the business.
- Advice on the form, content and frequency of reporting data at different levels of management by evolving methods of compilation and presentation which avoid duplication in effort, conserve clerical time and release management resources for more productive purposes.
- Advice to management on the interpretation and use of the data.

b. ***Expenditure Control and Evaluation*:**

- Assisting management to determine measures for effective utilization of capital and introduction of appraisal techniques for new investments and divestments.
- Designing budgetary and cost control systems for capital and revenue expenditure to promote operational efficiency.
- Management by objectives and motivation and control.
- Operational audit for evaluation of performance.

c. ***Working Capital Management:***

- Assisting management in the efficient use of working capital as an aid to improve productivity and the corporate fight against inflation-materials management, inventory control, cash management, credit control, source and utilization of funds, optimal allocation of funds between competing activities, and raising investment of short-term funds.

d. ***Organization and Methods:***

- Advising management on principles of organization and methods which could be employed for effective delegation and planning of work. Reviewing the procedures and equipment for operational control and development of systems which would lead to optimization of office efficiency in such areas as sales accounting, purchasing procedures, wage payments etc.
- Corporate planning: Long-range planning and setting up of corporate objectives. Financial planning and review of company policies for effective utilization of resources.
- Advising management on amalgamations, constructions, takeovers and expansion schemes.

e. ***Feasibility studies:***

Assist in the preparation of feasibility studies of new projects and expansion schemes, specifically covering the areas such as market survey, profit forecasts and financial institutions.

f. ***Data processing:***

- Assist in the benefits of mechanized systems and feasibility of incorporating computer applications for accounting and commercial activities with a view to reduce clerical costs and improve speed and efficiency of data processing for timely and optimal management decisions.
- Assist in the choice of the equipment; organization of a data processing department; utilization of facilities; preparation of input; choice of output; storage; and internal control and security.

g. ***Business Problems:***

- Assist in finding solutions for specific business problems such as product mix decisions, pricing decisions, making representation to Government on various matter.
- Use of statistical and analytical techniques for business forecasting.

h. ***Personnel and Training:***

- Appraisal of personnel policies and practices. Review of salary structures and perquisites including retirement benefits.
- Management development and evaluation.

- Provide training courses and general introduction courses on management accounting data processing and allied subjects.

i. ***Executive Selections Services:***
Assist in the selection of executive personnel in the areas of production, marketing, accounts, data processing, personnel, general administration etc. by:
- assessment of company requirements
- advertisements for and reviewing applications received and
- Arranging interviews of short-listed applicants for final selection.

3.1.8 Other services:

(i) ***Secretarial work:*** Companies. Clubs, and associations-indeed, all organizations involve secretarial work. It involves handling the correspondence, keep files in proper order, takes minutes of the meeting conducted Accountants are competent to this work who support the management including executive using the variety of management, communication and organization skills.

(ii) ***Share registration work:*** Accountants are often used by many companies to undertake the work involved in registering share transfers and new issues.

(iii) ***Company formation:*** In conjunction with legal advisers, accountants help in the formation of a company or advice against doing so.

(iv) ***Receiverships, liquidation in winding up*** An unpleasant subject. But someone has to take on the onerous duties of liquidator when a company is being wound up or receiver when a debenture holder exercises a right to recover a loan on which the borrower has defaulted. Accountant is just the man for the job. He is also just the man to help you to keep insolvency away if you consult him in time.

(v) ***Arbitrations:*** Time and again, accountants are invited by parties to a dispute to act as arbitrators of settle disputes of various kinds.

(vi) ***As regards the Cost Accountants:*** A cost accountant's job is to continuously report cost data and related information at frequent intervals to the management.

(vii) ***Accountant and information Services****:* The information system should be such that comparability of financial statements as between both business and individual years is possible so that it benefits both the management and the investors. Dependence on computerized information systems has put new responsibilities on an accountant. Information will be effective if information system supplies the information promptly and in an unambiguous language. Professional accountant should develop a system by which there is a effective flow of information both horizontally and vertically.

3.2 ACCOUNTANT IN INDUSTRY

He works with the functional departments and translates the organization's aims in terms of financial expectations. Therefore, accountant has to make a thorough study of the business and individuals in the functional departments, whether they are engineers or salesmen. A qualified accountant will be able to play an important role in performing important functions of a business relating to accounting, costing and budgetary control, estimating and treasury.

Professional Accountant employs a skeptical mind to their work founded on the basis of their knowledge of the company's financials. Using their experience, knowledge and understanding of the company and the environment in which it operates, professional accountants in business analyze the challenging environment. Their training in accounting enables them to adopt a pragmatic and objective approach to solving issues. This is a valuable asset to management, particularly in small and medium enterprises

Accountancy professionals in business assist with corporate strategy, provide advice and help businesses to reduce costs, improve their top line and mitigate risks. As board of directors, professional accountants in business represent the interest of the owners of the company (i.e., shareholders in a public company). Their roles ordinarily include: governing the organization (such as, approving annual budgets and accounting to the stakeholders for the company's performance); appointing the chief executive; and determining management's compensation. As chief financial officers, professional accountants have oversight over all matters relating to the company's financial health. This includes creating and driving the strategic direction of the business to analyzing, creating and communicating financial information. As internal auditors, professional accountants provide independent assurance to management that the organization's risk management, governance and internal control processes are operating effectively. They also offer advice on areas for enhancements. In the public sector, professional accountants in government shape fiscal policies that had far-reaching impacts on the lives of many.

3.3 ROLE OF CHARTED ACCOUNTING IN PUBLIC SECTOR ENTERPRISES

Both in the developed and developing countries, public sector enterprises have become a special feature of the national economy. The system of accounting, auditing, financial and budgetary control has, therefore, become a matter of interest and concern to the nation, and does not remain confined merely to a limited number of shareholders. The form of accounting followed by these corporations or companies is different from that of ordinary government accounting. It is the duty of the accountants to prepare the books of accounts and reports of these public corporations in such a way that they enable the general public to know how far it appears from the various types of records and statements of accounts of these enterprises that they justify their existence.

3.4 ROLE OF CHARTED ACCOUNTING IN FRAMING FISCAL POLICIES

Accountant has a positive role in the determination of proper fiscal policies for the advancement of trade, commerce and industry. They should develop new techniques and prepare themselves for new fields of service in their commitment to the concept of the public goods and service. Business knowledge is pooled together. It is a social obligation for both accountants in industry and in practice to disclose greater information regarding the corporate results. The state of affairs of the economy can be ascertained only when such consolidated corporate information is disclosed

3.5 ACCOUNTANT AND ECONOMIC GROWTH

In the present times accountants should conceive their duties as broadly as the conditions might require and do not restrict them to only literal compliance of the law. Their aim should be not to allow any individual to gain at the cost of the nation. Accountants have to accept a positive role and do their best to encourage efficiency in individual business units and encourage those social objectives which form the main foundation of welfare state.

Conclusion: In view of the growing trends of computerized management system accountants are undergoing the rigors of continual training and education in the new technique of statistical inference probabilistic models, regression analysis, simulation and operations research. Knowledge of these areas of mathematics and statistics has become as essential for the accountant as knowledge of the fundamentals of double entry.

Summary

In this unit we have studied the various role of accountant and its impact on the society. We are able to understand that the accountants with their education, training, analytical mind and experience is best qualified to provide multiple need-based services to the ever-growing society. Where, the accountants of earlier eras were more concerned with the maintenance and audit of books of account and the immediate possibilities provided by other spheres of activity did not then exist the accountants of today can do full justice not only to matters relating to taxation, costing, management accounting, financial lay-out, company legislation and procedures but they can delve deep into the fields relating to financial policies, budgetary policies and even economic principles. Besides, the accountants are providing contributions in framing fiscal policies and economic growth which all resulted in the accounting as a dignified profession in the society.

Self-Examination Questions

Short Descriptive Questions (SDQs)

1. What are the areas of services provided by the accountant to society?
2. What types of financial advices are provided by the accountants?
3. Who does an accountant assist in formulating the national economic & industrial policy?
4. Explain the following:
   a. An Accountant can handle tax matters effectively.
   b. An Accountant can assist in managing the efficient use of working capital.
   c. Accountants have a positive role in the determination of proper fiscal policies.

CHAPTER- 1

Fundamentals of Accounting: Introduction

UNIT 4:

Conceptual Framework of Accounting

Learning Objectives

1. *Be familiar with the different measurement bases namely historical cost, current cost realizable value and present value.*
2. *Try to understand the various measurement bases that can give objective valuation to transactions and events.*
3. *Traditional accounting system mostly used historical cost as measurement base e xcept in certain cases.*
4. *To understand that accounting system is based on some postulates or concept and to analyze their implication while recording transactions and events.*
5. *Understand the fundamental accounting assumptions.*
6. *De familiar with the Nepal Accounting Standaards (NASs).*
7. *Understand the qualitative characteristics of financial statements.*

4 INTRODUCTION

All business transactions should be properly recorded in order to prepare financial statements in understandable manner. These transactions and events should be measured in systematic as well as reliable manner. Unless the measurement base is settled, proper book-keeping of the record could not be possible. Since accounting is meant for generating information suitable for users' judgment and decisions. Generation of such information is proceeded by recording, classifying, and summarizing data. By this process, it measures performance and financial position of the business entity.

4.1 MEASUREMENT BASES

Measurement bases are the various methods developed to recognize the monetary value of financial transactions in accounting system. A businessman purchased a plant paying Rs. 900,000. The question is that at which value we shall record this transaction. Similarly, at end of the accounting period we find 1,000 units of goods are lying at the store which were purchased @ Rs. 100 per unit but can be sold @ Rs. 125 per unit. Shall we record this event at purchase price or selling price? In particular, measurement bases are the methods developed for determining the:

A. Amount at which costs should be recognized in the Income Statement, and

B. Amount at which material items should be stated in the Statement of Financial Position.

There are four generally accepted measurement bases. These are:

(i) Historical Cost
(ii) Current Cost
(iii) Realizable Value
(iv) Present Value

***(i) Historical Cost*:** It means acquisition price. In the given example, since the businessman paid Rs. 900,000 to purchase the plant, its acquisition price is Rs. 900,000. The historical cost of goods is Rs. 100,000 (1,000 units @ Rs. 100).

According to this base, assets are recorded at an amount of cash or cash equivalent paid or fair value of consideration given at the time of acquisition. Liabilities are recorded at the amount of proceeds received in exchange for the obligation. In some cases a liability is recorded in the amount of cash or cash equivalent expected to be paid to satisfy it in the normal course of business.

When one businessman Mr. Ram, borrows Rs. 1,000,000 loan from a bank @ 12% interest per annum it is to be recorded at the amount of proceeds received in exchange for obligation. In this case, obligation is the repayment of loan as well as payment of interest at an agreed rate i.e.12%. Proceed received of Rs. 1,000,000 is historical cost of the transaction. As per the historical cost basis it is to be recorded at an amount expected to be paid to discharge the liability.

(ii) ***Current Cost:*** Current cost gives an alternative measurement base. Assets are carried at the amount of cash or cash equivalent that would be paid if the same or an equivalent asset was acquired currently. For example, the businessman Mr. Ram purchased a plant on 1st January 2007 at Rs. 900,000. As per historical cost base he has to record it at Rs. 900,000 i.e. acquisition price. As on 1st January 2013 the cost of plant is 1,200,000 that mean he has to pay Rs. 1,200,000 for acquiring the said plant. As per current cost base value of plant shall have to be adjusted equal to Rs. 1,200,000. Similarly, depreciation on said plant shall also require adjusting on the basis of new value.

Under this base, liabilities are carried at the undiscounted amount of cash or cash equivalents that would be required to settle the obligation currently. Suppose, Mr. Ram took loan of Rs. 1,000,000 from bank on 1st January 2007 @ 12% interest per annum. As on 1st January 2013 bank announces a discount @ 10% on the loan amount if it is paid within one month from that date. As per the historical cost base the liability is recorded at Rs. 1,000,000 at the amount of proceeds receive in exchange of obligation. However, under current cost base, same liability has to be recorded at discounted value of loan amount which would be Rs. 900,000.

(iii) ***Realizable Value*****:** Suppose Mr. Ram found that he can get Rs. 700,000 if he would sell the machine purchased on 1st January 2007 for Rs. 900,000 and which would cost Rs. 1,200,000 in case he would buy it currently. Take also that Mr. Ram found that he has no money to pay off the bank loan currently.

As per realizable value, assets are carried at the amount of cash or equivalent that could currently be obtained by selling the assets in an orderly disposal. In other words, assets are recorded at their disposal value in ordinary transaction. Similarly, liabilities are recorded at their settlement value i.e. the undiscounted amounts of cash or cash equivalents expected to be paid to satisfy the liabilities in the normal course of business.

So the machine should be recorded at Rs. 700,000 the realizable value in an orderly sale while the bank loan should be recorded at Rs. 1,000,000 the settlement value in the normal course of business.

(iv) ***Present Value:*** The present value of future net cash inflows and net cash outflows could be calculated by the help of discounting factor at given rate. Let us take an example that the cost of machine would be Rs. 1,000,000 and that machine can generate annual net cash inflows of Rs. 180,000 for next 10 years and prevailing interest rate is 10%. Since the interest rate is 10% that means if you deposit Rs. 100 in bank that will become Rs. 110 which includes your written back of initially deposited amount as well as interest of Rs.10 earned during the one-year period. Therefore, Rs. 110 is the future value at end of one-year period of your Rs. 100 at present. In other words, Rs. 100 is the present value of future value of Rs. 110 at end of one-year period.

As per present value base, an asset is carried at the present discounted value of the future net cash inflows generated from use of said asset in normal course of business. Likewise, liabilities are carried at the present discounted value of future net cash outflows that are expected to be required to settle the liabilities in the normal course of business.

The term "discount", "cash inflow" and "cash outflow" need a little elaboration. Rs. 100 in hand as on 1.1.2012 is not equivalent to Rs. 100 in hand as on 31.12.2012. There is a time gap of one year. If you had Rs. 100 as on 1.1.2012 you could use it at that time. If you received it only on 31.12.2012, you had to sacrifice your use for one year. The value of this sacrifice is called "time value of money". You would sacrifice i.e. you would agree to take money on 31.12.2012 if you had been compensated for the sacrifice. So a rational man will never exchange Rs. 100 as on 1.1.2012 with Rs. 100 to be received on 31.12.2012. Then Rs. 100 of 1.1.2012 is not equivalent to Rs. 100 of 31.12.2012. To make the money receivable at a future date equal with the money of the present date it is to be devalued. Such devaluation is called discounting of future money.

Perhaps you know the compound interest rule: $A = P(1+I)^n$

A = Amount

P = Principal

I = Interest/100

N = Time

By the help of above equation we can understand the relationship between present money, principal and the future money amount. If A, I and n are given, to find out P, the equation is to be changed slightly

$$P = A /(1+i)^n$$

Using the equation we can find out the present value if we know the values of A, I and n. Let us suppose that i =15%, now what is the present value of Rs. 180,000 to be received as on 31.12.2012 (take 1.1.2012 as the time of reference)

$$P = 180{,}000/(1+.15)^1 = 156{,}521.74$$

Similarly,

Time of receipt	Money value Rs.	Present value Rs.
31.12.2013	180,000	136,105.86
31.12.2014	180,000	118,352.92
31.12.2015	180,000	102,915.58
31.12.2016	180,000	89,491.81
31.12.2017	180,000	77,818.97
31.12.2018	180,000	67,668.67
31.12.2019	180,000	58,842.32
31.12.2020	180,000	51,167.23
31.12.2021	180,000	44,493.25

Total of all these present values is Rs. 903,378.35. Since the machine purchased by businessman, will produce cash equivalent to Rs. 903,378.35 in terms of present value, it is to be valued at such amount as per present value measurement base.

Likewise, liabilities are also valued by finding present value of net cash out flows during the loan period. Basically, net cash out flow with respect to loan taken from bank or any parties consist periodical interest to be paid as well as repayment of loan amount. In above example, a businessman took a loan of Rs. 1,000,000 @ 12% p.a. interest for 10 years. That means a businessman has to pay interest amounting Rs. 120,000 in each year and pay back entire loan at end of 10th year.

As we know, the present value of an Annuity or A for n period is

A= annuity

i = interest

t = time 1,2,3 ……..n

$A \times [1-\{1/(1+i)^{n}\}/i\ ]$

By the help of above rule, present value of future net cash flow can be calculated as follow.

Present value of loan taken by businessman would be:

$120{,}000 \times [1-\{1/(1+.15)^{10}\ \}/0.15 + 10{,}00{,}000/(1.15)^{10}$

= Rs. 6022,252 + 247,185

=Rs. 849,437

Therefore, value of loan to be recorded under present value basis would be Rs. 849,437.

Hence, from the above exercise of various measurement bases, we can arrive at the following results:

(Figures in Rs.)

Particulars	**Historical Cost**	**Current Cost**	**Realizable Value**	**Present Value**
Asset: Machine	900,000	1,200,000	700,000	903,378
Liability: Loan	1,000,000	900,000	1,000,000	849,437

4.2 GENERALLY ACCEPTED ACCOUNTING PRINCIPLES (GAAP)

Generally Accepted Accounting Principles may be defined as those rules of action or conduct which are derived from experience and practice and when they prove useful, they become accepted as principles of accounting.

According to the American Institute of Certified Public Accountants (AICPA), the principles which have substantial authoritative support become a part of the generally accepted accounting principles.

The generally acceptance of the accounting principles or practices depends upon how well they meet the following three criteria:

(a) **Relevance**: A principle is relevant to the extent it result in information that is meaningful and useful to the user of the accounting information.

(b) **Objectivity:** Objectivity implies reliability and trustworthiness. A principle is objective to the extent the accounting information is not influenced by personal bias or judgments of those who provide it. It also implies verifiability which means that there is some way of ascertaining the correctness of the information reported.

(c) **Feasibility:** A principle is feasible to the extend it can be implemented without much complexity or cost.

4.3 ACCOUNTING CONCEPTS

The terms "accounting principles", "postulates of accounting", "accounting concepts", and "accounting conventions" mean those basic points of agreement on which financial accounting theory and practices are founded.

The following are the widely accepted accounting concepts. Many authors frequently mention these as conventions.

▪ Business Entity	▪ Money Measurement	▪ Periodicity
▪ Cost	▪ Realization	▪ Matching
▪ Dual aspect	▪ Conservatism	

a. Business Entity/Accounting Entity Concept

According to this concept, a business is treated as a separate entity that is distinct from its owner who provides the required capital to Transactions are made distinct between (i) personal transactions and business transaction and only those economic events which affect the business unit are recorded, and (ii) transactions of one business entity and those of another business entity. This concept can be expressed through an accounting equation, viz., Assets = Liabilities + Capital. The equation clearly shows that the business itself owns the assets and in turn owes to various claimants. It is worth mentioning here that the business entity concept as applied in accounting for sole trading units is different from the legal concept. The expenses, income, assets and liabilities not related to the sole proprietorship business are excluded from accounting. However, a sole proprietor is personally liable and required to utilize non-business assets or private assets also to settle the business creditors as per law. Thus, in the case of sole proprietorship, business and non-business assets and liabilities are treated alike in the eyes of law. In the case of a partnership, firm, for paying the business liabilities the business assets are used first and it any surplus remains thereafter, it can be used for paying off the private liabilities of each partner. Similarly, the private assets are first used to pay off the private liabilities of partners and if any surplus remains, it is treated as part of the firm's property and is used for paying the firm's liabilities. In the case of a company, its existence does not depend on the life span of any shareholder.

b. Money Measurement Concept

According to this concept, in the books of accounts only such transactions which are capable of being expressed in monetary terms are recorded. In other words, the information which cannot be expressed in the terms of money is not included in accounting records. Money is considered as a common denominator, by means of which various facts, events and transactions about a business can be expressed in terms of numbers. It is a useful way of converting accounting data into a common unit. Otherwise, it would be impossible to make any fair comparisons between various types of assets, or different types of transactions. Monetary terms are used because money acts as a common unit of measurements and the different transactions expressed in different units are brought to a common unit of measurement.

The Conceptual Framework of Nepal Financial Reporting Standard states: "Measurement is the process of determining the monetary amounts at which the elements of the financial statements are to be recognized and carried in the Statement Of Financial Position and income statement. This involves the selection of the particular basis of measurement."

c. Cost Concept/Historical Cost Concept

As per this concept, transactions are recorded at the price actually paid or liability incurred against such transaction. According to this concept, an asset is ordinarily recorded in the accounting records at price actually paid to acquire it at a time of its acquisition and the cost become the basis for the accounting during the period of acquisition and subsequent accounting period.

The jurisdiction for the use of this concept lies in the fact that it is objectively verifiable. This does not mean that the asset will always be shown at cost. The cost of an asset is systematically reduced from year to year by charging depreciation and the asset is shown at reduced figure known as book value of an asset. The purpose of providing depreciation is to allocate the cost of an asset over its useful life and not to adjust its cost so as to bring it close to the market value.

d. Realization Concept

This concept states that revenue from business transaction should be recorded in the books of accounts only when it is realized or obtain the legal right to receive the money.. It does not anticipate events though anticipated adverse effects of events that have already occurred are usually recorded. This is of great importance in stopping business firms from inflating their profits by recording sales and incomes that are likely to accrue. Unless money has been realized either cash has been received or legal obligation to receive has been assumed by the consumer, no sale can be said to have taken place and no profit or income can be said to have arisen.

e. Periodicity Concept

This is also called the concept of definite accounting period. As per going concern concept an indefinite life of the entity is assumed. For business entity it causes inconvenience to measure performance achieved by the entity in the ordinary course of business. If a business company lasts for 100 years, it is not desirable to measure its performance as well as financial position only at the end of its life. So a small but workable fraction of time is chosen out of infinite life cycle of the business entity for measuring performance and looking at the financial position. Generally one year period is taken up for performance measurement and appraisal of financial position.

Thus, for performance appraisal it is not necessary to look into the revenue and expenses of an unduly long time frame. This concept makes the accounting system workable and the term 'accrual' meaningful. If one thinks of indefinite time frame nothing will accrue. There cannot be unpaid expenses and non-receipt of revenue. Accrued expenses or accrued revenue is only with reference to a finite time frame which is called accounting period. In Nepal, accounting period starts from 1^{st} Shrawan every year and ends at the end of Ashad in next year. In India, accounting period starts from 1^{st} April every year and ends at the end of March in next year.

f. Matching Concept

The matching concept requires that the expenses for an accounting period should be matched against related incomes, rather than recognizing revenues as being earned at the time when cash is received or recognizing expenses when cash is paid, and there by, comparing cash receipts with cash payments.

Illustration:

Mr. Keshav started garment business. He purchased 10,000 pcs. of garments @ Rs. 100 per piece and sold 8,000 paces. @ Rs. 150 per piece during the accounting period of 12 months 1st January to 31st December 2012. He paid shop rent @ Rs. 3,000 per month for 11 months and paid Rs. 800,000 to the suppliers of garments and received Rs. 1,000,000 from the customers.

Let us see how the accrual and periodicity concepts operate:

Periodicity concept fixes up the time frame for which the performance is to be measured and financial position is to be appraised. Here, it is January 2012 to December 2012. So revenues and expenses are to be measured for the year 2012 and assets and liabilities are to be ascertained as on 31^{st} December, 2012.

Accrual concept operates to measure revenue of Rs. 1,200,000 (arising out of sale of garments 8,000 pieces x Rs. 150) which accrued during 2012, not the cash received Rs. 1,000,000 and also the expenses correctly. Shop rent for 12 months is an expense item amounting to Rs. 36,000, not the cash paid amounting Rs 33,000

Should the accountant treat Rs. 1,000,000 as expenses for purchase of merchandise? And should he treat Rs. 164,000 as profit? (Revenue Rs. 1,200,000-Merchandise Rs. 1,000,000, shop rent 36,000) Obviously the answer is **'NO'**. Matching links revenue with expenses.

Revenue – Expenses = Profit.

But this unqualified equation may create misconception. It should be defined as Periodic profit = Periodic Revenue – Matched Expenses. From the revenue of an accounting period such expenses are deducted which are expended to generate the revenue to determine profit of that period.

In the given example revenue relates to only sale of 8,000 pcs of garments. So, the cost of 8,000 pcs of garments should be treated as an expense.

STATEMENT OF PROFIT OR LOSS

Particular	**Rs.**
Revenue	1,200,000
Less: General Expenses	
Purchase Merchandise	800,000
Shop Rent Expenses	36,000
Profit of the year	**364,000**

STATEMENT OF FINANCIAL POSITION

Particular	**Rs.**
Assets:	
Stock (2,000 pieces. X Rs. 100)	200,000
Debtors	200,000
Cash (Cash receipt Rs, 10,00,000)	
(Cash payments Rs. 8,33,000)	167,000
	567,000
Liabilities:	
Trade creditors	200,000
Expenses Creditors	3,000
Capital (for profit)	364,000
	567,000

So, accrual, periodicity and matching are the three procedural conventions that work simultaneously for income measurement and recognition of assets and liabilities, while going concern, cost and realization concepts give the valuation criteria. Entity and money measurement are viewed as basic concepts on which other procedural concepts hinged.

Take the following cases and see how matching of cost and revenue is done in the process of profit measurements:

(1) Annual sales Rs. 300,000. Accounting period is 1/1/2012-31/12/2012. Sales performed on 31/12/2012 amounting to Rs. 50,000 for which cost of goods sold Rs. 35,000. Such goods are still lying in the store at the buyer's risk. The sale functions are complete when the ownership and risks associated are transferred from sellers to buyers. Sales are recognized as revenue, cost of goods sold should also be recognized as expense. Cost of Inventory at the end of financial year should not include cost of such goods which have already been sold.

(2) Fixed assets are used to generate revenue. It is difficult to exactly determine the proportion of the cost of fixed assets to be matched against revenue. Various methods of allocation of cost of fixed assets like straight-line and written down value is usually employed to find out depreciation. Such depreciations are matched against revenue in the profit determination process.

(3) Administrative expenses are not directly related to sales. These are generally called indirect expenses. These expenses are also called period costs. These are incurred on time basis-fortnightly, monthly, quarterly, etc. Whenever such administration expenses are incurred in the normal course of business for revenue generation, such expenses of the accounting period are charged to revenue. It may so happen that part of such expenses is incurred to generate revenue in the next accounting period. But that possibility is ignored and the totals of administrative expenses are charged to Statement Of Profit or Loss. If administrative expenses are related to construction of fixed assets which is reliably measure , such expenses incurred for construction of fixed assets should be capitalized.

g. Dual Aspect Concept

According to this basic concept of accounting, every transaction has a two-fold aspect, viz., (1). Giving certain benefits and (2) Receiving certain benefits. The basic principle of double entry system is that every debit has a corresponding and equal amount of credit. This is the underlying assumption of this concept.

Every transaction or event may effect in following ways:

(i) It increases one Asset and decreases other Assets;
(ii) It increases one Asset and simultaneously increases Liability;
(iii) It decreases one Asset, increases another Asset;
(iv) It decreases one Asset, decreases a Liability.

Alternatively:

(v) It increases one Liability, decreases other Liability
(vi) It increases a Liability, increases an Asset;
(vii) It decreases Liability, increases other Liability
(viii) It decreases Liability, decreases an Asset.

Further, the accounting equation viz., Assets = Capital + Liabilities or Capital = Assets – Liabilities, will further clarify this concept, i.e., at any point of time the total assets of the business unit are equal to its total liabilities. Liabilities relate both to the outsiders and the owners. Liabilities to the owners are considered as capital and other liabilities like loan, creditors and payables are the claim of outsider.. Therefore, at any point of time, the total assets of a business are equal to its total liabilities...

Illustration 1:

Statement Of Financial Position as on 31/12/2012

Liabilities	Rs	Assets	Rs
Capital	500,000	Plant & Machinery	475,000
Bank Loan	150,000	Furniture	50,000
Other Payable	50,000	Bank	75,000
		Cash	100,000
	700,000		**700,000**

Transactions of 1/1/2013:

(a) Purchase of new furniture costing Rs. 60,000 by paying in cash.
(b) A new machine is purchased for Rs. 75,000 on credit; cash is to be paid later on.
(c) Cash paid to repay bank loan to the extent of Rs. 50,000.
(d) Raised bank loan of Rs. 50,000 to pay off other payable.

Required : Show the Effects of the transactions in Statement of Financial position

Solution

(a) Increase in value of furniture and decrease in cash balance by Rs. 60,000. Case - (i &iii)

Statement Of Financial Position as on 1/1/2013

Liabilities	Rs.	Assets	Rs.
Capital	500,000	Plant & Machinery	475,000
Bank Loan	150,000	Furniture	110,000
Other payable	50,000	Bank	75,000
		Cash	40,000
	700,000		**700,000**

(b) Increase in machine value and increase in creditors called other payable by Rs.75,000.

Case - (ii)

Statement Of Financial Position as on 1/1/2013

Liabilities	Rs.	Assets	Rs.
Capital	500,000	Plant & Machinery	550,000

Bank Loan	150,000	Furniture	110,000
Other Payable	**125,000**	Bank	75,000
		Cash	40,000
	775,000		**775,000**

(c) Decrease in bank loan and decrease in bank by Rs. 50,000.

Case - (iv & viii)

Statement Of Financial Position as on 1/1/2013

Liabilities	**Rs.**	**Assets**	**Rs.**
Capital	500,000	Plant & Machinery	550,000
Bank Loan	100,000	Furniture	110,000
Other payable	125,000	Bank	25,000
		Cash	40,000
	725,000		**725,000**

(d) Increase in Bank loan and decrease in other payable by Rs. 50,000.

Case - (v & vii)

Statement Of Financial Position as on 1/1/2013

Liabilities	**Rs.**	**Assets**	**Rs.**
Capital	500,000	Plant & Machinery	550,000
Bank Loan	150,000	Furniture	110,000
Other payable	75,000	Bank	25,000
		Cash	40,000
	725,000		**725,000**

h. Conservatism (or Prudence) Concept

Conservatism is a prudence reaction to uncertainty to ensure that uncertainty and risks inherent in business situations are adequately considered. Where there is a reasonable choice of accounting treatments, the concept of conservatism refers to early recognition of unfavorable events. This concept requires an accountant to record an event in such a way as to show a weaker state of affairs than what actually exists and thereby drawn attention to events that result in the lowest value of an income. It states that –the accountant should not anticipate income and should provide for all possible losses. When there are many alternative values of an asset, an accountant should choose the method which leads to the lesser value. It means that this concept requires that assets and profits should not be overstated and revenue never anticipated, being recognized only when there is a reasonable certainty about its realisation. At the same time, provision must be made for all possible liabilities, whether the amount is known with certainty or is bases on estimation. For illustration, inventories are recorded at their cost or market price, whichever is less, or if there is an appreciation that a debt may not be realised, a specific amount is set aside from profit as a provision for doubtful debts.

The realization concept also states that no change should be counted unless it has materialized. The Conservatism Concept puts a further brake on it. It is not prudent to count unrealized gain but it is desirable to guard against all possible losses.

For this concept there should be at least three qualitative characteristics of financial statements, namely, (i) prudence, i.e. judgment about the possible future losses which are to be guarded, as well as gains which are uncertain. (ii) Neutrality, i.e. unbiased outlook is required to identify and record such possible losses, as well as to exclude uncertain gains, (iii) faithful representation of alternative values.

It may be argued that conservatism must involve "understating gains and values" “overstating losses and liabilities". Accountants are in the position of trust and do not attempt to be dishonest. The concept of conservatism attempt to state the lowest likely value for the profit and assets, and the highest likely value for the losses or liabilities incurred.

i. Full Disclosure Concept

This concept requires the entity to disclosure all the relevant and reliable information of the business which may be useful for the users. This principle implies that Financial Statements should convey all the information instead of concealing such information.

As an example, we can take notes to accounts is appended to the financial statemenst as a practice of this principle. The disclosure should be full, fair & adequate so that the users of the financial statements can make correct decision regarding the financial performance and position of the business.

This concept is like an exception to the Materiality Concept.

4.4 FUNDAMENTAL ACCOUNTING ASSUMPTIONS

Fundamental accounting assumptions underline the preparation and presentation of financial statements. They are usually not specifically stated because their acceptance and use are assumed. Disclosure in financial statements is necessary if they are not followed. As per Nepal Accounting Standard (NAS) 1 'Presentation of Financial Statements’ issued by Nepal Accounting Standard Board (NASB) – going concern, accrual basis and consistency are taken as basic accounting assumptions to prepare the financial statements. So every entity should follow these assumptions for preparing financial statements unless otherwise stated.

a. Going Concern

Under this concept, it is assumed that the business will remain in operation into the foreseeable future in pursuit of its goals and objectives without any intention of closure or liquidation. It implies stability and continuity for a period, sufficient to carry business plan. It assumed that business activities will continue at least for a span of time necessary to meet its present contractual obligations and to recover the original cost of its fixed assets during their commercially useful life.

Accordingly the transactions and events are recorded. It is because of this concept that necessitates distinction between expenditure that will render benefit over a long period and that whose benefit will be exhausted within the financial period. Assuming that the entity will continue indefinitely allows accountants to value long-term assets, such as land, at cost on the Statement of Financial Position since they are to be used rather than sold. Market values of these assets would be relevant only if they were for sale. For instance, accountants would still record land purchased in 2014 at its cost of Rs 100,000 on the Statement Of Financial Position even though its market value has risen to Rs 300,000.

b. Consistency

The convention of consistency refers to the state of accounting rules, concepts, principles, practices and conventions being observed and applied constantly, i.e., from one year to another there should not be any change. If accounting rules, principles and practices are consistently followed, the results and performance of one period can he compared easily and meaningfully with the other. It also prevents personal bias as the persons involved have to follow the consistent rules, principles, concepts and conventions. This convention, however, does not completely ignore changes. It admits changes wherever indispensable and adds to the improved and modern techniques of accounting.

c. Accrual

The accrual method of accounting requires that revenue be recognized and assigned to the accounting period in which it is earned. Similarly, expenses must be recognized and assigned to the accounting period in which they are incurred.

The accrual method relies on the principle of matching revenues and expenses. This principle says that the expenses for a period, which are the costs of doing business to earn income, should be compared to the revenues for the period, which are the income earned as the result of those expenses. In other words, the expenses for the period should accurately match up with the costs of producing revenue for the period.

In general, there are two types of adjustments that need to be made at the end of the accounting period. The first type of adjustment arises when more expense or revenue has been recorded than was actually incurred or earned during the accounting period. An example of this might be the pre-payment of a 2-year insurance premium, say, for Rs 200,000. The actual insurance expense for the year would be only Rs 100,000. Therefore, an adjusting entry at the end of the accounting period is necessary to show the correct amount of insurance expense for that period.

Similarly, there may be revenue that was received but not actually earned during the accounting period. For example, the business may have been paid for services that will not actually be provided or earned until the next year. In this case, an adjusting entry at the end of the accounting period is made to defer, that is, to postpone, the recognition of revenue to the period it is actually earned.

4.5 ACCOUNTING POLICIES

Accounting policies refer to specific accounting principles, bases, conventions, rules and practices and methods of applying these principles adopted by the enterprise in the preparation and presentation of financial statements. The accounting policies are based on the accounting concept as discussed above and the method of practice.

There is no single list of accounting policies which are applicable to all enterprises in all circumstances. Basically, enterprises operate in diverse and complex environment and so they have to adopt various policies. The choice of specific accounting policy appropriate to the specific circumstances in which the enterprise is operating calls for considerate judgement by the management itself.

4.6 ACCOUNTING STANDARDS & ITS DEVELOPMENT

Accounting Standards are the common sets of principles and procedures that define the basis of financial accounting policies and practices. In other word, these are set of rules which are kept to practice and are widely accepted.

In 1972 International Accounting Standards Committee (IASC), was formed for development of International Accounting Standards (IASs). This committee comprises the professional bodies of more than 72 countries. The committee has issued 40 IASs so far. In 1977, another professional body, the International Federation of Accountants (IFAC) was established with 63 founding members from 51 countries which has now grown to include over 175 members and associates in more than 135 countries and jurisdictions worldwide.

4.7 NEPAL ACCOUNTING STANDARDS BOARD (NASB)

The Nepal Accounting Standards Board (NASB) was formed under the provision of The Institute of Chartered Accountants of Nepal Act 1997. The main function of NASB is to formulate Accounting Standards which is a set of accounting policies and broad guidelines regarding the principles and methods to be followed while preparing and presenting the financial statements. While formulating accounting standards NASB takes into consideration applicable laws, customs, usage and business environment.

The parallel international body is the International Accounting Standards Board (IASB). NASB takes into consideration the standards issued by IASB, called International Accounting Standards (IASs) or International Financial Reporting Standards (IFRSs).

The NASB has so far issued 28 accounting standards and 13 Nepal Financial Reporting Standards

NFRS/ NAS	**Standard Name**
NAS 01	Presentation of Financial Statements
NAS 02	Inventories
NAS 07	Statement Of Cash Flow
NAS 08	Accounting Policies Change in Accounting Estimates & Errors
NAS 10	Events After the Balance Sheet Date
NAS 11	Construction Contract
NAS 12	Income Taxes
NAS 16	Property, Plant and Equipment
NAS 17	Leases
NAS 18	Revenue
NAS 19	Employees Benefit
NAS 20	Accounting for Government Grants and Disclosure of Government Assistance
NAS 21	The Effects of Changes in Foreign Exchange Rates
NAS 23	Borrowing cost
NAS 24	Related Party Disclosures
NAS 26	Accounting and Reporting by Retirement Benefit Plans
NAS 27	consolidated & Separate Financial Statements
NAS 28	Investment in Associates
NAS 32	Financial Instruments : Presentations
NAS 33	Earnings Per Share
NAS 34	Interim Financial Reporting
NAS 36	Impairment of Assets
NAS 37	Provisions, Contingent Liabilities and Contingent Assets
NAS 38	Intangible Assets
NAS 39	Financial Instruments : Recognition & Measurements
NAS 40	Investment Property
NAS 41	Agriculture
NFRS 1	First Time Adoption of Nepal Financial Reporting Standards
NFRS 2	Share Based Payments
NFRS 3	Business Combinations
NFRS 4	Insurance Contracts
NFRS 5	Non-Current Assets held for Sale & Discontinued Operation
NFRS 6	Exploration for and Evaluation of Mineral Resource

NFRS 7	Financial Instruments: Disclosures
NFRS 8	Operation Segments
NFRS 9	Financial Instrument
NFRS 10	Consolidated Financial Statements
NFRS 11	Joint Arrangements
NFRS 12	Disclosure of Interest in Other Entities
NFRS 13	Fair Value Measurement

4.8 QUALITATIVE CHARACTERISTICS OF FINANCIAL STATEMENTS

Qualitative characteristics are attributes that make the information provided in financial statements useful to the users. The fundamental qualitative characteristic of the financial information are

a. Relevance;
b. Faithful representation
c. Material

Other enhancing qualitative characteristic of financial information are

a. Comparability.
b. Verifiability
c. Timeliness
d. Understandability

a. Relevance:

To be useful, information must be relevant to the decision-making needs of users. Information has the quality of relevance when it influences the economic decisions of users by helping them evaluate past, present or future events or confirming, or correcting, their past evaluations. The relevance of information is affected by its nature and materiality. Information becomes material if its omission or misstatement could influence the economic decisions of users taken on the basis of financial statements. Materiality depends upon the size of the item and error judged in the particular circumstances of its omission or misstatement. Thus materiality provides a threshold or cut off point rather than being primary qualitative characteristic which information must have it is to be useful.

b. Faithful Representation

Financial information must not only represent relevant characteristic but it must also faithfully represent the phenomena that it purports to represent. To be faithful representation, presentation would have three characteristic ie complete, neutral and free from error.

All information necessary for a user to understand the transactions are completely presented in the financial statement including all necessary descriptions and explanations of significant facts about the quality and nature of transaction and events

Selection or presentation of financial statement should be without bias. Financial statement should not be manipulated to increase the probability that financial information will be received favorably or unfavorably by the users

Free from error means there are no error or omission in the description of the phenomenon and the process used to produce the reported information that has been selected and applied with no errors in the process.

c. Material

Materiality principle permits other concepts to be ignored, if the effect is not considered material. According to this principle, all the items having significant economic effect on the business of the enterprise should be disclosed in the financial statements and any insignificant item which will only increase the work of the accountant but will not be relevant to the user's need should not be disclosed in the Financial Statements.

The term materiality is the subjective term. It is on the judgment, common sense and discretion of the accountant that which item is material and which is not. For example, depreciation on small items like; calculator, books etc. is taken as full in the year of purchase though used by the enterprise for more than a year. This is because the amount of calculator or books is very small to be shown in the Statement Of Financial Position though it is the asset of the company. Similarly, stationery purchased by the enterprise though not used fully in the accounting year of purchase still shown as an expense of that year because of materiality concept.

The other enhancing qualitative characteristics of financial statements are comparability, verifiability, timeliness and understandability.

a. Comparability:

The financial statements should allow the users to compare the financial position and performance of an entity over the period in order to identify its trends. Further it must allow the users to compare the financial statements of different entities in order to evaluate their relative financial position, performance and changes in financial position. By this way the users can form some judgment. Hence, the measurement and display of the financial effect of like transactions and other events must be carried out in a consistent way throughout an entity and over time for that entity and in a consistent way for different entities.

b. Verifiability

Verifiability means that different knowledgeable and independent observer could reach consensus, although not necessarily complete agreement, that a particular depiction is a faithful representation. Verifiability helps assure users that information faithfully represents the economic phenomena it purports to represents.

c. Timeliness

Timeliness principle in financial information means need for information to be available to decision maker in time to be capable of influencing their decisions. Timeliness is important to protect the users of accounting information from basing their decisions on outdated information

d. Understandability:

An essential quality of the information provided in financial statements is that it is readily understandable by users. For this purpose, users are assumed to have a reasonable knowledge of business and economic activities and accounting and a willingness to study the information with reasonable diligence. However, information about complex matter that should be included in the financial statements because of its relevance to the economic decision-making needs of users should not be excluded merely on the grounds that it may be too difficult for certain users to understand.

If accounting information is to present faithfully the transactions and other events that it purports to represent, it is necessary that they are accounted for and presented in accordance with their substance and economic reality, "Not by their legal form”. For example, if a business enterprise sells its assets to others but still uses the assets as usual for the purpose of the business by making some arrangement with the sells, it simply becomes a legal transaction. The economic reality is that the business is using the assets as usual for deriving the benefit. Financial statement information should contain the substance of this transaction and should not only record going by legality. In order to be reliable the financial statements information should be neutral i.e. free from bias. The preparation of financial statements however, have to contend with the uncertainties that inevitably surround many events and circumstances, such as the collectability of doubtful receivables, the probable useful life of plant and equipment and the number of warranty claims that may occur. Such uncertainties are recognized by the disclosure of their nature and extent and by exercise of prudence in the preparation of financial statements. Prudence is the inclusion of a degree of caution in the exercise of judgment needed in making the estimates required under condition of uncertainty such that assets and income are not overstated and loss and liability are not understated.

Summary

In this unit, we have discussed that there are four measurement bases namely Historical cost, Current cost, Realizable value and Present value. The traditional accounting system is mostly on the lines of historical cost based measurements. All other measurement bases are also suitably used although less frequently in the traditional accounting system.

The structure of traditional historical cost based accounting has been built up on the foundation given by the following concepts or postulates: Entity, Money Measurement, Gong Concern, Cost, Realization, Accrual, Periodicity, Matching, Dual Aspect, Consistency, Conservatism and Materiality.

NAS 1 "Presentation of Financial Statement" states that going concern, consistency and accrual are the fundamental accounting assumptions. If there is any deviation from these assumptions it is to be disclosed clearly.

The framework for the preparation and presentation of financial statements in Nepal Accounting Standards states that the understandability, relevance, reliability, comparability, faithful representation, substance over form, neutrality, prudence and completeness are some of the qualitative characteristics of financial statements. Hence, it is highly recommended that the accountants give utmost importance to these characteristics for meaningful presentation of accounting data to the users.

Self-Examination Questions

I. Multiple Choice Questions (MCQs)

1. Every transaction and events should be recorded in books of account at their _____
   (a) Current Cost (b) Historical Cost
   (c) Present Cost (d) Any of the above

2. All the following items are classified as Fundamental Accounting Assumptions except
   (a) Consistency (b) Business Entity
   (c) Accrual Basis (d) Going Concern

3. Two primary qualitative characteristic of financial statements are
   (a) Understandability and Materiality (b) Relevance and reliability
   (c) Relevance and Materiality (c) Understanding and reliability

4. Kopila Enterprises follows the straight line method of depreciation policy year after year due to
   (a) Materiality (b) Convenience
   (c) Consistency (d) None of the above

5. Fixed Assets are held in the business for the purpose of
   (a) Resale (b) Conversion into cash
   (c) Earning Income (d) None of the above

6., Decrease in the amount of creditors results in
   (a) Increase in cash (b) Decrease in cash
   (c) Decrease in Assets (d) No change in assets

7. Economic life of an entity is split into the periodic interval as per
   (a) Periodicity (b) Matching
   (c) Materiality (d) Accrual Basis

8. All of the following are measurement principles except

(a) Historical Cost (b) Present Value
(c) Future Value (d) Realisable Value

M/s. Swapneel Enterprises purchased a plant amounting Rs. 100,000 on 1.4.2007. On 31.3.2011 the similar plant could be purchased for Rs. 200,000 but the realizable value of the machinery (purchased on 1.4.2007) was estimated at Rs. 150,000. The present discounted value of the future net cash inflows that the plant was expected to generate in the normal course of business, was calculated as Rs. 120,000.

9. The current cost of the plant above is

a. Rs. 100,000 b. Rs. 200,000
c. Rs. 150,000 d. Rs. 120,000

10. The present value of plant above is

a. Rs. 100,000 b. Rs. 200,000
c. Rs. 150,000 d. Rs. 120,000

11. The historical cost of the plant above is

a. Rs. 100,000 b. Rs. 200,000
c. Rs. 150,000 d. Rs. 120,000

12. A businessman purchased goods for Rs. 500,000 and sold 3/4 of the goods for Rs. 550,000 and met expenses Rs. 10,000 for the year 2012. He counted net profit Rs. 40,000. Which of the following accounting concepts did violate?

(a) Matching (b) Entity
(c) Prudence (d) None of the above

13. An accountant found that a company purchased building for Rs. 25,00,000 on 1st January 2013. The Market value of the Building was Rs. 35,00,000 on 31st December. 2013. If he values the Building for Rs. 35,00,000 while finalizing the accounts which of the following accounting concepts does he violate?

(a) Cost (b) Realization
(c) Money Measurement (d) None of the above

14. A businessman purchased merchandise worth Rs. 12 lakhs and sold 11/12 of the merchandise during the year. The market value of the remaining merchandise was Rs. 96,000. He valued the closing stock of merchandise at cost. Which of the accounting concept did he violate by such treatment?

(a) Cost (b) Matching
(c) Conservatism (d) None of the above

15. Personal transactions are distinguished from business transactions of an accounting period in accordance with

    (a) Periodicity Concept (b) Entity Concept
    (c) Money Measurement Concept (d) None of the above

16. Mr. Y followed WDV method and SLM method of depreciation during FY 2066/67 and 2067/68 respectively. He has violated
    (a) Conservatism Principle (b) Materiality Principle
    (c) Consistency Principle (d) Cost Principle

17. Nepal Accounting Standards (NASs) in Nepal are issued by
    (a) Nepal Government
    (b) Supreme Court
    (c) The Nepal Accounting Standards Board (NASB)
    (d) The Institute of Chartered Accountants of Nepal (ICAN)

18. It is essential to standardize the accounting principles and policies in order to ensure
    (a) Transparency (b) Consistency
    (c) Comparability (d) All of the Above

19. At present how many IFRS has been issued by ICAN ?
    (a) 15 (b) 20
    (c) 13 (d) None of the above

20. The assets are classified as current assets and fixed assets in accordance with –
    (a) Accounting period assumption (b) Matching Principle
    (c) Consistency Principle (d) Going concern Principle

21. Prudence Principle is an exception to the –
    (a) Matching Principle (b) Going concern Principle
    (c) Conservatism (d) Consistency

II. Short Descriptive Questions (SDQs)

1. What are the various measurement bases of business transactions?
2. Discuss the different accounting concepts used by the professional accountant.
3. What are the fundamental accounting assumptions?
4. Write Short note on:
   a. Nepal Accounting Standards
   b. Accounting Policy.
   c. Qualitative characteristics of financial statements.
   d. Materiality Concept

ANSWER							
Multiple Choice Questions (MCQs)							
1	b	6	c	11	a	16	c
2	b	7	a	12	a	17	c
3	b	8	c	13	a	18	d
4	c	9	b	14	c	19	c
5	c	10	d	15	b	20	d
21	d						

CHAPTER- 1

Fundamentals of Accounting: Introduction

UNIT 5:

Accounting as a Measurement Discipline

Learning Objectives

1. *Understand the meaning of measurement and its basic elements.*
2. *Try to reconcile how far accounting is a measurement discipline with reference to three basic elements of measurement.*
3. *Observe the distinction between measurement and valuation.*

5 INTRODUCTION

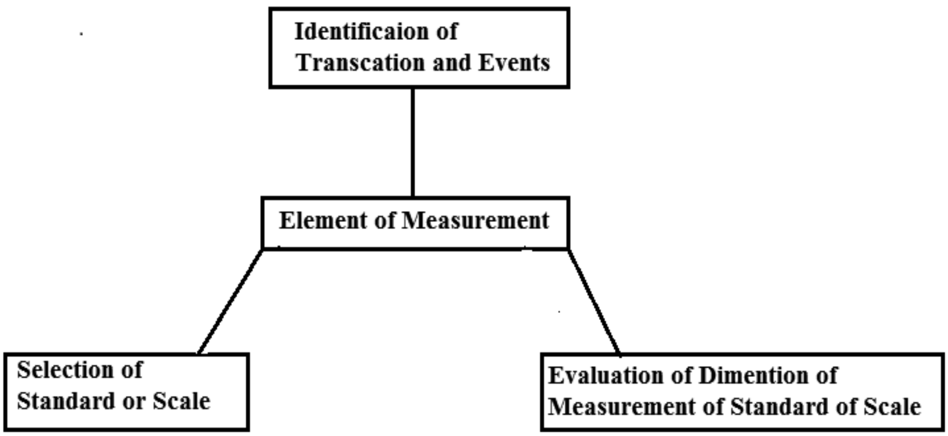
Measurement is vital aspect of accounting. In accounting, money is the scale of measurement that measure transactions and events in terms of money. Any measurement discipline deals with three basic elements of measurement viz., identification of transactions and events to be measured, selection of standard or scale to be used, and evaluation of dimension of measurement standards of scale.

5.1 MEANING OF MEASUREMENT

Prof. R.J. Chambers defined measurement as "assignment of number to objects and events according to rules specifying the property to be measured, the scale to be used and the dimension of the unit. Thus, the basic three elements of measurements are:

(i) Identification of transactions and events to be measured
(ii) Selection of standard or scale to be used.
(iii) Evaluation of dimension of measurement standard of scale.

Chambers' definition has been widely used to judge how far accounting can be treated as a measurement discipline.



5.2 TRANSACTIONS OR EVENTS TO BE MEASURED

Accounting is defined as the process of identifying, measuring and communicating economic information to permit informed judgments and decisions.

Since, decision maker need past and present future information. However, the past information is generally communicated to the external user. There is no uniform set of events and transactions in accounting which are required for decision making. For example, in cash management, the decision makers need past cash receipts and expenses data along with projected receipts and expenses. Similarly, while extending loan to customers it will require information regarding repayment capability (popularly known as debt servicing) of principal and interest.

This also includes past information, current state of affairs as well as future projections. It may be mentioned that past and present transactions or events can be measured with some degree of accuracy but future events and transactions are only predicted but not measured. Prediction is an essential part of accounting information. Decision makers have to take decisions about the unseen future for which they need suitable information.

5.3 STANDARD OR SCALE OF MEASUREMENT

As per the money measurement concept, Any transactions which can be measured in monetary value and are relevant to business transactions, will be recorded. So, in accounting system, money is the scale of measurement although quantitative information is also communicated along with monetary term as a part and partial of annual report at present.

Measurement is concerned with the process of assigning numbers to the attributes or characteristics of the elements being measured. Money as a measurement scale has no universal application because it takes the shape of currency ruling in a country which differs from one reporting country to another reporting country. For example, the scale of measurement in Nepal is Rupee, Pound sterling in UK, dollar in USA,. Also there is no constant exchange relationship among the currencies. Therefore, foreign assets and liabilities may vary in different time period due to change in exchange rate between reporting currency and transacted currency. Thus, the rate of exchange fluctuates between two currencies over time, money as measurement scale also becomes volatile.

5.4 DIMENSION OF MEASUREMENT SCALE

An ideal measurement scale should be stable over time. Money as a scale of measurement is not stable in the dimension for comparison over time because the same quantity of money may not have the ability to buy same quantity of identical goods at different dates. This occurs due to continuous change in the input-output prices. Thus, information of one year measured in money terms may not be comparable with that of another year.

Suppose sales of a company in two different years are as follows:

Year 1		Year 2	
Quantity	**Rs.**	**Quantity**	**Rs.**
10,000	1,000,000	9,000	1,080,000

Looking at the monetary figures , it could be observed that there is 8% growth in sales value. However, if we look at the quantum of sales, it had decreased by 10%. The growth envisaged through monetary figures is only due to price change. Let us suppose further that the cost of production for the above mentioned two years is as follows:

Year 1		Year 2	
Quantity	**Rs.**	**Quantity**	**Rs.**
10,000	800,000	9,000	900,000

Taking Gross Profit = Sales – Cost of Production. Then in the first year profit was Rs. 200,000 while in the second year the profit was Rs. 180,000. There was 10% decline in gross profit.

So money as a unit of measurement is not stable in dimension.

Thus, on evaluating the dimension of money as a measurement scale of transaction and event used for accounting purpose it could be observed that accounting is not an exact measurement discipline because accounting measures information mostly in monetary term which is (a) not a stable scale, (b) not having universal applicability, and (c) not stable in dimension for comparison over time. Though measurement is an important part of accounting discipline but a set of theorems which govern the measurement system (such as going concern, consistency, and accrual) should be carefully understood to know how the cogs of the accounting–wheel works. Although quantitative information is also required in many cases but such information is only supplementary to monetary information

5.5 MEASUREMENT AND VALUATION

Earlier we have discussed four valuation bases used in accounting namely, historical cost, current cost, realizable value and present value. Values relates to the benefit to be derived from objects, abilities or ideas. To the economist, value is the utility (i.e. satisfaction) of an economic resource to the person contemplating or enjoying its use. This is to say, value is measured in terms money. Suppose, a car is acquired by paying Rs. 20, 00,000. Its value lies in satisfaction to be derived by that individual using the car in future. Economists often use ordinal scale to indicate the level of satisfaction. But accountants use only cardinal scales. If the value of car is taken as Rs. 20,00,000 it is only one type of value called acquisition cost or historical cost. So value is indicated by measurement. In accounting always the value is measured in terms of money.

Summary

Any measurement discipline deals with three basic elements of measurement viz. identification of objects and events to be measured, selection of standard or scale to be used, and evaluation of dimension of measurement standards of scale. Measurement is the vital aspect of accounting and money is the scale of measurement i.e. primarily transactions and events are measured in terms of money. Measurement is the assignment of number to objects and events according to the rules identifying the property to be measured, the scale to be used and the dimension of the unit. There is no uniform set of events and transactions in accounting which are required for all the decision making.

The past and present object or events can be measured with some degree of accuracy but future events and objects are only predicted but not measured. Prediction is an essential part of accounting information. Decision makers have to take decisions about the unseen future for which they need suitable information. An ideal measurement scale should be stable over time however accounting is not an exact measurement discipline because accounting measures information mostly in monetary term which is (a) not a stable scale, (b) not having universal applicability, and (c) not stable in dimension for comparison over time. Though measurement is an important part of accounting discipline but a set of theorems which govern the measurement system (such as going concern, consistency, and accrual) should be carefully understood to know how the cogs of the accounting–wheel works.

Self-Examination Questions

I. Short Descriptive Questions (SDQs)

1. What is the standard measurement unit in accounting ? Does accounting measurement unit provide a constant dimension ?

2. Distinguish between value and measurement. Is it possible to use same measurement unit for different valuation bases ?

CHAPTER- 1

Fundamentals of Accounting: Introduction

UNIT 6:

Financial Statements

Learning Objectives:

1. *Understand what financial statements are all about.*
2. *Learn the various components of financial statements i.e. a Statement Of Financial Position, an income statement, a statement of changes in equity, a cash flow statement and an explanatory notes to accounts.*
3. *Analyze the purposes of various components of the financial statements.*

6 FINANCIAL STATEMENTS

Financial statements are the set of documents that are a structured representation of the financial position of the transactions undertaken by an entity. It is produced as a final output from the overall accounting processes undertaken by an enterprise .

Traditionally, the financial statements only included:

(a) A Statement Of Financial Position (or position statement) which shows the financial position of an entity at a particular point of time; and
(b) An Statement of Profit or Loss which shows the financial performance of business operation during an accounting period.

However, nowadays, a complete set of financial statements includes in addition to the aforesaid two basic financial statements, a Statement of Change in Equity, Cash Flow Statement and Explanatory Notes to the Accounts.

The objective of financial statements is to provide information about the financial position, financial performance and cash flows of an entity that is useful to a wide range of users in making economic decisions. Financial statements also show the results of management's stewardship of the resource entrusted to it. To meet this objective, financial statements provide information about an entity's

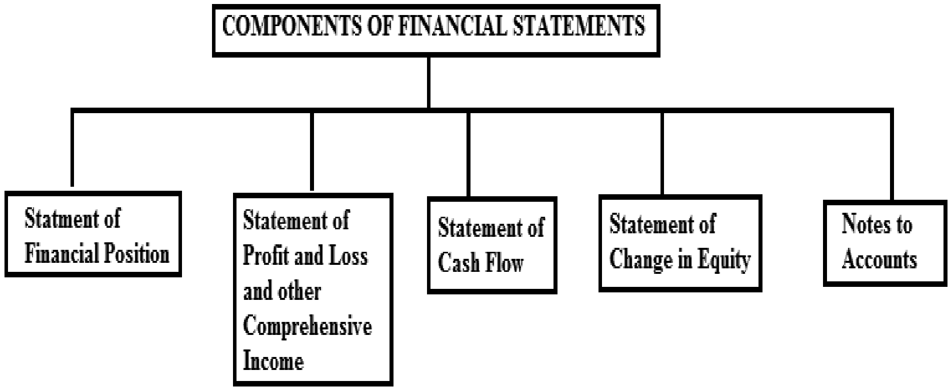
(a) Assets;
(b) Liabilities
(c) Equity;
(d) Income and expenses, including gains and losses;
(e) Changes in equity; and
(f) Cash Flow

This information, along with other information in the notes to financial statements, assists users in predicting the timing and certainty of the generation of cash and cash equivalents.

6.1 COMPONENTS OF FINANCIAL STATEMENTS

Nepal Accounting Standard on Presentation of Financial Statement (NAS 01) states a complete set of financial statements includes the following components:

a. Statement of Financial Position as at the end of the periods;
b. Statement of Profit or Loss and Other Comprehensive Income for the period
c. A Statement of Cash Flow for the period
d. A Statement of Changes in Equity for the period; and
e. Notes to the Accounts comprising a summary of significant accounting policies and other explanatory notes.



a Statement of Financial Position (Balance Sheet)

The Statement of Financial Position for the period exhibits its assets, external liabilities, capital and reserves at a given date. It summarizes two balances i.e. one balance for assets and the other balance for liabilities of the enterprise including what it owes to the proprietor, viz., capital. The Statement of Financial Position, therefore, is defined as a statement summarizing the financial position of a business on a given date. The Elements directly related to the measurement of financial position are assets, liability and equity. These are defined as follows

- An assets is a resource controlled by the enterprises as a result of past events from which future economic benefits are expected to flow to the enterprises
- A Liability is present obligation of the enterprises as a result of past events , the settlement of which is expected to result in an outflow from the enterprises of resources embodying economic benefits
- Equity is the residual interest in the assets of the enterprise after deducting all its liabilities.

A few points should be noted about a Statement of Financial Position. The first is that it is prepared as on a certain date and not for a period. The Statement of Financial Position is true only on the date concerned and not on any other day.

The second point is that the total of all assets must be equal to the total of all liabilities (including capital). Since capital is nothing but difference between assets and liabilities to outsiders, it is easy to understand why the two balances of the Statement Of Financial Position should agree. Normally, however one does not determine capital by deducting liabilities from the total assets. One utilizes the figure which the Capital Account gives. It is a test of accuracy therefore after entering the balance in the Capital Account, the two sides of the Statement of Financial Position should agree. This also flows from the principle of double entry.

The third point to note is that a Statement of Financial Position can be prepared only after the Statement of Profit and Loss and other comprehensive income for the period is prepared. This is the reason why the term “Final Accounts” is applied collectively to the Statement of Profit and Loss and other comprehensive income and the Statement of Financial Position. But the Statement of Financial Position is not an account and it does not have debit and credit sides. All the accounts which have not been closed by Statement of Profit and Loss must appear in the Statement of Financial Position ; otherwise the two balances of the Statement of Financial Position will not agree and it will not reflect the correct financial position of the enterprise.

i. Uses of Statement of Financial Position

The Statement of Financial Position is regarded as a prominent accounting report. The various economic users may use the Statement of Financial Position to derive much useful information as per below:

1. Ascertain the ownership interest including minority interest of the business.
2. Ascertain the position of assets, liabilities and net worth of the business.
3. Assess the position of cash and cash equivalent, inventories, receivables and payables of the business.
4. Assess different items of assets and liabilities in terms of liquidity.
5. Assist in calculating different management ratios.

b. Statement of Profit or Loss and Other Comprehensive Income

The accounting report that summarizes the revenues and the expenses of an accounting period is called the Statement of Profit or Loss and Comprehensive Income. In other words, it is a report of an entity's performance i.e. profit or loss during the period of operation.

The Statement of Profit and Loss shows how the entity's operation for the period have increased net assets (assets less liabilities) through revenues and decreased net assets through expenses. Revenue and expenses are defined as follow

- Income is increase in economic benefits during the accounting period in the form of inflows or enhancements of assets or decreases of liabilities that result in increases in equity, other than those relating to contributions from equity participants
- Expenses are decreased in economic benefits during the accounting period in the form of outflows or depletions of assets or incurrences of liabilities that result in decreases in equity , other than those relating to distributions to equity participants.

Because the income statement measures performance over a period of time, whether it may be a month, a quarter or of a longer period, it must always indicate the exact period covered by the statement.

i. Uses of Statement of Profit or Loss and Comprehensive Income

The various economic users may use the income statement to derive much useful information on:

1. Financial performance of an enterprise in terms of profitability.
2. Predict future performance of an enterprise based upon past performance and assess the capability of generating future cash flows.
3. Assess the performance of the management and make decisions.

c. Statement of Cash Flow

Cash flow statement is a summary of inflows and outflows of cash and cash equivalent from operating, investing and financing activities of an enterprise during the period. It presents the information on how the changes in Statement Of Financial Position for more than one period and income statement affect cash and cash equivalents, and breaks the analysis down to operating, investing, and financing activities.

Students should note that the cash flow statements are prepared under cash basis of accounting as against the accrual basis followed in the case of Statement Of Financial Position and Income Statements. Accordingly it includes only inflows and outflows of cash and cash equivalents; it excludes transactions that do not directly affect cash receipts and payments. These noncash transactions include depreciation or write-offs on bad debts or credit losses to name a few.

i. Uses of Statement of Cash Flow

Cash flow statement is the analytical tool that presents information on:

1. Enterprise’s ability to generate cash from different activities, viz., operating, investing and financing activities.
2. Enterprise's liquidity and solvency and its ability to change cash flows in future circumstances.
3. Evaluating changes in assets, liabilities and equity.
4. Improving the comparability of different firms' operating performance by eliminating the effects of different accounting methods
5. Possibility of the amount, timing and probability of future cash flows

d. Statement of Changes in Equity

As its name suggests a statement of changes in equity is a statement that presents the change in equity structure i.e. both capital and equity reserves of an enterprise during the period. It explains the causes of changes in equity by virtue of fresh issue/buy back of capital, profit or loss during the period, distribution of dividend etc.

Change in an entity's equity between two Statement Of Financial Position dates reflect the increase or decrease in its net assets or wealth during the period, under the particular measurement principles adopted and disclosed in the financial statements. Except for changes resulting from transactions with shareholders, such as capital contributions and dividends, the overall change in equity represents the total gains and losses generated by the entities activities during the period.

i. Uses of Statement of Changes in Equity

The statement of changes in equity is useful to measure the increase or decrease in an enterprise’s net assets or wealth during the period. It also helps an economic user to analyze the financial health of an enterprises in terms of net worth, capital contributions, status of reserves and retained earnings and its use, capacity of dividend distribution etc.

e. Notes to the Accounts

Notes to the Accounts are additional information on financial statements to supplement the user's need. Notes are given particularly relating to those items of the financial statements that needs more clarification and disclosure. For instance; legal status and objectives of the company, activities undertaken, financial condition, debt position, going concern assessment, contingent liabilities, or contextual information explaining the financial numbers (e.g. to indicate a lawsuit). Further, it also includes a description of measurement bases, accounting policies adopted and a declaration of compliance with the Nepal Accounting Standards while preparation of financial statements.

i. Uses of Notes to the Accounts

Notes to Financial Statements help explain the computation of specific items in the financial statement. The information contained in the notes not only supplements financial statement information, but they clarify line-items that are part of the financial statements. For example, if a company lists an impairment loss on a property, plant and equipment in their income statement, Notes to Financial Statements could serve to elaborate the reason for the impairment loss by providing specific information relative to the asset. Notes to the Financial Statements are also used to explain the method of accounting used to prepare the financial statements, and they provide valuations for how particular accounts have been represented.

6.2 LIMITATION OF FINANCIAL STATEMENTS

Financial statements are full of information about the results of operations, financial position and cash flows of an enterprise. It would be unthinkable to appraise the performance and position of a firm without the aid of these statements. An enterprise proclaims its efficiency, profitability and position based upon those statements so the accounting is said to be the language of business.

However, the message conveyed by the financial statements are not infallible and often, the conclusions indicated by the financial statements are not readily acceptable. This is because by their very nature, the statements suffer from a number of limitations as per below:

1. While complying with the accounting standards, the management has a choice out of a number of accounting policies, chiefly in regard to capitalization of borrowing cost, valuation of inventory etc. This will adversely affect the comparability of financial statements of one enterprise with another.
2. Financial Statements are drawn up primarily to satisfy the needs of the owners or shareholders. As such it may not address the information needs of other numerous interested parties of the financial statements such employees, government or regulating agencies, investors, creditors, financial analyst, academicians etc.
3. The financial statements are drawn up merely perform the custodial function, showing whether or not the funds entrusted to the management have been faithfully managed. As such a shareholder may find it difficult to decide on the basis of the information contained in the financial statements whether to dispose of his holdings or increase them.

4. The financial statements does not address the qualitative factors of an enterprise such as skill and loyalty of the workers, attitudes of consumers towards the company, research and development effort, the quality and caliber of management etc. which are vital for the continued success of the company.

5. Many items of financial statements are in the nature of estimates, for example; depreciation, provision for doubtful debt etc. As such these estimates amount may be different than the actual amount upon real recovery or settlement, deviation on estimates affect the true financial position of an enterprise.

6. Financial statements have now begun to suffer from a very serious limitation which arises from inflation. Even if an enterprise is only a year old, the values of the assets stated in the Statement Of Financial Position will be completely out of tune with the prevailing values. This means that the profitability worked out on the basis of the Statement Of Financial Position figures will be misleading. Further, it is to be recognized that good deal of profit reported in the Statement of Profit or Loss of a company today is due to inflation and, therefore illusionary. This is proved by the fact that a large number of manufacturing organizations in Nepal today are sick because, even though they reported good profits in the past, they could not build up enough funds to replace their plant and machinery when it became obsolete.

Summary

In this unit we have studied that the financial statements are the organized summaries of detailed information about the financial position and performance of an enterprise. We were able to gain an understanding on different components of financial statements such as; a Statement Of Financial Position; an income statement; a statement of changes in equity; a cash flow statement; and notes to the accounts. Financial statements are full of information about the results of operations, financial position and cash flows of an enterprise which is used by economic decision makers in their various rational economic decisions. Further, financial statements are one of the commonly used medium for an enterprise to proclaim its efficiency, profitability and position. Even though the financial statements are of great use there are certain limitations in the message conveyed by it. Therefore, one should not readily accept the conclusions indicated by the financial statements because of the limitation existed in its very nature.

Self-Examination Questions

I. Multiple Choice Questions (MCQs)

1. The main aim of accounting is to:

(a) Maintain ledger accounts for every transaction.
(b) Provide financial information to users of such information.
(c) Produce a trial balance.
(d) Record every financial transaction individually.

2. The main aim of financial accounting is to:

(a) Record all transactions in the books of account.
(b) Provide management with detailed analyses of costs.
(c) Present the financial results of the organization by means of recognised statements.
(d) Calculate profit.

3. Financial statements differ from management accounts in that they:

(a) are prepared monthly for internal control purposes.
(b) contain details of costs incurred in manufacturing.
(c) are summarised and prepared mainly for external users of accounting information.
(d) provide information to enable the trial balance to be prepared.

4. Which one of the following does not apply to the preparation of financial statements?

(a) They are prepared annually.
(b) They provide a summary of the outcome of financial transactions.
(c) They are prepared mainly for external users of accounting information.
(d) They are prepared to show the detailed costs of manufacturing and trading.

5. Which of the following statements gives the best definition of the objective of accounting?

(a) To provide useful information to users.
(b) To record, categorize and summarize financial transactions.
(c) To calculate the taxation due to the government.
(d) To calculate the amount of dividend to pay to shareholders.

6. Which one of the following sentences does not explain the distinction between financial statements and management accounts?

(a) Financial statements are primarily for external users and management accounts are primarily for internal users.
(b) Financial statements are normally produced annually, and management accounts are normally produced monthly.
(c) Financial statements are more accurate than management accounts.
(d) Financial statements are audited by an external auditor and management accounts do not normally have an external audit

7. Gross profit for 20X1 can be calculated from:

(a) Purchases for 20X1, plus inventories at 31 December 20X1, less inventories at 1 January 20X1.
(b) Purchases for 20X1, less inventories at 31 December 20X1, plus inventories at 1 January 20X1.
(c) cost of goods sold during 20X1, plus sales during 20X1.
(d) net profit for 20X1, plus expenses for 20X1.

8. The capital of a sole trader would change as a result of:
(a) a payable being paid on his account by cheque.
(b) raw materials being purchased on credit.
(c) non-current assets being purchased on credit.
(d) wages being paid in cash.

9. The ' accounting equation ' can be rewritten as:
(a) assets plus profit less drawings less liabilities equals closing capital.
(b) assets less liabilities less drawings equals opening capital plus profi t.
(c) assets less liabilities less opening capital plus drawings equals profi t.
(d) opening capital plus profi t less drawings less liabilities equals assets.

10. The accounting equation can change as a result of certain transactions. Which one of the following transactions would not affect the accounting equation?
(a) Selling goods for more than their cost.
(b) Purchasing a non-current asset on credit.
(c) The owner withdrawing cash.
(d) Receivables paying their accounts in full, in cash.

11. The profit of a business may be calculated by using which one of the following formulae?
(a) Opening capital − drawings = capital introduced − closing capital.
(b) Closing capital = opening capital. − drawings − capital introduced
(c) Opening capital = drawings − capital introduced − closing capital.
(d) Closing capital − drawings = capital introduced − opening capital.

12. A credit balance of Rs.917 brought down on Y Ltd's account in the books of X Ltd means that
(a) X Ltd owes Y Ltd Rs.917.
(b) Y Ltd owes X Ltd Rs.917.
(c) X Ltd has paid Y Ltd Rs.917.
(d) X Ltd is owed Rs.917 by Y Ltd.

13. Which one of the following statements is correct?
(a) Assets and liabilities normally have credit balances.
(b) Liabilities and revenues normally have debit balances.
(c) Assets and revenues normally have credit balances.
(d) Assets and expenses normally have debit balances.

14. On 1 January, a business had a customer, J King, who owed Rs.400. During January, J King bought goods for Rs.700 and returned goods valued at Rs.250. He also paid Rs.320 in cash towards the outstanding balance. The balance on J King's account at 31 January is:
(a) Rs.530 debit.
(b) Rs.530 credit.

(c) Rs.270 debit.
(d) Rs.270 credit.

15. The correct entries needed to record the return of office equipment that had been bought on credit from P Young, and not yet paid for, are:

Debit	Credit
a. Office equipment	S ales
b. Office equipment	P Young
c. P Young	Offi ce equipment
d. Cash	Office equipment

16. Which one of the following statements regarding the balance on a ledger account is not correct?

(a) A credit balance exists where the total of credit entries is more than the total of debit entries.
(b) A debit balance exists where the total of debit entries is less than the total of credit entries.
(c) A credit balance exists where the total of debit entries is less than the total of credit entries.
(d) A debit balance exists where the total of debit entries is more than the total of credit entries.

17. Which of the following is the correct entry to record the purchase on credit of inventories intended for resale?

Debit	Credit
a. Inventories	Receivable
b. Inventories	Payable
c. Purchases	Payable
d. Payable	Purchases

18. A receives goods from B on credit terms and A subsequently pays by cheque. A then discovers that the goods are faulty and cancels the cheque before it is cashed by B. How should A record the cancellation of the cheque in his books?

Debit	Credit
a. Payables	Returns outwards
b. Payables	Bank
c. Bank	Payables
d. Returns outwards	Payables

I. Short Descriptive Questions (SDQs)

1. What do you mean by Financial Statements and what are its objectives?
2. What are the different components of Financial Statements? State their purposes.
3. How can an economic decision maker use financial statements for arriving at a decision?
4. "Statement Of Financial Position is status report and Income Statement and Cash Flow Statement are flow report" discuss.
5. State with reasons whether the following are true or false.
   (i) Internal management is the only user of accounts and their information.
   (ii) Financial statements consist of Statement Of Financial Position and income statements only.

(iii) A cash flow statement presents the status of a firm's funds at one instant of time.

(iv) Notes to accounts are additional notes and information added to the end of the financial statement to supplement the reader with more information.

(v) Statement of changes in equity is a statement which explains cause of changes in assets and liabilities during the period

ANSWER

Multiple Choice Questions (MCQs)

1	b	6	c	11	b	16	b
2	c	7	d	12	a	17	c
3	c	8	d	13	d	18	c
4	d	9	c	14	a		
5	a	10	d	15	c		

CHAPTER- 2

Accounting Systems and Processes

UNIT 1:

Fundamentals of Double Engry Accounting System

Learning Objective

1. *1.Try to understand the Double Entry System and its advantages.*
2. *2.Understand the principles of debit and credit and the accounting equation.*
3. *3.Learn the definitions of journal and ledger and note the journalizing process.*
4. *4.See how accounts can be classified into personal and impersonal.*
5. *5.Learn the technique of ledger posting and how to balance an account.*
6. *6.Understand the Trial Balance and the purposes served. Learn the technique of taking balances from ledger accounts to prepare Trial Balance.*
7. *7.Learn the technique of opening accounts each year taking closing balances of the previous year.*
8. *8.Understand the use of account heads through chart of accounts.*

1.1 DOUBLE ENTRY SYSTEM

Double entry system was introduced to the business world by an Italian merchant named Lucas Pacioli in 1494 A.D. Though the system of recording business transactions in a systematic manner has originated in Italy, it was perfected in England and other European countries during the 18th century only i.e., after the Industrial Revolution. Many countries have adopted this system today.

The systematic recording of the financial transactions of an enterprise is known as bookkeeping or account keeping. The purpose of account is to show the financial condition of an enterprise, the changes therein, and out-comes thereof. Double-entry book keeping is a system of account keeping wherein all the financial transaction of an enterprise are recorded in a manner to show the effect on the assets, the liabilities, the owner's equity, the revenue , and the expenses .

Double Entry System of Bookkeeping refers to a system of accounting under which both the aspect (i.e. debit and credit) of every transaction are recognized and recorded in the accounts . It may be defined as system which analyses the transcations and events into debit and credit and records both the aspects in chronological manner. The terms debit and credit connote in accounting is to specify the effect of the financial transcations and events on side of an account The system is called double entry accounting system because each transaction is supported by an entry or entries which contain an equality of debits and credits. Each entry effects at least two account.

- The record of a transaction is said an entry in the books of accounts. Each entry in the double-entry system contains two parts to show both the debit and credit elements involved in the transaction. These two parts i.e. debit and credit amounts of each entry must exactly equal to other.
- Tallying debit and credit an entry does not mean that one debit should always be equal to one credit. In case of the complex nature entries the sum of the debit amounts must be equal to the sum of credit amounts regardless of the number of entries.
- The basic principle of this system is, for every debit, there must be a corresponding credit of equal amount and for every credit, there must be a corresponding debit of equal amount.

Given below are some of the examples of double effects:

a) If someone receives something – the receiver and giver are affected simultaneously.

b) If some money is spent – outgoing of money and benefit arising from it is affected simultaneously.

c) If some money is received – receipt of money and providing benefit arriving from it is affected simultaneously, etc.

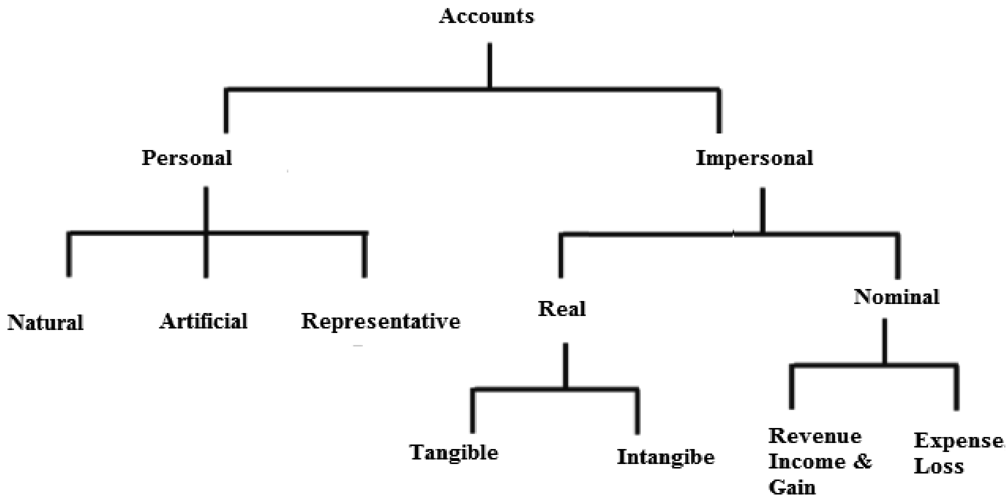
1.2 BASIC CLASSIFICATION OF ACCOUNTS AND ACCOUNTING RULE

An account is a summary of the relevant transactions at a one place relating to a particular head. As per traditional debit-credit approach, fundamentally, account may be divided into two major classes:

a) PersonalAccount
b) Impersonal Account

The impersonal accounts may further be sub-classified into

(b1) Real Accounts
(b2) Nominal Accounts.



a. Personal Accounts

Personal accounts are those accounts which relate to someone i.e. all accounts bearing personal names are termed as personal accounts. These accounts relate to natural person, artificial persons and representative persons. These accounts basically deal with advances, receivables, creditors, capital and liabilities.

These accounts are classified in to three categories

a) Natural personal accounts –the term natural persons mean persons who are creation of god. For e.g.;-Raja's account, Dahal's account etc

b) Artificial personal accounts-these accounts includes accounts of corporate bodies or institutions. For e.g.;- Hari Trader's Account, Ram & Son's Account, etc.

c) Representative personal account-these are accounts which represents certain person or group of persons. For example salary due, rent outstanding etc

Accounting Rule

Debit : The receiver
Credit : The giver

b. Impersonal Accounts:

Accounts, which are not personal in nature such as machinery account, cash account, rent account, salary account etc. are called impersonal accounts. These can be further sub-divided as follows:

i. Real Account

Real accounts are accounts, which relates to property or assets of the firm but not debt. These accounts relate to tangible or intangible assets. For example, accounts regarding land, building, investment, goodwill etc. are real account. Cash in hand and cash at bank account are also real account.

Accounting Rule

Debit : What comes into the business or addition to an asset
Credit : What goes out from the business

ii. Nominal Account

Nominal accounts are those, which explain the sources of revenue and expenses. These accounts relate to expenses, losses, income and gains. The net result of all the nominal accounts is referred as profit or loss, which is transferred to the Balance Sheet. Thus these accounts constitute the basis for the preparation of the Statement of Profit or Loss.

Accounting rule

Debit : All expenses and losses
Credit : All income and gains

Therefore, debits in expenses accounts increases the total expenses, while credit will decrease the same. Similarly, debit items decrease revenue accounts and credit item will increase the revenue accounts. In a normal situation, there will be no credit entry in an expense account. Similarly, there will be no debit entry in an income account.

Illustration 1

Analyze the following transactions according to the traditional approach:

(a) Kailash started his business with cash
(b) Borrowed from bank
(c) Purchased store furniture
(d) Purchase furniture from Furniture Land on credit
(e) Purchase merchandise for cash
(f) Purchase merchandise from supplier on credit
(g) Returned goods to supplier
(h) Sold merchandise for cash
(i) Sale merchandise to Shekhar on credit
(j) Shekhar returned merchandise
(k) Received cash from Shekhar
(l) Paid cash to supplier
(m) Deposited into bank

(n) Withdrew cash for personal use
(o) Withdrew cash from bank for office use
(p) Withdrew cash from bank for personal use
(q) Received cheque from Shekhar
(r) Deposited Shekhar's cheque next day.
(s) Bank intimated that shekhar's Cheque was dishonoured
(t) Paid supplier by cheque
(u) Paid salary
(v) Paid rent
(w) Merchandise withdrawn for personal use
(x) Paid an advance to suppliers of merchandise
(y) Received an advance from customers
(z) Paid interest on loan
(aa) Paid installment of loan
(bb) Interest allowed by bank

Required:
i. Analyze the transactions under Accounting Rule (Debit and Credit Rule)

Solution:
i. Analysis of Transactions under Debit and Credit Rule

T. No.	What are the Accounts involved?	What are the nature of accounts involved	How Affected	Whether to Dr. or Cr.
(a)	Cash A/C Capital A/C Cash A/C	Real/Assets Personal/Liabilities	Cash is coming in or asset increase Giver/increase in liability	Debit Credit
(b)	Bank Loan A/C Furniture A/C Cash A/C	Real/Assets Personal/Liabilities	Cash is coming in or asset increase Giver/increase in liability	Debit Credit
(c)	Furniture A/C Furniture Land A/C Purchase A/C Cash A/C	Real/Assets	Furniture is coming in or assets increase. Cash is going out/asset decreases.	Debit Credit

		Real/Assets		
	Purchase A/C Supplier A/C		Furniture is coming in or increase in asset	
(d)	Supplier A/C			Debit
	Purchase Return A/C Cash A/C	Real/Assets	Giver/increase in liability	Credit
	Sales A/C	PersonalLiabilities		
(e)	Shekhar's A/C			
	Sales A/C		Purchase is an expenses	Debit
	Sales Return A/C Shekhar's A/C	Nominal/Expenses	Cash is going out/asset decrease.	Credit
		Real/asset		
(f)	Cash A/C		Purchases is an expenses	
	Shekhar's A/C		Giver/increase in liability	Debit
	Supplier's A/C Cash A/C	Nominal/Expense		Credit
(g)		Personal/Liabilities		
	Bank A/C Cash A/C		Receiver/decrease in liabilities	Debit
	Drawing A/C Cash A/C	Personal/Liabilities		Credit
	Cash A/C Bank A/C		Decrease in expenses	
(h)		Nominal/Expense		Debit
	Drawing A/C Bank A/C		Cash is coming in or asset increase	
	Cash A/C Shekhar's A/C	Real/ Assets	Sales is income	Credit
(i)	Bank A/C Cash A/C	Nominal/Income	Receiver/increase in asset as receivable	Debit
	Shekhar's A/CBank		Sales is revenue (Income)	

	Supplier's A/C Bank A/C	Personal/ Asset		Credit
(j)	Salary A/C Cash A/C	Nominal Nominal	Reduce in income Giver/Decrease in Assets	Debit Credit
(k)	Rent A/C Bank A/C Drawing A/C Purchase A/C	Personal/ Real Real/Assets	Cash is coming in or asset increase Giver/Decrease in Asset	Debit Credit
(l)	Supplier A/C Cash A/C Cash A/C Customers A/C	Personal/Assets Personal/Liabilities	Receiver/Decrease in Liabilities Goes out/ Decrease in Asset	Debit Credit
(m)	Interest on loan A/C Cash A/C Loan A/C Cash A/C	Real/Assets	Comes in/Increase in Asset	Debit Credit
(n)	Bank A/C Interest Income A/C	Real/Assets Real/Assets	Goes out/Decrease in Asset	Debit Credit
(o)		Personal/Liabilities Real/Assets	Receiver/Decrease in Liabilities Goes out/Decrease in Asset	Debit Credit
(p)		Real/Assets Real/Assets	Comes in/Increase in Asset Goes out/Decrease in Asset	Debit Credit

(q)		Personal/Liabilities		Debit
		Real/Assets		Credit
			Receiver/Decrease in Liabilities	
(r)		Real/Assets		Debit
		Personal/Assets	Goes out/Decrease in Asset	Credit
(s)		Real/Assets	Comes in/Increase in Asset	Debit
		Real/Assets		
			Giver/Decrease in Asset	Credit
(t)		Personal/Assets		
			Comes in/Increase in Asset	Debit
		Real/Assets		Credit
			Goes out/Decrease in Asset	
(u)				
		Personal/Liabilities		Debit
		Real/Assets	Increase in Asset	Credit
(v)			Goes out/Decrease in Asset	
		Nominal/Expense		Debit
		Real/Assets		Credit
			Receiver/Decrease in Liabilities	
(w)		Nominal/Expense	Goes out/Decrease in Asset	
		Real/Assets		Debit
				Credit
			Salary is an expenses	
			Goes out/Decrease in Asset	
(x)		Personal/Liabilities		

(y) (z) (aa) (ab)		Nominal/Expense Personal/Assets Real/Assets Real/Assets Personal/Liabilities Nominal/Expense Real/Assets Personal/Liabilities Real/Assets Real/Assets Nominal/Income	Rent is an expense Goes out/Decrease in Asset Receiver/Decrease in Liabilities It is decrease in business expense Receiver/increase in Asset Goes out/decrease in asset coming in/increase in asset Giver/increase in liabilities Interest is an expenses Goes out/Decrease in Asset Decrease in liability Goes out/Decrease in Asset	Debit Credit Debit Credit Debit Credit Debit Credit Debit Credit

			comes in/increase in asset Bank interest is an income	

1.3 ACCOUNTING EQUATION

An accounting equation is a statement of equality between the resources and the sources which finance the resources and is expressed as under:

Resources = Sources of Finance

As stated above, the economic resources of an entity are called assets. The assets refer to the tangible objects (e.g. Land and Building, Plant and machinery, Furniture, Investments, Stock, Debtors, Bank Balance and Cash Balance) or intangible rights (e.g. Patents, Trademarks, Copyright) owned by an enterprise and carrying probable future benefits. The sources of finance come from equity and liabilities which is the claims of various parties against these assets. Basically equity is the claim of the owners of the business and liabilities are the claims of creditors (that is, everyone other than the owners of the business). Owners' equity for an incorporated business is commonly called shareholders' equity. Since all of the assets of a business are claimed by someone either by its owners or by its creditors and since the total of these claims cannot exceed the amount of assets to be claimed. Thus, the aforesaid accounting equation may be expressed as follows:

Total Assets = Total Equities

or

Total Assets=Liabilities+ Owners' Equity (Capital)

Since, the liability holders have a definite and prior claim against the assets. The capital is also called as a residual of assets over liabilities and may be expressed as follows:

Capital = Total Assets – Total Liabilities

This equation is fundamental in the sense that it gives foundation to the double entry system of book keeping. This equation holds good for all transactions and events and at all periods of time since every transaction and event has two aspects. Accounting systems are set up so as to record both of these aspects of a transaction; this is why accounting is called a double-entry system.

Above equation can be extended as follows:

Capital = Assets – (Non Current Liabilities + Current Liablities)

or

Capital = Non Current Assets + Current Assets - Non Current Liabilities - Current Liabilities

or,

Capital + Non Current Liabilities = Non current Assets + Current Assets - Current Liabilities
With the help of examples we shall now analyze the accounting equations as per below:

Transaction 1

On Shrawan 1, 2076 Pandey Pvt. Ltd. was established with a capital of Rs. 4,000,000 contributed in cash. The transaction affected the equation as follows:

Assets	=	**Liabilities**	+	**Owners' equity**
Cash				**Capital**
+ 4,000,000				+ 4,000,000

The given transaction increased the assets, specifically cash, and the owners' equity of the business, capital. It did not affect liabilities because the company did not have an obligation to an outside party from this transaction. The total amount on the left side of the equation is equal to the total amounts on the right side, as they should be.

Transaction 2

On Shrawan 2, 2076, Pandey Pvt. Ltd. borrowed loan worth Rs. 1,000,000 from a bank. The effect of the transaction on the equation is:

Assets	=	**Liabilities**	+	**Owners' equity**
Cash		**Loan**		**Capital**
4,000,000 + 1,000,000	= =	+ 1,000,000		4,000,000
Total 5,000,000		1,000,000		4,000,000
Bal 5,000,000		Balance	5,000,000	

The transcation increased the asset in the form of cash and also increased the liability in the form of Bank's loan, by the same amount, Rs. 1,000,000. After completing the transaction, Pandey Pvt. Ltd. had assets of Rs. 5,000,000, liabilities of Rs. 1,000,000, and owners' equity of Rs. 4,000,000.

Transaction 3

On Shrawan 3,2076 Pandey Pvt. Ltd. acquired Plant and Machinery for Rs. 150,000 on cash. Plant and Machinery is an example of an asset that the company expects to provide services for more than one year.

Assets		=	**Liabilities**	+	**Owners' equity**
Cash	**Plant**		**Bank Loan**		**Capital**
5,000,000			1,000,000		4,000,000
(-) 150,000	+ 150,000				

4,850,000	150,000		1,000,000		4,000,000
Balance = 5,000,000			Balance = 5,000,000		

This transaction of the cash purchase of Plant and Machinery, increases the asset in the form of plant and machinery, and decreases another asset in the form of Cash, by the same amount. The form of the assets change, but the total amount of assets is unchanged. Moreover, the right side items are completely unchanged. Pandey Pvt. Ltd. can prepare a Statement of Financial Positon at any point in time, even every transaction. The Balance Sheet for Shrawan 3, after the first three transactions, would like this:

Pandey Pvt. Ltd.
Statement of Financial Positon Shrawan 3, 2076

Liabilities and Owners' Equity	**Rs.**	**Assets**	**Rs.**
Capital	40,00,000	Cash	48,50,000
Bank Loan	10,00,000	Plant and Machinery	1,50,000
	50,00,000		**50,00,000**

Transaction 4.
On Shrawan 4, 2076 Pandey Pvt. Ltd. purchased inventories for cash worth Rs. 1,200,000. Inventory refers to goods held by the company for the purpose of sale to customers. It increases level of inventory and decreases cash balance due to payment made in cash.

Assets			**=**	**Liabilities**	**+**	**Owners' equity**
Cash	**Plant**	**Inventories**		**Bank Loan**		**Capital**
4,850,000	150,000			1,000,000		4,000,000
(-) 1,200,000		(+) 1,200,000				
3,650,000	150,000	1,200,000		1,000,000		4,000,000
Balance = 5,000,000				Balance = 5,000,000		

Transaction 5

On Shrawan 4, 2076 Pandey Pvt. Ltd. purchased inventory on credit of Rs.100,000.

Assets			**=**	**Liabilities**		**+**	**Owners' equity**
Cash	**Plant**	**Inventories**		**Bank Loan**	**Others**		**Capital**
3,650,000	150,000	1,200,000		1,000,000			4,000,000
		(+) 1,00,000			(+)100,000		

3,650,000	150,000	1,300,000		1,000,000	100,000		4,000,000
Balance = 5,100,000				**Balance = 5,100,000**			

Transaction 6.

On Shrawan 6, 2076 Pandey Pvt. Ltd. purchased inventories worth Rs. 300,000 by paying cash Rs. 100,000 and balance in credit.

Assets			=	Liabilities		+	Owners' equity
Cash	**Plant**	**Inventories**		**Bank Loan**	**Others**		**Capital**
3,650,000	150,000	1,300,000		1,000,000	100,000		4,000,000
(-) 100,000		(+) 3,00,000			(+) 200,000		
3,550,000	150,000	1,600,000		1,000,000	300,000		4,000,000
Balance = 5,300,000				**Balance = 5,300,000**			

Transaction 7.

On Shrawan 7, 2076 , Pandey Pvt. Ltd. sold a part of plant costing Rs. 10,000 at the same price in cash.

Assets			=	Liabilities		+	Owners' equity
Cash	**Plant**	**Inventories**		**Bank Loan**	**Others**		**Capital**
3,550,000	150,000	1,600,000		1,000,000	300,000		4,000,000
(+) 10,000	(-) 10,000						
3,560,000	10,000	1,600,000		1,000,000	300,000		4,000,000
Balance = 5,300,000				**Balance = 5,300,000**			

Transaction 8,

On Shrawan 8, 2076, Pandey Pvt. Ltd. returned some of inventory to supplier worth Rs.8,000 and consequently the liability was reduced.

Assets			=	Liabilities		+	Owners' equity
Cash	**Plant**	**Inventories**		**Bank Loan**	**Others**		**Capital**
3,560,000	10,000	1,600,000		1,000,000	300,000		4,000,000

		(-)8,000			(-) 8,000		
3,560,000	10,000	1,592,000		1,000,000	292,000		4,000,000
Balance = 5,292,000				**Balance = 5,292,000**			

Transaction 9,

On Shrawan 10, 2076 Pandey Pvt. Ltd. paid Rs. 40,000 to supplier of inventories.

Assets			=	**Liabilities**		+	**Owners' equity**
Cash	**Plant**	**Inventories**		**Bank Loan**	**Others**		**Capital**
3,560,000	10,000	1,592,000		1,000,000	292,000		4,000,000
(-) 40,000					(-) 40,000		
3,520,000	10,000	1,592,000		1,000,000	252,000		4,000,000
Balance = 5,252,000				**Balance = 5,252,000**			

Rules for accounting equation:

Following rules help in making the accounting equation:

(i) Assets: If there is increase in assets, this increase is debited in assets account. If there is decrease in assets, this decrease credited in assets account.

(ii) Liabilities: When liabilities are increase, outsider's Liabilities are credited and when liabilities are decreased, outsider's liabilities are debited.

(iii) Capital: When capital is increased, it is credited and when capital is withdrawn, it is debited.

(iv) Expenses: Owner's equity is decreased by the amount of expenses and expenses account should be debited

(v) Income or profits: Owner's equity is increased by the amount of revenue and income account should be credited.

Illustration 2:

Following are the transactions of Mr. Kailash:

(a) Kailash started his business with cash

(b) Borrowed from bank

(c) Purchased store furniture
(d) Purchase furniture from Furniture Land on credit
(e) Purchase merchandise for cash
(f) Purchase merchandise from supplier on credit
(g) Returned goods to supplier
(h) Sold merchandise for cash
(i) Sale merchandise to Shekhar on credit
(j) Shekhar returned merchandise
(k) Received cash from Shekhar
(l) Paid cash to supplier
(m) Deposited into bank
(n) Withdrew cash for personal use
(o) Withdrew cash from bank for office use
(p) Withdrew cash from bank for personal use
(q) Received cheque from Shekhar
(r) Deposited Shekhar's cheque next day.
(s) Bank intimated that shekhar's Cheque was dishonoured
(t) Paid supplier by cheque
(u) Paid salary
(v) Paid rent
(w) Merchandise withdrawn for personal use
(x) Paid an advance to suppliers of merchandise
(y) Received an advance from customers
(z) Paid interest on loan
(aa) Paid installment of loan
(bb) Interest allowed by bank

Required:

i. Analyze the transactions under Accounting Equation Approach.

Solution:

T. No.	What are the Accounts involved?	What are the nature of accounts involved	How Affected	Whether to Dr. or Cr.
(a)	Cash A/C Capital A/C	Assets Capital	Increase Increase	Debit Credit

(b)	Cash A/C Bank Loan A/C	Assets Liabilities	Increase Increase	Debit Credit
(c)	Furniture A/C Cash A/C	Assets Assets	Increase Decrease	Debit Credit
(d)	Furniture A/C Furniture Land A/C	Assets Liabilities	Increase Increase	Debit Credit
(e)	Purchase A/C Cash A/C	Expenses Assets	Increase Decrease	Debit Credit
(f)	Purchase A/C Supplier A/C	Expenses Liabilities	Increase Increase	Debit Credit
(g)	Supplier A/C Purchase Return A/C	Liabilities Expenses	Decrease Decrease	Debit Credit
(h)	Cash A/C Sales A/C	Assets Income	Increase Increase	Debit Credit
(i)	Shekhar's A/C Sales A/C	Asset Income	Increase Increase	Debit Credit
(j)	Sales Return A/C Shekhar's A/C	Income Asset	Decrease Decrease	Debit Credit
(k)	Cash A/C Shekhar's A/C	Asset Asset	Increase Decrease	Debit Credit
(l)	Supplier's A/C Cash A/C	Liabilities Asset	Decrease Decrease	Debit Credit
(m)	Bank A/C Cash A/C	Assets Assets	Increase Decrease	Debit Credit
(n)	Drawing A/C Cash A/C	Capital Asset	Decrease Decrease	Debit Credit
(o)	Cash A/C Bank A/C	Asset Asset	Increase Decrease	Debit Credit
(p)	Drawing A/C Bank A/C	Capital Asset	Decrease Decrease	Debit Credit

(q)	Cash A/C Shekhar's A/C	Asset Asset	Increase. Decrease	Debit Credit
(r)	Bank A/C Cash A/C	Asset Asset	Increase Decrease	Debit Credit
(s)	Shekhar's A/C Bank	Asset Asset	Increase Decrease	Debit Credit
(t)	Supplier's A/C Bank A/C	Liability Asset	Decrease Decrease	Debit Credit
(u)	Salary A/C Cash A/C	Expenses Asset	Increase Decrease	Debit Credit
(v)	Rent A/C Bank A/C	Expense Asset	Increase Decrease	Debit Credit
(w)	Drawing A/C Purchase A/C	Capital Expense	Decrease Decrease	Debit Credit
(x)	Advance to Supplier A/C Cash A/C	Asset Asset	Increase Decrease	Debit Credit
(y)	Cash A/C Advance from Customers A/C	Asset Liability	Increase Increase	Debit Credit
(z)	Interest on Loan A/C Cash A/C	Expense Asset	Increase Decrease	Debit Credit
(aa)	Loan A/C Cash A/C	Liability Asset	Decrease Decrease	Debit Credit
(ba)	Bank A/C Bank interest A/C	Asset Income	Increase Increase	Debit Credit

1.4 BASIC OF ACCOUNTING

There are basically three possible ways to maintain accounts. They are accrual (mercantile) basis, cash basis and hybrid system. These systems are categorized on the basis of when to recognize a revenue and expense.

a. Accrual Basis: Under the accrual basis of accounting, transcations and events are recognized in the books of account when they occur (not as cash or its equivalent is received or paid) and they are recorded in the accounting records and reported in the financial statements of the periods to which they relate. So business transactions are recorded when they occur and not when the related payments are received or made. Nepal Accounting standard on Presentation of financial statements (NAS 01) issued by The Institute of Chartered Accountants of Nepal states that an entity shall prepare its financial statements, except for cash flow information, using the accrual basis of accounting.

b. Cash Basis: The cash method of accounting requires that revenue are recognized when cash is received, and that expenses are recognized when payments are made. This is a simple accounting method, and so is attractive to smaller businesses. Under this method of recording transactions business transcations are reflected in the books of accounts for the period in which actual receipts or actual payments are made.

c. Hybrid system: When certain items of revenue or expenditure are recorded in the books of account on cash basis and certain items on mercantile basis, the basis of accounting so employed is called 'hybrid basis of accounting'. For example, a company may follow mercantile system of accounting in respect of its export business. However, government subsidies and duty drawbacks on exports to be received from government are recorded only when they are actually received i.e., on cash basis. Such a method could be adopted because of uncertainty with respect of quantum, amount and time of receipt of such incentives and drawbacks. Such a method of accounting followed by the company is called the hybrid basis of accounting. In practice, the profit or loss shown under this basis will not be realistic. Conservative policy guides this system which prefer recognising income when received but cautious to provide for all expenses, whether paid or not..

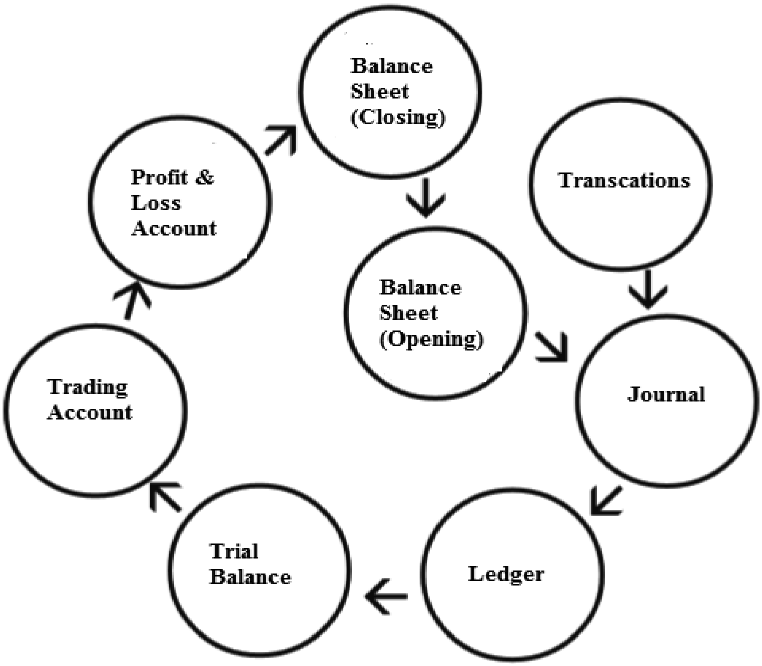
Note:
The accrual basis of accounting provides a better picture of a company's profits during an accounting period. The reason is that the income statement prepared under the accrual basis will report all of the revenues actually earned during the period and all of the expenses incurred in order to earn the revenues. The accrual basis of accounting also provides a better picture of a company's financial position at a point in time. The reason is that all assets that were earned and all liabilities that were incurred will be reported.

1.5 BASIC ACCOUNTING PROCEDURES

After taking decisions such as selecting a business, selecting the form of organisation of business, making decision about the amount of capital to be invested, selecting suitable site, acquiring equipment & supplies, selecting staff, getting customers & selling the goods etc. a business man finally resorts to record keeping.

For all types of business organisations, transactions such as purchases, sales, manufacturing & selling expenses, collection from customers & payment to suppliers do take place. These business transactions are recorded in a set of ruled books such as journal, ledger, cash book etc. Unless these transactions are recorded properly organisations will not be in a position to know where exactly the operation of organisations stands.

The following is the complete procedure of Accounting System.:



Step 1: The recording process begins with the **source documents.** These are the original records of any transaction. Example of source of documents include sales slips or invoices, check stubs, purchase orders, receiving reports, cash receipt slips, and minutes of the board of directors. As soon as a transaction occurs, it generates a source document. For example, when a company sells a product to a customer, it makes a invoice/receipt for sale. Companies keep source documents on file so they can use them to verify the details of a transaction and the accuracy of subsequent records, if necessary.

Step 2: In the second step of the recording process, we place an analysis of the transaction, based on the source documents, in a books of original entry called the **Journal Entries.** The journal entries are a formal chronological listing of each transaction and how it affects the balances in particular accounts. It is basically a log of all events (transactions) in an enterprise.

Step 3: The third step is to enter transactions into the **Ledger**. In ledger posting each component of the transcation are entered into the appropriate accounts depending upon the nature of account

Step 4: The fourth step is the preparation of the **Trial Balance**, which is a summary of ledger balances. This listing aids in verifying clerical accuracy and in preparing financial statements. Thus, preparation of trial balance depends upon the requirement of the organization, perhaps each month or each quarter as the firm prepares its financial statements. The timing of the first four steps varies. Transactions occur constantly so companies prepare source documents continuously. Depending on the size and nature of the organization, transaction analysis may occur continuously, weekly, or monthly. Basically, the preparation of trial balance must conform to the need of the users of the data.

Step 5: The final step in the accounting process is the preparation of **Financial Statements.** Financial Statements are the final documents produced from the accounting system that furnishes information regarding the financial position, performance and cash flows of an enterprise**.** It includes preparation of Trading Account, Statement of Profit or Loss and Statement of Financial Position for the end of the year. They are normally prepared at least once in a year. However, in some cases they are even prepared quarterly or half yearly depending upon the nature of the business and statutory requirements of the regulatory authorities.

1.6 JOURNALIZING TRANSACTIONS

A journal is a book in which transactions are recorded in the order in which they occur i.e. in chronological order. A journal is called a book of primary entry (also called a book of original entry) because all the business transactions are recorded first in this book.

Journalizing is the process of entering transactions into the journal book. A journal entry is an analysis of all the effects of a single transaction on the various accounts, usually accompanied by an explanation. For each transaction, this analysis identifies the accounts to be debited and credited.

Format of a Journal;

The normal format of a journal is shown below:

JOURNAL VOUCHER

DATE 1	PARTICULARS 2	L.F 3	DEBIT AMOUNT 4	CREDIT AMOUNT 5
	TOTAL AMOUNT			
NARRATIONS:				

The columns in the above format are numbered only to make clear the following but otherwise they are not numbered

Steps in Journalizing

1. Before one can journalize transactions, one must think, on the basis of the accounting rules (debit and credit rule), the effect of the transactions on assets, liabilities, expenses, gains etc. of the firm. In accordance with the effects, the account to be debited or credited will be determined. Then the entry will be made in the journal, as indicated below.In the first column the date of the transaction is entered.

2. In the second column, the details regarding account titles and description are recorded. The name of the account to be debited is entered first at the extreme left of the particulars column next to the date and the abbreviation 'Dr.' is written at the right extreme of the same column in the same line. The name of the account to be credited is entered in the next line preceded by the word "To" leaving a few spaces away from the extreme left of the particulars column.

3. In the next line immediately to the account credited, a short description about the transaction is given which is known as "Narration". "Narration" may include particulars required to identify and understand the transaction and should be adequate enough to explain the transaction. It usually starts with the word "Being" or "For" which means what it is and is written within parentheses. The use of the word "Being" is completely dispensed with, in modern parlance. To indicate the completion of the entry for a transaction, a line is usually drawn all through the particulars column.

4. In the third column, the page number of the ledger on which the account written up is entered, so as to use for cross-referencing to the ledger accounts.

5. In the fourth and the fifth column, the amounts debited or credited to the various accounts are entered.

(Note: Except the Ledger .Folio. column, all other columns are recorded at the time of journalizing. The Ledger.Folio.column is recorded at the time of posting.)

It should be noted that the papers or documents supporting the transactions and establishing its veracity are known as *vouchers*. These should be filed in proper order together with necessary references, so that in times of need these can be referred to.

Illustration 3:

- On 2076.4.2 Pandey Pvt. Ltd. was established upon issue of fully paid up shares worth Rs. 4,000,000 in cash.
- On 2076.4.2 it obtained bank loan worth Rs. 1,000,000.
- On 2076.4.3 it purchased inventories worth Rs. 150,000 by paying cash.

Journal Entries of the above transactions of Pandey Pvt. Ltd. may appear as follows:

Pandey Pvt. Ltd.

Journal Entries

Date	Particulars	L.F.	Debit (Rs.)	Credit (Rs.)
2076 /4/2	Cash Dr. To, Share Capital (Share capital issued for cash)	100 300	4,000,000	4,000,000
2076 /4/2	Cash Dr. To, Bank Loan (Borrowed loan from bank)	100 200	1,000,000	1,000,000
2076 /4/3	Purchases a/c Dr. To, Cash (Inventories purchased for trading for cash)	170 100	150,000	150,000

Explanation:

Transaction 1- Pandey Pvt. Ltd. was established upon fully paid up share capital of Rs. 4,000,000. This means that the company received Rs. 4,000,000 in cash. According to the accounting rules discussed in preceding paragraphs, the increase in an asset has to be debited to it. Similarly, the company also owed Rs. 4,000,000 to the Shareholders as share capital. As per rule, the increase in capital should be credited to it. Therefore, Cash account is debited and share capital is credited.

Transaction 2- Company borrowed bank loan. With this transaction, company's cash balance as well as liability towards bank increased by Rs. 1,000,000. Therefore, cash account is debited and bank loan account is credited.

Transaction 3- Inventories was acquired for trading for cash Rs. 150,000. Applying the same rule, purchse account is debited and cash is credited, as expense is increased against the decrease of another asset.

Notes :Trading and Non-Trading Goods

The goods/merchandise in which business deals is called trading goods. There may be many transactions relating to trading goods. So, we should debit purchases account while making purchase of trading goods and credit sales account while making sales of trading goods. There is no need to record profit/loss at the time of recording sales transaction. For eg; Mr. Kumar purchases goods from ABC Sppppliers worth Rs. 9,700. In this case, purchases account will be debited and ABC Supplier’s account will be credited.

The goods other than trading is called non-trading goods. This kind of transaction happened casually. So, we should debit concerned account while making purchase and credit concerned account while making sales. Similarly, we have to record profit/loss at the time of recording sale of non-trading goods. For eg; Mr. Kumar purchases Fax Machine costing Rs. 12,000 to use in office. In this case Fax Machine account will be debited and cash/bank account will be credited.

Illustration 4 :

Make necessary journal entries from following transactions of the month of Shrawan 2076 .

1 Mr. Rakesh started business with Rs. 2,000,000 in the bank and Rs. 500,000 cash.
2 Bought shop fittings Rs. 140,000 and Van Rs. 600,000 both paid by cheque;
3 Paid rent by cheque Rs. 50,000.
4 Bought good for resale on credit from M/s. Z & Co. Rs. 500,000;
5 Cash sale Rs. 50,000;
6 Paid part time wages of assistant in cash Rs. 8,000;
7 Paid insurance premium by cheque Rs. 1,500;
8 Cash Sales Rs. 50,000
9 Goods returned to M/s. Z & Co. Rs. 10,000;
10 Paid M/s. Z & Co. by cheque Rs. 300,000;
11 Bought goods for resale from M/s. R & Co. Rs. 250,000;
12 Sold goods to Mr. Aakash for cash Rs. 180,000;
13 Sold goods to Mr.Samundra Trading on Credit Rs. 250,000;
14 Cash paid to M/s. Z & Co. Rs. 50,000;
15 Withdrawal for personal use Rs. 100,000 from bank;
16 Paid salary to Mr. Sewakram, an accountant Rs. 15,000
17 Cash received from Mr. Samundra Trading Rs. 225,000 for full settlement;
18 Withdrawal cash from bank for office use Rs. 100,000
19 Bought stationery, paid in cash Rs. 5,000;
20 Settlement of amount owed to M/s. Z & Co. by paying Rs. 125,000 through cheque and balance is treated as discount allowed by company.
21 Purchase of goods from Mr. Sharakar of the list price of Rs. 30,000 at a trade discount of 10%.
22 Bought of goods of the list price of Rs. 125,000 from Mr. Mohan less 20% trade discount and 2% cash discount and paid 40% of original liability by cheque and balance in cash.

Solution:

Journal entries of Mr. Rakesh

Date	Particulars (Accounts and explanation)		Debit (Rs.)	Credit (Rs.)
2076 /4/1	Cash A/C	Dr.	500,000	
	Bank A/C	Dr.	2,000,000	
	To, Capital A/C			2,500,000
	(Mr. Rakesh started business with Rs. 2,500,000 by depositing Rs. 2,000,000 into bank)			
2076/4/2	Furniture and Fittings A/C	Dr.	140,000	
	Vehicle (Van) A/C	Dr.	600,000	
	To, Bank A/C			740,000
	(Being purchase of furniture and fitting and van for			

	the business)		
2076/4/3	Rent Expenses A/C Dr. To, Bank A/C (Being rent paid by cheque)	50,000	50,000
2076/4/4	Purchase A/C Dr. To, Sundry Creditor (M/s. Z & Co.) (Being goods purchased on credit)	500,000	500,000
2076/4/5	Cash A/C Dr. To, Sales A/C (Being goods sold on cash)	50,000	50,000
2076/4/6	Wages Expense A/C Dr. To, Cash A/C (Part time wages paid to Assistant for the period of .....)	8,000	8,000
2076/4/7	Insurance Premium Exp. A/C Dr. To, Bank A/C (Insurance premium paid by cheque)	1,500	1,500
2076/4/8	Cash A/C Dr. To, Sales A/C (Being goods sold no cash)	50,000	50,000
2076/4/9	Sundry Creditor (M/s. Z & Co.) A/C Dr. To, Purchase Return A/C (Being goods returned to M/s Z & Co.)	10,000	10,000
2076/4/10	Sundry Creditor (M/S Z & Co.) A/C Dr. To, Bank A/C (Partial payment of made to M/S Z & Co.)	300,000	300,000
2076/4/11	Purchase A/C Dr. To, Sundry Creditor (M/s. R &Co.) A/C (Being goods purchased on credit from M/s. R & Co)	250,000	250,000
2076/4/12	Cash A/C Dr. To, Sales A/C (Being goods sold on cash)	180,000	180,000
2076/4/13	Sundry Debtors (Mr. Samundra Trading) A/C Dr. To, Sales A/C (Being goods sold on credit)	250,000	250,000
2076/4/14	Sundry Creditor (M/s. Z & Co.) A/C Dr. To, Cash A/C (Being cash paid)	50,000	50,000
2076/4/15	Drawing A/C Dr. To, Bank A/C (Cash withdrew from bank for personal use)	100,000	100,000
2076/4/16	Salary Expense A/C Dr. To, Cash A/C	15,000	15,000

	(Salary of an Accountant paid)		
2076/4/17	Cash A/C Dr. Discount Expense A/C Dr. To, Sundry Debtors (Mr. Samundra Trading) (Payment of past due amount received from Mr. Samundra Trading and allowed discount as a full settlement)	225,000 25,000	 250,000
2076/4/18	Cash A/C Dr. To, Bank (Cash withdrawal for office use)	100,000	 100,000
2076/4/19	Stationery Expense A/C Dr. To, Cash (Purchase of stationery for cash)	5,000	 5,000
2076/4/20	Sundry Creditors (M/s. Z & Co.) A/C Dr. To, Bank A/C To, Bank A/C To, Discount Received A/C (Settlement of amount owed to M/s. Z & Co. by paying Rs. 125,000 and balance amount of Rs. 25,000 treated as discount received)	140,000	 125,000 15,000
2076/4/21	Purchase A/C Dr. To, Sundry Creditor (Mr. Sharakar) (Being goods purchase from Mr. Sharakar at a trade discount of 10% List Price 30,000 Less: Trade discount 10%3,000 Rs. 27,000	27,000	 27,000
2076/4/22	Purchase A/C Dr. To, Sundry Creditor (Mr. Mohan) A/C (Being goods purchased from Mr. Mohan at a trade discount of 20%) List Price 125,000 Less: Trade disc.@20% 25,000 100,000	100,000	 100,000
2076/4/22	Sundry Creditor (Mr. Mohan) A/C Dr. To, Discount Received A/C To, Bank A/C To, Cash A/C (Being payment made to Mr. Mohan under cash discount of 2% payment)	100,000	 2,000 40,000 58,000

Illustration 5:

Recording of Sales Transactions

01.01.2019	Sold Goods for Rs 75,000
02.01.2019	Sold goods to Pradeep for Rs 245,000
03.01.2019	Sold good to Ajay for Rs 130,000 against a current dated cheque
04.01.2019	Sold goods to Sailendra for the list price of Rs 300,000 at a trade discount of 10%
05.01.2019	Sold good to Pramod of the list price of Rs 125,000 less 20% trade discount and received a current date cheque under a cash discount of 2%
06.01.2019	Sold goods to Pravakar of the list price of Rs 125,000 less 20 % trade discount and 2 % cash discount and paid 40% by cheque and balance is due
07.01.2019	Sold goods costing Rs 40,000 to Banita for cash at a profit of 25% on cost less 20% trade discount and charged 8% VAT and paid cartage Rs 100 (not to be charged from customer)
08.01.2019	Sold goods costing Rs 40,000 to Samir at a profit of 20% on sales less 20% trade discount and charged 8% VAT and paid cartage Rs 100 to be charged from the customer
09.01.2019	Pradeep rejected and returned 10% of goods
10.01.2019	Sailendra rejected and returned 10 % of goods

Solution:

Journal Voucher

Date	Particular		Dr (Rs)	Cr (Rs)
01.01.2019	Cash A/c	Dr	75,000	
	To Sales A/c			75,000
	(Being the goods sold for Cash)			
02.01.2019	Pradeep A/c	Dr	245,000	
	To Sales A/c			245,000
	(Being Sold goods to Pradeep for Rs 245,000)			
03.01.2019	Bank A/c	Dr	130,000	
	To Sales A/c			130,000
	(Sold good to Ajay for Rs 130,000 against a current dated cheque)			
04.01.2019	Sailendra A/c	Dr	270,000	

	To Sales A/c (Sold goods to Sailendra for the list price of Rs 300,000 at a trade discount of 10%)			270,000
05.01.2019	Bank A/c	Dr	98,000	
	Discount Allowed A/c	Dr	2,000	
	To Sales A/c			100,000
	(Sold good to Pramod of the list price of Rs 125,000 less 20% trade discount and received a current date cheque under a cash discount of 2%)			
	List Price	*125,000*		
	Less Trade Discount 20%	*25,000*		
	Invoice Price	*100,000*		
	Less Cash discount 2%	*2,000*		
	Net Received	*98,000*		
06.01.2019	Pravakar A/c	Dr	100,000	
	To Sales A/c			100,000
	(Sold goods to Pravakar of the list price of Rs 125000 less 20 % trade discount and 2 % cash discount and paid 40% by cheque)			
	List Price	*125,000*		
	Less Trade Discount 20%	*25,000*		
	Invoice Price	*100,000*		
	Bank A/c	Dr	39,200	
	Discount Allowed A/c	Dr	800	
	To Pravakar A/c			40,000
	(Being 40% payment made from Pravakar under a cash discount of 2%)			
	40% of Sales Rs 100,000	*40,000*		
	Less Cash discount (2% of Rs 40000)	*800*		
	Net payment made	*39,200*		
07.01.2019	Cash A/c	Dr	43,200	

	To Sales A/c		40,000
	To VAT on Sales A/c		3,200
	Sold goods costing Rs 40,000 to Banita for cash at a profit of 25% on cost less 20% trade discount and charged 8% VAT and paid cartage Rs 100 (not to be charged from customer) *Cost* *40,000* *Add Profit 25 % on Cost* *10,000* *List Price* *50,000* *Less : Trade discount @ 2 %* *10,000* *Invoice price* *40,000* *Add: VAT @ 8%* *3,200* *Total Invoice Value* *43,200*		
	Cartage outwards A/c	100	
	To Cash A/c		100
	(Being Cartage charge paid)		
08.01.2019	Samir A/c Dr	43,200	
	To Sales A/c		40,000
	To VAT on Sales A/c		3,200
	Sold goods costing Rs 40,000 to Samir at a profit of 20% on sales less 20% trade discount and charged 8% VAT and paid cartage Rs 100 to be charged from the customer *Cost* *40,000* *Add: Profit 20% on Sales* *10,000* *List Price* *50,000* *Less : Trade discount @ 20 %* *10,000* *Invoice price* *40,000* *Add: VAT @ 8%* *3,200* *Total Invoice Value* *43,200*		
	Samir A/c Dr	100	
	To Sales A/c		100
	(Being Carriage charged to be		

	recovered from customer)		
	Cartage outwards A/c Dr To Cash A/c (Being Cartage charge paid)	100	100
09.01.2019	Sales Return A/c Dr To Pradeep A/c (Pradeep rejected and returned 10% of goods)	24,500	24,500
10.01.2019	Sales Return A/c Dr To Sailendra A/c (Sailendra rejected and returned 10 % of goods)	27,000	27,000

Illustration 6:

Recording of Purchase Transaction

01.01.2019	Bought Goods for Rs 10,000
02.01.2019	Purchased Goods from Prashant Rs 20,000
03.01.2019	Bought Goods from Pramod for Rs 30,000 against a current dated cheque
04.01.2019	Purchased goods form Susil of the list price of Rs 30,000 at a trade discount of 10 %
05.01.2019	Bought goods of the list price of Rs 125,000 from Tulshi less 20% trade discount and 2% cash discount and paid 40% by cheque and remaining amount is due
06.01.2019	Rejected and returned 10% of goods supplied by Prashant
07.01.2019	Rejected and returned 10% of goods supplied by Susil
08.01.2019	Purchase goods costing Rs 40,000 from Samir less 20% trade discount and charged 8% VAT and paid cartage Rs 100 to bring the material

Solution:

Journal Voucher

Date	Particular	Dr (Rs)	Cr (Rs)
01.01.2019	Purchase A/c Dr To cash A/c (Bought Goods for Rs 10,000)	10,000	10,000

02.01.2019	Purchase A/c To Prashant A/c (Purchased Goods from Prashant Rs 20,000)	Dr	20,000	 20,000
03.01.2019	Purchase A/c To Bank A/c (Bought Goods from Pramod for Rs 30,000 against a current dated cheque)	Dr	30,000	 30,000
04.01.2019	Purchase A/c To Susil (Purchased Goods form Susil of the list price of Rs 30000 at a trade discount of 10 %) List price Less: Trade Discount 10%	Dr 30,000 3,000 27,000	27,000	 27,000
05.01.2019	Purchase A/c To Tulshi (Bought goods of the list price of Rs 125,000 from Tulshi less 20% trade discount and 2% cash discount and paid 40% by cheque) List price Less: Trade Discount 10% Tulshi A/c To Discount Received A/c To Bank A/c (Being 40% payment made to Tulshi under a cash discount of 2% payment ie 40% of 100,000)	Dr 125,000 25,000 100,000 Dr	100,000 40,000	 100,000 800 39,200

	Gross Paid Amount Less: Cash discount @ 2% Net Payment	40,000 800 39,200		
06.01.2019	Prashant A/c To purchase Return A/c (Rejected and returned 10% of goods supplied by Prashant)	Dr	2,000	2,000
07.01.2019	Susil A/c To Purchase Return A/c (Rejected and returned 10% of goods supplied by Susil)	Dr	2,700	2,700
08.01.2019	Purchase Cartage Inward Vat on Purchase A/c To Samir A/c To Cah A/c (Purchase goods costing Rs 40,000 from Samir less 20% trade discount and charged 8% VAT and paid cartage Rs 100 to bring the material) Cost Less : Trade discount @ 20 %	Dr Dr Dr 40,000 8,000	32,000 100 2,560	 34,560 100
	Invoice price Add: VAT @ 8% Total Invoice Value Add : Cartage Charges 	32,000 2,560 34,560 100 34,760		

Illustration 7:

Journalize the following transactions

01.01.2019	Goods costing Rs 15,000 given as charity (sale price of such good is Rs 20,000)
02.01.2019	Goods costing Rs 25,000 given as sample (sale price of such goods is Rs 32,000)

03.01.2019	Goods costing Rs 8,000 (sales price 12,000) stolen in the transit to warehouse
04.01.2019	Goods costing Rs 28,000 (sales price 32,000 destroyed by the fire. But the insurance claim was paid Rs 21,000)
05.01.2019	Good costing Rs 60,000 (Sales price Rs 75,000) stolen by the employee
06.01.2019	Goods costing Rs 25,000 (sales price Rs 32,000) used in making the furniture of office
07.01.2019	Received a cheque from Rajesh to whom goods were sold for Rs 25,000 Discount allowed to him @ 1%
08.01.2019	Cheque received from Rajesh was dishonored and bank charged Rs 500
09.01.2019	Rajesh was insolvent and balance amount could not be realized

Solution:

Journal Voucher

Date	Particular		Dr (Rs)	Cr (Rs)
01.01.2019	Charity A/c	Dr	15,000	
	To Purchase A/c			15,000
	(Being Goods costing Rs 15,000 given as charity)			
02.01.2019	Sales Promotion A/c	Dr	25,000	
	To Purchase A/c			25,000
	(Being Goods costing Rs 25,000 given as sample)			
03.01.2019	Loss in transit A/c	Dr	8,000	
	To Purchase A/c			8,000
	(Being Goods costing Rs 8,000 stolen in the transit to warehouse)			
04.01.2019	Bank A/c	Dr	21,000	
	Loss due to Fire A/c	Dr	7,000	
	To Purchase A/c			28,000
	(Being Goods costing Rs 28,000 loss by fire and the insurance claim was paid Rs 21,000)			
05.01.2019	Loss due to Embezzlement	Dr	60,000	

	To Purchase A/c (Being Good costing Rs 60,000 stolen by the employee)			60,000
06.01.2019	Furniture A/c To Purchase A/c (Being Goods costing Rs 25,000 used in making the furniture of office)	Dr	25,000	 25,000
07.01.2019	Bank A/c Discount Allowed A/c To Rajesh A/c Received a cheque from Rajesh to whom goods were sold for Rs 25,000 Discount allowed to him @ 1%	Dr Dr	24,750 250	 25,000
08.01.2019	Rajesh A/c To Discount Allowed A/c To Bank A/c (Being Cheque received from Rajesh was dishonored and bank charged Rs 500)	Dr	25,500	 250 25,250
09.01.2019	Bad debt A/c To Rajesh A/c (Being Rajesh was insolvent and balance amount could not be realized)	Dr	25,500	 25,500

1.7 LEDGER

After recording a transaction in the journal, the next stage is the transfer of transactions in the respective accounts opened in the ledger. Ledger is a main book of account in which various accounts of personal, real and nominal nature, are opened and maintained. In journal, as all the business transactions are recorded chronologically, it is very difficult to obtain all the transactions pertaining to one head of account together at one place. But, the preparation of different ledger accounts helps to get a consolidated picture of the transactions pertaining to one ledger account at a time. Thus, a ledger account may be defined as a summary statement of all the transactions relating to a person, asset, expense, or income or gain or loss which have taken place during a specified period and shows their net effect ultimately. From the above definition, it is clear that when transactions take place, they are first entered in the journal and subsequently posted to the concerned accounts in the ledger. Posting refers to the process of entering in the ledger the information given in the journal. In the past, the ledgers were kept in bound books.

But with the passage of time, they became loose-leaf ones and the advantages of the same lie in the removal of completed accounts, insertion of new accounts and arrangement of accounts in any required manner.

1.7.1 Format of a Ledger Account

A ledger account can be prepared in any one of the following two forms:

Form 1:

NAME OF ACCOUNT: .... LEDGER FOLIO NO: ....

DR. CR.

DATE	PARTICULARS	J. F	AMOUNT	DATE	PARTICULARS	J. F	AMOUNT
TOTAL AMOUNT				TOTAL AMOUNT			

Form 2

NAME OF ACCOUNT: .... LEDGER FOLIO NO: ....

DR. CR.

DATE	PARTICULARS	J. F	DEBIT AMOUNT	CREDIT AMOUNT	DR./ CR	BALANCE AMOUNT	REMARKS
TOTAL AMOUNT							

1.7.2 Steps for Posting

Posting is the process of transferring the transactions recorded in the books of original entry (journal entries) to the concerned accounts opened in the ledger. The purpose of posting of transaction into the ledger is to record all homogeneous transactions in one set of record known as 'account'. It is necessary to transfer all journal entries into various accounts in the ledger according to similar nature of transaction in order to know the net effect of these transactions during a given period on a particular account.

The various steps involved in posting the transactions into the ledger are as per below:

a. Debit transactions:

An account which has been debited in the journal entries shall be posted in the ledger by following the below steps:

Step 1- With the help of an index; open that page on which the concerned account appears.

Step 2- Enter the date of transaction, in the "date column" on the debit side.

Step 3- Record the name of account credited in the journal, in the "Particulars column" on the debit side as "To, ... (title of account credited)

Step 4- Record the page number of the journal in the "Folio column" on the debit side and in the journal, write the page number of the ledger on which a particular account appears in the "Ledger Folio Column".

Step 5- Enter the relevant in the 'Amount column' on the debit side.

b. Credit transactions:

An account which has been credited in the journal entries shall be posted in the ledger by following the below steps:

Step 1- With the help of an index; open that page on which the concerned account appears.

Step 2- Enter the date of transaction, in the "date column" on the credit side.

Step 3- Record the name of account debited in the journal, in the "Particulars column" on the credit side as " By, ... (title of account debited)

Step 4- Record the page number of the journal in the "Folio column" on the credit side and in the journal, write the page number of the ledger on which a particular account appears in the "Ledger Folio Column".

Step 5- Enter the relevant in the 'Amount column' on the credit side.

Illustration 8

Mr. Sohan started College Cafeteria on Shrawan 1, 2076. Sohan was the sole owner of the business. The following transactions all took place in Shrawan. Revenue and expenses transactions represent summaries of sales and expenses for the entire month; In practice, such entries could be made every day. We will present each transaction, analyze it, and show how it would be entered in the accounts. Each transaction is numbered.

1. On Shrawan 1, Sohan invested Rs. 500,000 in the business as owner.

The Journal Entry of the above transaction would be:

Date	Particular	Debit	Credit
Srawan 1	Cash A/c …… Dr.	Rs. 500,000	
	To Capital A/c		Rs. 500,000

The ledger entry of the above transactions would appear as follow:

Dr. Cash Account Cr.

Date	Particular	Folio no.	(Rs.)	Date	Particular	Folio no.	(Rs.)
Shrawan 1	To Capital A/c	1	500,000				

Dr. Capital Account Cr.

Date	Particular	Folio no.	(Rs.)	Date	Particular	Folio no.	(Rs.)
				Shrawan 1	By Cash A/c	1	500,000

2. On Shrawan 2, the firm paid Rs. 7,500 rent for the month of Shrawan.

The Journal Entry of the above transaction would be:

Date	Particular	Debit	Credit
Srawan 2	Rent A/c Dr.	Rs. 7,500	
	To Cash A/c		Rs. 7,500

The ledger entry of the above transactions would appear as follow:

Dr. Cash Account Cr.

Date	Particular	Folio no.	(Rs.)	Date	Particular	Folio no.	(Rs.)
Shrawan 1	To Capital A/c	1	500,000	Shrawan 2	By Rent A/c	2	7,500

Dr. Rent Account Cr.

Date	Particular	Folio no.	(Rs.)	Date	Particular	Folio no.	(Rs.)
Shrawan 2	To Cash A/c	2	7,500				

3. On Shrawan 3, the firm borrowed Rs. 40,000 from a bank.

The Journal Entry of the above transaction would be:

Shrawan 1	Cash A/c Dr.	Rs. 40,000	
	To Loan A/c		Rs. 40,000

The ledger entry of the above transactions would appear as follow:

Dr. **Cash Account** **Cr.**

Date	Particular	Folio no.	(Rs.)	Date	Particular	Folio no.	(Rs.)
Shrawan 1 Shrawan 3	To Capital A/c To Loan A/c	1 3	500,000 40,000	Shrawan 2	By Rent A/c	2	7,500

Dr. **Loan Account** **Cr.**

Date	Particular	Folio no.	(Rs.)	Date	Particular	Folio no.	(Rs.)
				Shrawan 3	By Loan A/c	3	40,000

4. During Shrawan 4, Pizza sales were Rs. 120,000, all for cash.

The Journal Entry of the above transaction would be:

Shrawan 1	Cash A/c Dr.	Rs. 120,000	
	To Sales A/c		Rs. 120,000

The ledger entry of the above transactions would appear as follow:

Dr. **Cash Account** **Cr.**

Date	Particular	Folio no.	(Rs.)	Date	Particular	Folio no.	(Rs.)
Shrawan 1 Shrawan 3 Shrawan 4	To Capital A/c To Loan A/c To Sales A/c	1 3 4	500,000 40,000 120,000	Shrawan 2	By Rent A/c	2	7,500

Dr. **Sales Account** **Cr.**

Date	Particular	Folio no.	(Rs.)	Date	Particular	Folio no.	(Rs.)
				Shrawan 4	By Cash A/c	3	120,000

1.8 BALANCE OF ACCOUNTS

Basically, at the end of the each day, month or year it may be necessary to ascertain the balance in an account.. To ascertain the balance in any account, total the each sides of ledger and ascertain the difference; the difference is the balance of the ledger. If the ledger has the balance on the credit side it is called a credit balance else if the ledger has the balance on the debit side, it is a debit balance. The credit balance is written on the debit side as, "To Balance c/d (i.e. c/d means "carried down)". By doing so, the two sides will be equal. The totals are written on the two sides opposite one another.

Then the credit balance is written on the credit side as "By balance b/d (i.e. brought down)". This is the opening balance for the new accounting period. The debit balance similarly is written on the credit side as "By Balance c/d", the total are then written on the two sides as shown above and then the debit balance written on the debit side as "To Balance b/d", as the opening balance of the new period.

It should be noted that the nominal accounts are not balanced; the balance in the end are transferred to the Statement of Profit or Loss. Only the Real and Personal accounts ultimately show the balances at the end of the financial year.

The balancing for the ledger entries of the example given in preceding paragraph shall appear as follows:

Dr. **Cash Account** Cr.

Date	**Particular**	**Folio no.**	**(Rs.)**	**Date**	**Particular**	**Folio no.**	**(Rs.)**
Shrawan 1	To Capital A/c	1	500,000	Shrawan 2	By Rent A/c	2	7,500
Shrawan 3	To Loan A/c	3	40,000	Shrawan 31	By Balance c/d		652,500
Shrawan 4	To Sales A/c	4	120,000				
		Total	**660,000**			**Total**	**660,000**
Bhadra 1	To Balance b/d		652,500				

Dr. **Capital Account** **Cr.**

Date	**Particular**	**Folio no.**	**(Rs.)**	**Date**	**Particular**	**Folio no.**	**(Rs.)**
Shrawan 31	To Balance c/d		500,000	Shrawan 1	By Cash A/c	1	500,000
		Total	500,000			Total	500,000
				Bhadra 1	By Balance b/d		500,000

Dr. **Rent Account** **Cr.**

Date	**Particular**	**Folio no.**	**(Rs.)**	**Date**	**Particular**	**Folio no.**	**(Rs.)**
Shrawan 2	To Cash A/c	2	7,500	Shrawan 31	By Balance c/d		7,500
		Total	7,500			Total	7,500

Dr. Loan Account Cr.

Date	Particular	Folio no.	(Rs.)	Date	Particular	Folio no.	(Rs.)
Shrawan 31	To Balance c/d		40,000	Shrawan 3	By Loan A/c	3	40,000
		Total	40,000			Total	40,000
				Bhadra 1	By Balance b/d		40,000

Dr. Sales Account Cr.

Date	Particular	Folio no.	(Rs.)	Date	Particular	Folio no.	(Rs.)
Shrawan 31	To Balance c/d		120,000	Shrawan	By Cash A/c	3	120,000
		Total	120,000			Total	120,000

1.9 TRIAL BALANCE

According to the dual aspect concept, the total of debit balance must be equal to the credit balance. It is necessary that the correctness of posting to the ledger accounts and their balances be verified. This is done by preparing a trial balance.

Trial balance is a statement prepared with the balances or total of debits and credits of all the accounts in the ledger to test the arithmetical accuracy of the ledger accounts. As the name indicates, it is prepared to check the ledger balances. If the total of the debit and credit amount columns of the trial balance are equal, it is assumed that the posting to the ledger in terms of debit and credit amounts is accurate. The agreement of a trial balance ensure arithmetical accuracy only, A concern can prepare trial balance at any time, but its preparation as on the closing date of an accounting year is compulsory.

According to M.S. Gosav “Trial balance is a statement containing the balances of all ledger accounts, as at any given date, arranged in the form of debit and credit columns placed side by side and prepared with the object of checking the arithmetical accuracy of ledger postings”.

1.9.1 Structure of a Trial Balance

The format of trial balance is simple as shown below:

TRIAL BALANCE

AS ON ....

S. NO	HEAD OF ACCOUNT	L.F	DEBIT AMOUNT	CREDIT AMOUNT
	TOTAL AMOUNT			

A Trial Balance contains mainly five columns as seen in the above format. In the second column the name of the account head is written. In the fourth and the fifth columns the total of the debit and the credit side of the account concerned or the debit and the credit balance, if any, is entered and totaled respectively.

Illustration 9:

Trial Balance of Pandey Pvt. Ltd.

As on 31st Shrawan, 2076

S.N.	Heads of Account	L.F.	Debit Rs.	Credit Rs.
1	Cash A/C		504,500	
2	Share Capital A/C			500,000
3	Prepaid Expenses A/C		7,500	
4	Notes Payable A/C			40,000
5	Equipment A/c		72,000	
6	Inventory A/C		5,500	
7	Accounts Payable A/C			22,000
8	Sales Revenue A/C			122,000
9	Wages Expenses A/C		30,000	
10	Cost of Sale A/C		60,000	
11	Utility Expenses A/C		4,500	
	Total		**684,000**	**684,000**

1.9.2 Features of a Trial Balance

1. It contains a list of all ledger account including cash account.
2. It is not a part of the double-entry system of bookkeeping; it is just a working paper.
3. It can be prepared any time during the accounting period.
4. It serves as an instrument for carrying out the job checking and testing.
5. Arithmetical accuracy of posting of the entries from journal to ledger can be ensured.
6. Some errors are not revealed by the Trial Balance, for example, errors of principle, error of omission etc.
7. Total of the debit and credit amount columns of the trial balance must tally. But, tallying of trial balance is not a conclusive evidence of accuracy of accounts.
8. Difference in the debit and credit columns points out that some mistakes have been committed.

1.9.3 Objectives in Drawing up a Trial Balance

1. It ensures that all transactions have been recorded with identical debit and credit amounts and the balance of each account has been computed correctly.
2. It facilitates the preparation of the Statement of Profit or Loss and the Statement of Financial Positon by making available the balances of all the accounts at one place.
3. It also ensures that the balance of each account, whether debit or credit, has been transferred properly to the respective columns of the trial balance and that the Trial Balance has been correctly added.
4. Some of the errors in the books of account can be detected by the Trial Balance and they can be rectified before the preparation of the final accounts.

1.9.4 Limitationsof a Trial Balance

It should be noted that the agreement of Trial Balance is not a conclusive proof of accuracy. In other words, in spite of the agreement of the trial balance some errors may remain. These may be of the following types:

1. Transaction has not been entered at all in the journal or it has been entered twice.
2. A wrong amount has been written in both columns of the journal.
3. A wrong account has been mentioned in the journal.
4. An entry has not at all been posted in the ledger.
5. Entry is posted twice in the ledger.

Still the preparation of trial balance is very useful; without it, the preparation of financial statement i.e the Statement of Profit or Loss and the Statement of Financial Positon would be difficult.

1.10 OPENING ENTRY

A firm closes the books of account at the end of each year and starts new books in the beginning of each year. The first entry in the journal is to record the closing balances of various assets and liabilities at the end of the previous year as the opening balances in the beginning of the current

year. The Statement of Financial Positon prepared at the end of the year records these balance and is the basis for this first entry. It is called the opening entry.
The assets shown in the Statement of Financial Positon are debited and the liabilities and the capital account are credited..

Illustration 10:

Statement of Financial Positon
As at 31st Asadh 2076

Equity and Liabilities	Rs.	Assets	Rs.
Share Capital	100,000	Property Plant and Equipment	100,000
Reserves	50,000	Cash in Hand	10,000
Trade Creditors	50,000	Cash at Bank	90,000
	200,000		**200,000**

Required: Journalize the opening entry

Solution:

The opening entry:

Particular		Debit	Credit
Property Plant and Equipment A/c	Dr.	100,000	
Cash A/c	Dr.	10,000	
Bank A/c	Dr.	90,000	
To Share Capital A/c			100,000
To Reserve A/c			50,000
To Trade Creditors A/c			50,000
(Being opening balances brought forward)			
		200,000	**200,000**

1.10.1 Posting of the Opening Entry

All the assets show debit balance. Such accounts are opened and the relevant amount written on the debit side as "To Balance b/d".

Example:

Property Plant and Equipment Account

Dr. **Cr.**

Date	Particulars	Rs.	Date	Particulars	Rs.
1st Shrawan 2076	To Balance b/d	100,000			

All the liabilities show credit balances. An account for each liability is opened and the relevant account is written on the credit side as "By Balance b/d".

Example:

Share Capital Account

Dr. Cr.

Date	Particulars	Rs.	Date	Particulars	Rs.
			1st Shrawan 2076	By Balance b/d	100,000

By posting the opening entry completely all the accounts of assets and liabilities in the beginning are opened. We illustrate below a complete cycle of journalizing, posting and trial balance.

Note: Students are advised to work out the illustration 3 themselves and then compare with the given solution.

Illustration 11:

From the following transactions of M/s Hari & Sons, write up the Journal in proper form, post to the ledger and extract a Trial Balance.

Date	Particulars	Rs.
2076 Shrawan		
1	Opening balance of Assets:	
1	Cash in Hand	10,000
1	Cash at Bank	50,000
1	Inventories	100,000
1	Vehicle	500,000
1	Furniture	50,000
1	Gita & Co.	40,000
1	Opening balance of Liabilities:	
1	Loan	300,000
1	Ram & Co.	100,000
1	Opening balance of Equity	
1	Capital	300,000
1	General Reserve	50,000
2	Bought goods on credit from Rabi Enterprises	25,000
3	Sold goods for cash to Riza	15,000
4	Received cash from Gita & Co. in full settlement of amount due on 2070 Shrawan 1	30,000
5	Sold goods to Gita & Co. on credit	3,000
6	Partial Payment made to Ram & Co. by cheque.	20,000
7	Furniture costing Rs. 5,000 sold in cash.	4,000
8	Bought goods for cash	25,000
10	Amount due to Rabi paid in cash. It allowed discount of 10% on the total amount.	22,500
14	Obtained additional loan from bank.	100,000
15	Paid house rent through cheque	10,000
18	Paid for electricity through cheque	3,000
19	Purchased computer through cheque	25,000

20	Paid for fuel and maintenance of vehicle through cheque	10,000
23	Paid staff salary for the month of Srawan 2066 through cheque	30,000
25	Sold goods in cash	50,000
27	Cash deposited in bank	51,500
28	Paid equal monthly installment of loan through cheque.	20,000
31	Drawings for personal use from bank	5,000
	Closing inventories	25,000

Solution:

Books of M/s Hari & Sons

Journal Entries

Date	Particulars		Dr.(Rs.)	Cr.(Rs.)
2076 Shrawan	Cash A/c	Dr.	10,000	
1	Bank A/c	Dr.	50,000	
	Inventories A/c	Dr.	100,000	
	Vehicle A/c	Dr.	500,000	
	Furniture A/c	Dr.	50,000	
	Gita & Co. A/c	Dr.	40,000	
	To Capital A/c			300,000
	To General Reserve A/c			50,000
	To Loan A/c			300,000
	To Ram & Co. A/c			100,000
	(Being Assets and Liabilities brought forward from previous year.			
" 2	Purchase A/c	Dr.	25,000	
	To Rabi Enterprises A/c			25,000
	(Being goods purchased on credit from Rabi Enterprises)			
" 3	Cash A/c	Dr.	15,000	
	To Sales A/c			15,000
	(Being sales made in cash)			
" 4	Cash A/c	Dr.	30,000	

	Discount Allowed A/c	Dr.	10,000	
	To Gita & Co. A/c			40,000
	(Being amount received from Gita Rs. 30,000 as full settlement, resulting in discount of Rs. 10,000)			
"5	Gita & Co. A/c	Dr.	3,000	
	To Sales A/c			3,000
	(Being sales made on credit to Gita & Co.)			
"6	Ram & Co. A/c	Dr.	20,000	
	To Bank A/c			20,000
	(Being partial payment made to Ram & Co.)			
" 7	Cash A/c	Dr.	4,000	
	Loss on sale of Furniture A/c	Dr.	1,000	
	To Furniture A/c			5,000
	(Being furniture sold at loss)			
" 8	Purchase A/c	Dr.	25,000	
	To Cash A/c			25,000
	(Being goods purchased on cash)			
"10	Rabi A/c	Dr.	25,000	
	To Cash A/c			22,500
	To Discount Received A/c			2,500
	(Being payment made to Rabi who allowed discount of 10% on total due)			
" 14	Bank A/c	Dr.	100,000	
	To Loan A/c			100,000
	(Being loan obtained from bank)			

"15	House Rent A/c To Bank A/c (Being house rent paid)	Dr.	10,000	 10,000
" 18	Electricity A/c To Bank A/c (Being electricity paid)	Dr.	3,000	 3,000
" 19	Computer A/c To Bank A/c (Being computer purchased)	Dr.	25,000	 25,000
" 20	Fuel and Maintenance A/c To Bank A/c (Being fuel and maintenance of vehicle paid)	Dr.	10,000	 10,000
"23	Salary A/c To Bank A/c (Being salary paid to the staffs for the month of Shrawan 2076)	Dr.	30,000	 30,000
	Cash A/c To Sales A/c (Being Sales made in Cash)	Dr.	50,000	 50,000
" 27	Bank A/c To Cash A/c (Being cash deposited in Bank)	Dr.	51,500	 51,500
" 28	Loan A/c To Bank A/c (Being equal monthly installment of bank loan paid)	Dr.	20,000	 20,000

" 31	Capital (Drawing) A/c Dr. To Bank A/c (Being amount withdraw from bank for personal user)	5,000	 5,000

Books of M/s Hari & Sons
Cash Account

Dr. **Cr.**

Date	Particulars	Rs.	Date	Particulars	Rs.
2076Shrawan 1	To Balance b/d	10,000	2076 Shrawan 8	By Purchase A/c	25,000
" 3	To Sales A/c	15,000	" 10	By Rabi A/c	22,500
" 4	To Gita & Co. A/c	30,000	"27	By Bank A/c	51,500
"7	To Furniture A/c	4,000	"31	By Balance c/d	10,000
" 25	To Sales A/c	50,000			
		109,000			**109,000**
2070 Bhadra 1	To Balance b/d	10,000			

Bank Account

Dr. **Cr.**

Date	Particulars	Rs.	Date	Particulars	Rs.
2076Shrawan 1	To Balance b/d	50,000	2076 Shrawan 8	By Ram & Co. A/c	20,000
" 14	To Loan A/c	100,000	" 10	By House Rent A/c	10,000
" 27	To Cash A/c	51,500	"18	By Electricity A/c	3,000
			"19	By, Computer A/c	25,000
			" 20	By Fuel & Maintenance A/c	10,000
			" 23	By Salary A/c	30,000
			" 28	By Loan A/c	20,000
			"31	By Capital A/c	5,000
				By Balance c/d	78,500
		201,500			**123,000**
2076 Bhadra 1	To Balance b/d	78,500			

Inventories Account

Dr.					Cr.
Date	**Particulars**	**Rs.**	**Date**	**Particulars**	**Rs.**
2076Shrawan	To Balance b/d	100,000	2076Shrawan	By Balance c/d	100,000

1			31		
		100,000			100,000
2076Bhadra 1	To Balance b/d	100,000			

Vehicle Account

Dr.					Cr.
Date	**Particulars**	**Rs.**	**Date**	**Particulars**	**Rs.**
2076Shrawan 1	To Balance b/d	500,000	2076Shrawan 31	By Balance c/d	500,000
		500,000			500,000
2076Bhadra 1	To Balance b/d	500,000			

Furniture Account

Dr. **Cr.**

Date	Particulars	Rs.	Date	Particulars	Rs.
2076 Shrawan 1	To Balance b/d	50,000	2076Shrawan 7	By Cash A/c	4,000
			"	By Loss on Sale of furniture A/c	1,000
			"31	By Balance c/d	45,000
		50,000			50,000
2076 Bhadra 1	To Balance b/d	45,000			

Gita & Co. Account

Dr **Cr.**

Date	Particulars	Rs.	Date	Particulars	Rs.
2076Shrawan 1	To Balance b/d	40,000	2076Shrawan 7	By Cash A/c	30,000
" 5	To Sales A/c	3,000	"	By Discount A/c	10,000
			"31	By Balance c/d	3,000
		43,000			43,000
2076Bhadra 1	To Balance b/d	3,000			

Capital Account

Dr. **Cr.**

Date	Particulars	Rs.	Date	Particulars	Rs.
2076 Shrawan 31	To Bank A/c	5,000	2076Shrawan 1	By Balance b/d	300,000
"	To Balance c/d	295,000			
		300,000			300,000
			2076 Bhadra 1	By Balance b/d	295,000

General Reserve Account

Dr.					Cr.
Date	**Particulars**	**Rs.**	**Date**	**Particulars**	**Rs.**
2076 Shrawan 31	To Balance c/d	50,000	2076 Shrawan 1	By Balance b/d	50,000
		50,000			50,000
			2076 Bhadra 1	By Balance b/d	50,000

Loan Account

Dr. **Cr.**

Date	Particulars	Rs.	Date	Particulars	Rs.
2076Shrawan 28	To Bank A/c	20,000	2076 Shrawan 1	By Balance b/d	300,000
"31	To Balance c/d	380,000	" 14	By Bank A/c	100,000
		400,000			400,000
			2076Bhadra 1	By Balance b/d	380,000

Ram & Co. Account

Dr. **Cr.**

Date	Particulars	Rs.	Date	Particulars	Rs.
2076 Shrawan 6	To Bank A/c	20,000	2076Shrawan 1	By Balance b/d	100,000
"31	To Balance c/d	80,000			

		100,000			100,000
			2076 Bhadra 1	By Balance b/d	80,000

Purchase Account

Dr. **Cr.**

Date	Particulars	Rs.	Date	Particulars	Rs.
2076 Shrawan 2	To Rabi A/c	25,000	2076 Shrawan 31	By Bal transferred to P/L A/c	50,000
" 8	To Cash A/c	25,000			
		50,000			50,000

Rabi Account

Dr. **Cr.**

Date	Particulars	Rs.	Date	Particulars	Rs.
2076 Shrawan 2	To Cash A/c	22,500	2076 Shrawan 1	By Purchase A/c	25,000
" 10	To Discount A/c	2,500			
		25,000			25,000

Sales Account

Dr. **Cr.**

Date	Particulars	Rs.	Date	Particulars	Rs.
			2076 Shrawan 3	By Cash A/c	15,000
			"5	By Gita & Co. A/c	3,000
2076 Shrawan 31	By Bal transferred to P/L A/c	68,000	" 25	By Cash A/c	50,000
		68,000			68,000

Discount Account

Dr. **Cr.**

Date	Particulars	Rs.	Date	Particulars	Rs.
2076. Srawan 4	To Gita & Co. A/c	10,000	2076. Srawan 10	By Rabi A/c	2,500
			2076. Srawan 31	By Bal transferred to P/L A/c	7,500
		10,000			10,000

Loss on Sales of Furniture Account

Dr. **Cr.**

Date	Particulars	Rs.	Date	Particulars	Rs.
2076 Shrawan 7	To Furniture A/c	1,000			
			2076 Shrawan 31	By Bal transferred to P/L A/c	1,000
		1,000			1,000

House Rent Account

Dr. **Cr.**

Date	Particulars	Rs.	Date	Particulars	Rs.
2076 Shrawan 15	To Bank A/c	10,000			
			2076Shrawan 31	By Bal transferred to P/L A/c	10,000
		10,000			10,000

Electricity Account

Dr. **Cr.**

Date	Particulars	Rs.	Date	Particulars	Rs.
2076 Shrawan 18	To Bank A/c	3,000			
			2076 Shrawan 31	By Bal transferred to P/L A/c	3,000
		3,000			3,000

Computer Account

Dr. **Cr.**

Date	Particulars	Rs.	Date	Particulars	Rs.
2076 Shrawan 19	To Bank A/c	25,000			
			2076 Shrawan 31	By Bal c/d	25,000
		25,000			25,000
2070 Bhadra 1	To Bal b/d	25,000			

Fuel and Maintenance Account

Dr. **Cr.**

Date	Particulars	Rs.	Date	Particulars	Rs.
2076 Shrawan 20	To Bank A/c	10,000			

			2076 Shrawan 31	By Bal transferred to P/L A/c	10,000
		10,000			10,000

Salary Account

Dr. **Cr.**

Date	Particulars	Rs.	Date	Particulars	Rs.
2076 Shrawan 23	To Bank A/c	30,000			
			2076 Shrawan 31	By Bal transferred to P/L A/c	30,000
		30,000			**30,000**

Books of M/s Hari & Sons
Trial Balance
As at Srawan 31, 2076

S. No.	Name of Account	L.F.	Dr. (Rs.)	Cr. Rs.
1	Cash Account		10,000	
2	Bank Account		78,500	
3	Inventories Account (Opening Stock)		100,000	
4	Vehicle Account		500,000	
5	Furniture Account		45,000	
6	Gita & Co. Account		3,000	
7	Capital Account		-	295,000
8	General Reserve Account		-	50,000
9	Loan Account		-	380,000
10	Ram & Co. Account		-	80,000
11	Purchase Account		50,000	
12	Sales Account		-	68,000
13	Discount Account		7,500	
14	Loss on Sale of Furniture Account		1,000	
15	House Rent Account		10,000	
16	Electricity Account		3,000	
17	Computer Account		25,000	

18	Fuel & Maintenance Account		10,000	
19	Salary Account		30,000	
			873,000	**873,000**

Note: *Closing stock is not generally considered while preparing a Trial Balance.*

1.11 CHART OF ACCOUNTS

To ensure consistency in recording transactions, organizations specify a chart of accounts, which is a numbered or coded list of all account titles. This list specifies the accounts (or categories) that the organization uses in recoding its activities. We use these account numbers as reference in the post reference column of the journal, as Exhibit as under. The following is the chart of accounts for Hypothetical Company.

Account Number	Account Title	Account Number	Account Title
100	Cash	202	Short Term Loan
120	Accounts Receivable	203	Accounts Payable
130	Inventory	300	Share Capital
140	Prepaid Expenses	400	Retained Earning
170	Office Equipment	500	Sales Revenue
180	Accumulated Depreciation	600	Cost of Goods Sold
190	Store Equipment	601	Rent Expenses
		602	Depreciation Expenses

Journalization of the acquisition of Office Equipment (Account No- 170) on Cash (Account No- 100) for the hypothetical company are as follow:

20X2		Dr.	Cr.
Jan, 3	170	15,000	
	100		15,000

This journal entry employs the accountant's shorthand, which uses codes without account names. Its brevity and lack of explanation would hamper any outsider's understanding of the transaction, but the entry's meaning would be clear to anyone within the organization.

1.12 SUBSIDIARY LEDGERS AND CONTROL ACCOUNTS

A **subsidiary ledger** is a group of similar accounts whose combined balances equal the balance in a specific general ledger account. The general ledger account that summarizes a subsidiary ledger's account balances is called a **control account** or **master account**. For example, an accounts receivable subsidiary ledger (customers' subsidiary ledger) includes a separate account for each customer who makes credit purchases. The combined balance of every account in this subsidiary ledger equals the balance of accounts receivable in the general ledger. Posting debit or credit to a subsidiary ledger account and general ledger control account does not violate the rule that total debit and credit entries must balance because subsidiary ledger accounts are not the part of the general ledger; they are supplementary accounts that provide the detail to support the balance in a control account.

Accounts Receivable Subsidiary Ledger

Kamal				AR 1
Date	Ref.	Debit	Credit	Balance
2012 Mar. 5		200		200

Jamal				AR 2
Date	Ref.	Debit	Credit	Balance
2012				
Mar. 22		700		700

Ram				AR 3
Date	Ref.	Debit	Credit	Balance
2012				
Mar.15		500		500

Rakesh				AR 4
Date	Ref.	Debit	Credit	Balance
2012				
Mar. 5		1,500		1,500
Mar. 22		1,000		2,500

Sagar				AR 5
Date	Ref.	Debit	Credit	Balance
2012				
Mar. 1		1,000		1,000

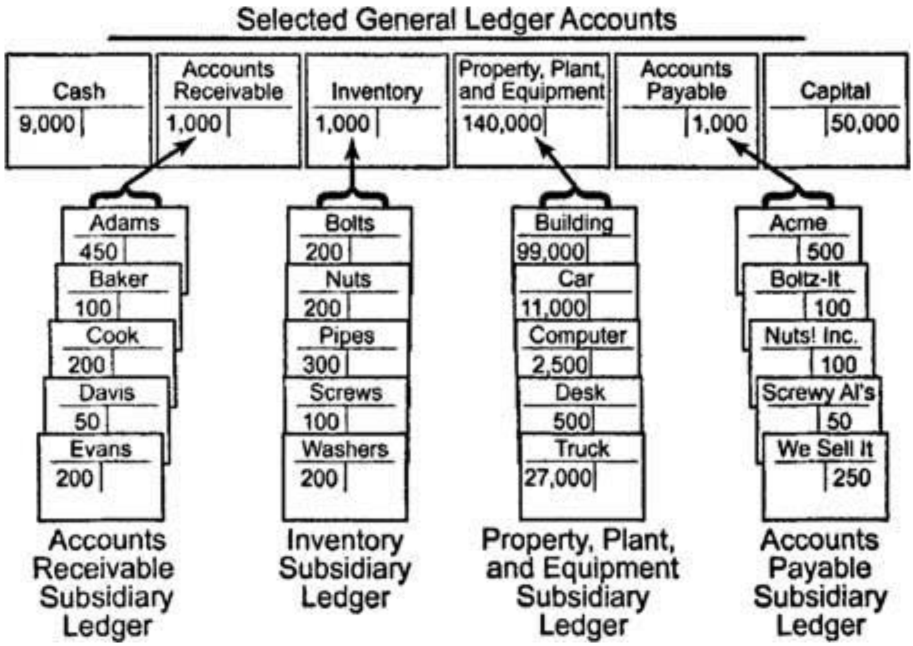
Control Account

Accounts Receivable				111
Date	Ref.	Debit	Credit	Balance
2012 March 31		4,900		4,900

200
700
500
2,500
<u>1,000</u>
4,900

The accounts receivable subsidiary ledger is essential to most businesses. Companies may have hundreds or even thousands of customers who purchase items on credit, make one or more payments for those items, and sometimes return items or purchase additional items before they finish paying for prior purchases. Recording all credit purchases, returns, and subsequent payments in a single account would make an individual customer's balance virtually impossible to calculate because the customer's transactions would be interspersed among thousands of other transactions. But the accounts receivable subsidiary ledger provides quick access to each customer's balance and account activity.

Companies create subsidiary ledgers whenever they need to monitor the individual components of a controlling general ledger account. In addition to the accounts receivable subsidiary ledger, companies often use an accounts payable subsidiary ledger (creditors' subsidiary ledger), which has separate accounts for each creditor, an inventory subsidiary ledger, which has separate accounts for each product, and a property, plant, and equipment subsidiary ledger, which has separate accounts for each fixed asset.



One advantage of this practice is that several bookkeepers can work on the ledger accounts simultaneously**.** In order to keep the general ledger in balance, a control account takes the place of the individual accounts. A control account shows the debits and credits of the accounts in summary form which was shown in detail in a subsidiary ledger. When subsidiary ledgers are used, each amount is, in effect, posted twice. It is posted, often daily, to the proper account in the subsidiary ledger. It becomes a part of the total that is posted at the end of the period to the control account in the general ledger. In a large business, most if not all of the general ledger accounts are control accounts.

Summary

We have discussed in this unit that the double entry accounting system is the only scientific system for recording transactions and events. According to this system, transactions and events that are recorded by suitable account headings are analyzed in terms of debit and credit. By this process total of debit becomes equal to total of credit. In other words, assets are always equal to equity and liabilities. Accounts are classified in the first instance as personal and impersonal; then impersonal accounts are further classified into real and nominal. In the accounting cycle transactions and events are first journalized, then posted to suitable ledger

accounts and all the accounts are balanced at the end of the year. Generally, balances of the nominal accounts are transferred to Trading and Statement of Profit or Loss for determination of profit or loss and balances of personal and real accounts are transferred to Statement of Financial Positon. However there are few exceptions to this rule. The trial balance is drawn by taking the balances of all ledger accounts periodically or at the end of the accounting period to test the arithmetic accuracy. Instead of journalizing the transactions and events in accordance with the process described in this unit business houses maintain subsidiary books to keep primary records.

Self-Examination Questions

I. Multiple Choice Questions (MCQs)

1. For payment of salary for the month of Kartik 2070 which account should be debited:
   (a) Cash Account (b) Salary Account
   (c) Kartik Account (d) None of the above

2. The rent paid to landlord is credited to
   (a) Landlord's Account (b) Rent Account
   (c) Cash Account (d) None of the above

3. Which account is odd one out?
   (a) Office Equipment & Furniture (b) Land & Building
   (c) Plant & Machinery (d) Stock of Materials

4. The trade discount should be credited to
   (a) Purchase Account (b) Trade Discount Account
   (c) Cash Account (d) Not recorded

5. Which component of Financial Statement represents, Assets = Liabilities+Capital
   (a) Income Statement (b) Statement of Financial Positon
   (c) Cash Flow Statement (d) All of the above

6. Prepaid Salary Account is
   (a) Personal (b) Real (c) Nominal (d) None of the above

7. Proprietor's Account is
   (a) Personal (b) Real (c) Nominal (d) None of the above

8. Patents Account is
   (a) Personal (b) Real (c) Nominal (d) None of the above

9. Cash Account is
   (a) Personal (b) Real (c) Nominal (d) None of the above

10. A sale of goods to Ram for cash should be debited to:
(a) Ram (b) Cash (c) Sales (d) Capital

11. Building account is a:
(a) Personal (b) Real (c) Nominal (d) None of the above

12. Goods worth Rs. 5,000 taken by proprietor should be credited to:
(a) Sales account (b) Drawing account
(c) Purchase account (d) Expenses account

13. The Statement of Financial Positon shows:
(a) Financial position (b) Performance
(c) Arithmetical accuracy (d) All of the above

14. The Statement of Profit or Loss shows:
(a) Financial position (b) Performance
(c) Arithmetical accuracy (d) All of the above

15. The Trial Balance shows:
(a) Financial position (b) Performance
(c) Arithmetical accuracy (d) Honesty of Accountant

16. Ledger book is popularly known as
(a) Secondary Book of Accounts (b) Principle Book of Accounts
(c) Subsidiary Book of Accounts (d) None of the above

17. Which of the following is correct?
(a) Assets = Capital – Liabilities (b) Assets = Liaiblites – Capital
(c) Assets = Capital + Liabilieis (d) Assets = Capital

18. If an entitity borrows a sum of money from a bank, there will be
(a) Incease in Capital (b) Derecase in Capital
(c) No effect in Capital (d) None of the above

19. The following account has a credit balance
(a) Carriage inward (b) Carriage Outward
(c) Return Inward (d) Returns Outward

20. A withdrawal of cash from business by the proprietor should be credited to
(a) Drawing Account (b) Capital Account
(c) Cash Account (d) Purchase Account

21. Good purchase in cash is an example of
(a) Increase in assets and owner's liability
(b) Decrease in assets and owner's liability

(c) decrease in liability and increase in owner's liability
(d) increase in liability and decrease in owner's liability

22. Goods purchase in credit is an example of –
(a) increase in assets and owners liability
(b) decrease in assets and owners liability
(c) decrease in liability and increase in owners liability
(d) increase in liability and decrease in owners liability

23. Goods returned to suppliers is an example of –
(a) increase in assets and owners liability
(b) decrease in assets and owners liability
(c) decrease in liability and increase in owners liability
(d) increase in liability and decrease in owners liability

24. Goods withdrawn by owner for personal use is an example of-
(a) no change in owners equity
(b) increase in assets and owners equity
(c) decrease in owners equity
(d) none of these

25. Goods destroyed by fire is an example of:
(a) no change in owners equity
(b) increase in assets and owners equity
(c) decrease in liability and owners equity
(d) none of these

II. Short Descriptive Questions (SDQs)

1 Discuss the double entry system of book-keeping and the accounting equation.
2. Elaborate the steps included in the Journalizing Process.
3. Write short Note on:
   a. Opening Entry
   b. Limitation of Trial Balance
   c. Chart of Accounts
   d. Balancing of Accounts
4. On 2076 Srawan 1, the position of Mr. Prakash Shrestha was as per below:
   Inventories: Rs. 100,000; Receivables: Rs. 50,000, Cash and Bank: Rs. 20,000, Land &Building: Rs. 500,000, Payables: 100,000, Bank Loan: 300,000.
   What was the amount of capital of Mr. Prakash Shrestha on that date? Prepare the opening journal entry

III. Practical Questions (PQs)

1. Enter the following transactions in the books of A & Co., sole proprietorship business of Mr. A.

a. Mr. A commences business (A & Co.) investing cash Rs. 500,000.
b. Purchased goods worth Rs. 50,000 by paying cash.
c. Sold goods to Mr. Umar Rs. 42,000 on credit.
d. Office expenses paid Rs. 20,000.
e. Purchased Furniture from Rara Furniture House Rs. 45,000.

2. From the following transactions, pass journal entries, post it in the ledger accounts and prepare trial balance.
   i. Mr. Singh established a business by injecting cash of Rs. 500,000.
   ii. Purchased inventories from Raja Suppliers worth Rs. 500,000 by paying 40% cash.
   iii. Purchased Computers for Rs 30,000 and Furniture for Rs. 60,000 by paying cash.
   iv. Opened a bank account at Nepal Bank Ltd. and deposited Rs. 200,000.
   v. Obtained Loan of Rs. 300,000 from a Hello Finance Company which charged 2% as a services charge on gross loan. Deposited the net loan amount into the bank on the same day.
   vi. The amount due to Raja Suppliers was fully paid through a cheque at a discount of 10% of the total due.
   vii. Sold goods to Shyam at Rs. 200,000, who paid 70% through cheque, 20% in cash and the balance was kept due.
   viii. Drawings by Mr. Singh Rs. 50,000 in cash.
   ix. Paid interest on Loan Rs. 30,000 through a cheque.
   x. Paid staff salary Rs. 25,000, electricity Rs. 15,000 and fuel Rs. 20,000 through cheque.
   xi. The balance due from Shyam was received in cash at 10% discount.

3. Arjun Started business with the cash Rs. 350,000 on 3rd Shrawan 2076 and opened bank account with Rs. 150,000 on 5th Shrawan with Nepal Bank Ltd. His other transactions were as follows during the month.
   5 Shrawan Purchase goods from M/s Suhana Suppliers Rs. 230,000
   7 Shrawan Sold goods on cash Rs. 130,000 (cost Rs. 100,000)
   8 Shrawan Paid salary Rs. 15,000 and Rent Rs. 8,000
   12 Shrawan Sold goods to Harihar Rs. 9,000
   15 Shrawan Cash withdraw from Bank for office use Rs. 9,500
   28 Shrawan Purchased goods for Rs. 100,000 from A & Co. and made partial payment of Rs. 60,000 through cheque
   29 Shrawan Received cash from Harihar Rs. 8,500 as full and final settlement
   You are asked to pass necessary journal entries with full narration.

4. Mr. Z started business with Building Rs. 450,000; Furniture Rs. 125,000; Machinery Rs. 325,000 and Bank Balance Rs. 112,500.
   i. Purchased goods for Rs. 100,000 from Kumar suppliers and made partial payment of Rs. 65,000 through bank.
   ii. Loan taken from Superstar Bank Ltd. Rs. 250,000
   iii. Sold goods on cash Rs. 150,000 (cost Rs. 120,000) and sold to Mr. Y Rs. 4,000 (costing Rs. 3,000) on credit.

iv. Interest Rs. 4,500 paid to bank and interest Rs. 1,500 still due but not paid.
v. Delivery Van has been purchased for Rs. 55,000 and spent Rs. 3,500 for its registration.
vi. Mr. Y who owes Rs. 4,000 become insolvent and only 80% of the amount due is received.
vii. Paid cash Rs. 19,000 and issued cheque Rs. 13,500 to Kumar Supplier as full and final settlement.
viii. Salary for the month is Rs. 20,000 but issued cheque amounting to Rs. 22,500.
ix. Mr. Z took away Furniture costing Rs. 1,800 for his personal use.
x. Paid Rs. 120,000 through cheque for partial settlement of Bank Loan.
xi. Rent paid for the month is Rs. 30,000. Mr. Z is using half of the floor for his residential purpose.
xii. Repair expenses for the vehicle amounting to Rs. 3,000 paid through cheque.
xiii. Rs. 15,000 spent for construction of Cycle Shed for staffs.
xiv. Mr. Z contributed Rs. 50,000 as additional capital.
xv. A part of machinery costing Rs. 35,000 has been sold for Rs. 37,500 on credit to M/s Kuku Traders.
xvi. Goods worth Rs. 2,500 destroyed in an accident. Insurance company paid Rs. 1,700 only as a claim.

You are required to pass necessary journal entries, posted them to concerned ledgers and prepare trial balance.

ANSWER

Multiple Choice Questions (MCQs)

1	b	6	a	11	b	16	a
2	c	7	a	12	c	17	c
3	d	8	b	13	a	18	c
4	d	9	b	14	b	19	d
5	b	10	b	15	c	20	c
21	b	22	d	23	c	24	a
25	a						

ATTACHMENT: ACCOUNTING TERMS

The following texts are provided with a view to clarify the important terms that are frequently used during the accounting process including during the preparation and presentation of financial statements.

Introduction

The objective of this attachment is to facilitate a basic understanding of the various terms as well as to promote consistency and uniformity in their usage. As such it does not purport or provide a comprehensive or rigid dictionary.

General Definitions

1. Statement of Financial Positon

A statement of financial position exhibits assets, liabilities, capital, reserves and other account balances of the entity at a given date at their respective book value. It is also called Balance Sheet.

2. Profit and Loss Statement

It is a financial statement which presents the revenues and expenses of an enterprise of an accounting period and shows the excess of revenues over expenses (or vice-versa). It is also known as Statement of Income.

3. Income and Expenditure Statement

A financial statement, often prepared by non-profit making enterprises like clubs, associations etc. to present their revenues and expenses for an accounting period and to show the excess of revenues over expenses (or vice versa) for that period. It is similar to profit and loss statement and is also called revenue and expenses statement.

4. Appropriation Account

An account sometimes includes a separate section of the profit and loss statement showing distribution of profit towards dividends, reserves, etc. which is called Appropriation Account or Profit/Loss Appropriation Account.

5. Assets

Assets are the tangible objects or intangible rights owned by an enterprise and carrying probable future benefits. Tangible assets include money, land, buildings, investments, inventory, cars, trucks or other valuables. Intangibles assets include patent, trademark, license etc.

5.1 Accrued Asset

It is a developing but not yet enforceable claim against another person which accumulates with the passage of time or the rendering of service or otherwise. It may arise from the rendering of services which at the date of accounting have been partly performed and are not yet billable.

5.2 Accounts Receivable or Trade/Sundry Debtors

Accounts receivable are amounts owed to the entity by its customers. Accounts receivable are reported on the Statement of Financial Positon at the amount owed less a provision for that portion that probably will not be collected. An amount owed towards the entity by someone other than a customer would appear under the separate heading notes receivable or other receivables rather than as accounts receivable.

5.3 Accrued Revenue

Revenue which has been earned in an accounting period but in respect of which no enforceable claim has become due in that period by the enterprise. It may arise from the rendering of services which at the date of accounting have been partly performed, and are not yet billable.

5.4 Advance

Payment made on account of, but before completion of a contract or before acquisition of goods or receipt of services.

5.5 Bad Debts

Debts owed to an enterprise which are considered to be irrecoverable are known as bad debts.

5.6 Cash and Cash Equivalents

Cash comprises cash on hand and demand deposits. Whereas cash equivalents are short-term highly liquid investments that are readily convertible to known amounts of cash and which are subject to an insignificant risk of changes in value. For e.g.: marketable securities like shares, debentures, etc

5.7 Capital Work-In-Progress

These are expenditure on capital assets which are in the process of construction or completion. For e.g Construction of Building in process

5.8 Contingent Asset

An asset the existence, ownership or value of which may be known or determined only upon the occurrence or non-occurrence of one or more uncertain future events are known as contingent asset.

5.9 Current Assets

Current assets are those assets that are held only for a short period of time. Assets that are reasonably expected to be realized in cash or sold or consumed during the normal operation cycle of an enterprise or within a period of one year from the date of the Statement of Financial Positon is treated as current assets. For example, cash, inventories, receivables, debtors etc.

5.10 Intangible Assets

These are the assets that do not have physical existence but are controlled by an enterprise. For e.g. copyright, trademarks, franchise and similar valuable but non physical things

5.11 Inventories

Inventories are the aggregate of those assets that are either (1) held for sale in the ordinary course of business, (2) are in process of production for such sale, or (3) are to be currently consumed in the production of goods or services to be available for sale. Note that inventory relates to goods that will be sold in the ordinary course of business. A truck offered for sale by a truck dealer is inventory. A truck used by the dealer to make service calls in not inventory; it is an item of fixed asset, which is a non-current asset.

5.12 Investments

These are investments made in the shares/securities of other companies with primary intention to either control or earn long-term return from them. They are therefore to be distinguished from marketable securities, which are current asset reflecting the short-term return because of excess cash balance.

5.13 Marketable Securities

Marketable securities are investments that are both readily marketable and are expected to be converted into cash generally within 3 months. They are investments made so as to earn some return on cash that otherwise would be temporarily idle.

5.14 Prepaid Expenses

Prepaid Expenses represent payment made for expenses in advance the benefit of which has not been obtained yet. An example is an insurance policy. A business pays for insurance protection in advance. Its right to this protection is an asset- an economic resource that will provide future benefits.. The amount on the Statement of Financial Positon is the future amount of the benefit.

5.14 Property, Plant and Equipment:

These are the assets of tangible nature whose economic benefit is expected to follow in an enterprise for more than a single period. For e.g.: land, building, vehicle etc. These are normally treated as non-current assets.

6 Liabilities

Liabilities are financial obligations of an enterprise towards external parties i.e. payable to other than owners. For e.g.: creditors, lenders etc.

6.1 Accounts payable or Trade/Sundry Creditors

It represents the claims of suppliers relating to goods supplied or services rendered, that they have furnished to an enterprise and which are yet to be paid.

6.2 Accrued Expenses

These are the expenses which are incurred in an accounting period but for which no enforceable claim has become due in that period against the enterprise. It may arise from the purchase of services which at the date of accounting have been partly performed, and are not billable by the parties

6.3 Accrued Liability

These are the developing but not yet enforceable claim by another person which accumulates with the passage of time or the receipt of service or otherwise. It may arise from the purchase of services which at the date of accounting have been partly performed and are not yet billable.

6.4 Accumulated Depreciation

The total depreciation on a tangible assets accumulated up to the specific date. This amount is subtracted from the original cost or valuation of the asset to arrive at its book value. Accumulated depreciation amount represents only the expired value of an asset; it is neither cash nor any other type of asset that can be used to buy another asset..

6.5 Bond /Debenture

It is a formal document constituting acknowledgement of a debt by an enterprise, usually given under its common seal and normally containing provisions regarding payment of interest, repayment of principal and security, if any. It is transferable in the appropriate manner.

6.6 Contingent Liability

An obligation relating to an existing condition or situation which may arise in future depending on the occurrence or non-occurrence of one or more uncertain future events.

6.7 Convertible Bond/Debenture

It is a bond/debenture which gives the holder a right to conversion, wholly or partly, into shares in accordance with the terms of issue.

6.8 Current Liabilities.

These are obligations that are expected to be settled in the normal course of business activity or within a period of 12 months from the date of Statement of Financial Positon.

6.9 Current Portion of Long-Term Debt

It represents that portion of a long-term loan that is payable within 12 months from the date of the Statement of Financial Positon. Such a portion is treated as current liabilities whereas the balance of the loan is treated as non-current liabilities.

6.10 Deferred Revenues

It is also called Un-earned revenues or pre-collected revenues. It represents the liability that arises because the entity has received advance payment for a service it has agreed to render in the future. An example is unearned subscription revenues, which represent magazine subscription payments received in advance, for which the publishing company agrees to deliver issues of its magazine during some future period.

6.11 Provision

An amount set aside or retained by way of providing for depreciation or diminution in value of assets or retained by way of providing for any known liability, the amount of which cannot be determined with substantial accuracy is a provision.

6.12 Secured Loan

Loan secured wholly or partly against an asset.

6.13 Tax Payable

It represents the amount of tax payable to the government of the country.

7 Equity

Equity represents the amount invested by the owners in an enterprise i.e capital/share capital. It also includes the retained earning pertaining to the owners.

7.1 Authorized Share Capital

It is that number and par value of each class of shares that an enterprise may issue in accordance with its instrument of incorporation. This is sometimes referred to as nominal share capital.

7.2 Bonus Shares

Shares allotted by capitalization of the reserves or surplus of a corporate enterprise or shares given to existing shareholders without any cost.

7.3 Call

It is a demand pursuant to terms of issue to pay a part or whole of the balance remaining payable on shares or debenture after allotment.

7.4 Called up Share Capital

That part of the subscribed share capital which shareholders have been required to pay.

7.5 Capital

Generally refers to the amount invested in an enterprise by its owners e.g. Paid up share capital in a corporate enterprise. It is also used to refer to the interest of owners in the assets of an enterprise.

7.6 Capital Employed

The finances deployed by an enterprise in its net property, plant and equipment, investments and working capital. Capital employed in an operation may, however, include investments made outside that operation.

7.7 Capital Redemption Reserve

A reserve created on redemption of the redeemable preference shares of a corporate enterprise out of its profits which otherwise have been available for distribution as dividend.

7.8 Capital Reserve

It is a reserve of a corporate enterprise which is not available for distribution as dividend.

7.9 Issued Share Capital

The portion of authorized share capital which has actually been offered for subscription is known as issued share capital. This includes any bonus shares allotted by the corporate enterprise.

7.10 Paid up Share Capital

That part of the subscribed share capital for which consideration in cash or otherwise has been received. This includes bonus shares allotted by the corporate.

7.11 Preference Share Capital

That part of the share capital of a corporate enterprise which enjoys preferential rights in respect of payment of fixed dividend and repayment of capital. Preference shares may also have full or partial participating rights in surplus profit or surplus capital.

7.12 Redeemable Preference Share

The preference share repayable either after a fixed period or at any time decided by the management (by giving due notice), under certain conditions prescribed by the instrument of incorporation or the terms of issue.

7.13 Reserves

The portion of earnings, receipts or other surplus of an enterprise (whether capital or revenue) appropriated by the management for a general or a specific purpose. The reserves are primarily of two types: Capital reserves and Revenue reserves.

7.14 Revenue Reserve

It is a reserve created out of Revenue profit which is used to make financial position strong and to meet various unforeseen contigencies.

7.15 Revaluation Reserve

A reserve created on the revaluation of assets of an enterprise represented by the surplus of the estimated replacement cost or estimated market values or the book values thereof.

7.16 Right Share

An allotment of shares on the issue of fresh capital by a corporate enterprise to which a shareholder is entitled on payment, by virtue of his holding certain shares in the enterprise in proportion to the numbers of shares already held by him.(Shares allotted to certain categories of debenture holders pursuant to the rights enjoyed by them are sometimes called right shares.)

7.17 Share Capital.

Share capital refers to the funds that a company raises in exchange for issuing an ownership interest in the company in the form of shares.

7.18 Share Discount

These are the excess of the face value of shares over their issue price.

7.19 Share Premium

These are the excess of issue price of shares over their face value.

7.20 Sinking Fund

A fund created for the repayment of a liability or for the replacement of an asset.

8 Income

The definition of income encompasses both revenue and gains. The "business income" is income from transactions and activities in the regular course of its trade or business, and includes income from tangible and intangible property.

8.1 Capital Profit

Excess of the proceeds realized from the sale, transfer, or exchange of the whole or a part of capital asset over its cost. When the result of this computation is negative, it is referred to as capital loss.

8.2 Cash Discount

It is a reduction granted by supplier from the invoice price in consideration of immediate payment of payment within stipulated period. It is allowed to encourage prompt payment. It is allowed on immediate payment or payment within stipulated period. It is not shown in invoice. It may vary with the period within which payment is made.

8.3 Gain

Gain represent other items that meet the definition of income and may or may not, arise in the course of the ordinary activities of an entity. Gains represent increases in economic benefits and as such are different in nature from revenue. Gains include, for example those arising on the disposal of non-current assets.

8.4 Gross Margin or Gross Profit

The excess of the proceeds of goods sold and services rendered during a period over their cost, before taking into account administration, selling, distribution and financing expenses. When the result of this computation is negative it is referred to as gross loss.

8.5 Net Profit

It is the excess of revenue during a particular accounting period. When the result of this computation is negative, it is referred to as net loss. The net profit may be shown before or after tax.

8.6 Operating Profit

The net profit arising from the normal operations and activities of an enterprise without taking account of extraneous transactions and expenses of a purely financial nature

8.7 Profit

It is a general term for the excess of revenue over related cost. When the result of this computation is negative it is referred to as loss.

9.8 Revenue

Revenue arises in the course of the ordinary activities of an entity and is referred to by a variety of different names including sales, fees, interest, dividend, royalties and rent.

10.9 Sales Turnover

The aggregate amount for which sales are effected or services rendered by an enterprise. The terms gross turnover and net turnover (or gross sales and net sales) are sometimes used to distinguish the sales aggregate before and after deduction of returns and trade discounts.

11. Expenses

In common usage, an **expense** or **expenditure** is an outflow of money to another person or group to pay for an item or service, or for a category of costs. The International Accounting Standards Board defined expenses as *"...decreases in economic benefits during the accounting period in the form of outflows or depletions of assets or incurrence of liabilities that result in decreases in equity, other than those relating to distributions to equity participants."*

11.1 Amortization

It refers to the gradual and systematic writing off of an intangible asset or an account over an appropriate period. The amount on which amortization is provided is referred to as amortizable amount. Depreciation accounting is a form of amortization applied to Depreciable assets.

11.2 Conversion Cost

Cost incurred to convert raw materials or components into finished or semi-finished products. This normally includes costs which are specifically attributable to units or production, i.e. direct labor, direct expenses and subcontracted work, and production overheads as applicable in accordance with either the direct or absorption costing method. Production overheads exclude expenses which relate to general administration, fiancé, selling and distribution.

11.3 Cost of Goods Sold

The cost of goods which are sold during an accounting period is called cost of goods sold. In manufacturing operations, it includes, (i) cost of materials; (ii) labor and factory overheads; selling and administrative expenses are normally excluded.

11.4 Cost of Purchase

The purchase price including duties and taxes, freight inwards, and other expenditure directly attributable to acquisition, less trade discounts, rebates, duty drawbacks, and subsidies in respect of such purchase.

11.5 Cost of Sales

Cost of goods sold plus selling and administrative expenses.

11.6 Depreciation

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

11.7 Discount

It is a reduction from a list price, quoted price or invoiced price.

11.8 Dividend

It is a distribution to shareholders out of the profit or reserve available for this purpose.

11.9 Preliminary Expenses

These are the expenses relating to the formation of an enterprise. These include legal, accounting and share issue expenses incurred for the formation of anenterprise.

11.10 Prepaid Expenses

These are the payment for expenses in an accounting period, the benefit of which will accrue in subsequent accounting period(s).

11.11 Provision for Doubtful Debts

A provision made for the debts considering credit sales not be repaid as expected

CHAPTER- 2

Accounting Systems and Processes

UNIT 2:

Cash Book

Learning Objectives:

1. *Understand that a cash book is both subsidiary book and a principal book.*
2. *Be familiar with various kinds of Cash Books.*
3. *Learn the technique of preparation of Simple Cash Book and how to balance it.*
4. *See how Double-Column Cash Book is prepared adding discount column along with cash column.*
5. *Be sure that discount columns of a two column cash book are not account.*
6. *To undterstand the techniques of preparing Three-column Cash Book.*
7. *Understand the concept of Petty cash book and the Imprest System of Petty Cash Book.*
8. *Learn how to maintain a Petty Cash Book and how to post the entries of the Petty Cash Book in the Ledger*

2.1 CASHBOOK-A SUBSIDIARY BOOK AND A PRINCIPAL BOOK

A Cash Book is a special journal which is used for recording all cash receipts and cash payments. Cash transactions are straightaway recorded in the Cash Book and on the basis of such a record, ledger accounts are prepared. Therefore, the Cash Book is a subsidiary book. But the Cash Book itself serves as the cash account and the bank account; the balances are entered in the trial balance directly. The Cash Book, therefore, is part of the ledger also. Hence, it has also to be treated as the principal book. The Cash Book is thus both a subsidiary book and a principal book.

2. 2 CASH BOOK-BOTH JOURNAL AND A LEDGER

The Cash Book is a book of original entry (or prime entry) since transactions are recorded for the first time from the source documents. The Cash Book is a ledger designed in the form of a Cash Account where cash receipts are recorded on the debit side and cash payments are recorded on the credit side. Thus, the Cash Book is both a journal and a ledger.

2. 3 TYPES OF CASH BOOK

The Cash Book may be of the four types:

(i) Simple Cash Book-for recoding cash transactions only.
(ii) Two-column Cash Book-for recording cash and bank transactions or cash and discount/bank and discount transactions.
(iii) Three-column Cash Book- for recording cash and bank transaction involving loss or gain on account of discount.
(iv) Petty Cash Book - for recording petty payments.

2.3.1 Simple Cash Book

Such a Cash Book appears like an ordinary account, with one amounts column on each side. The left-hand side records receipts of cash and the right-hand side records the payments. In fact, this is nothing but a Cash Account. Hence, there is no need to open this account in the ledger.

Format:

SIMPLE CASH BOOK

DR. **CR.**

DATE	PARTICULARS	L.F	AMOUNT	DATE	PARTICULARS	L.F	AMOUNT
TOTAL AMOUNT				TOTAL AMOUNT			

Balancing of the Cash Book: The cash book is balanced like other accounts. The receipts column is always bigger than payments column. The difference is written on the credit side as 'By balance c/d'. The totals are then entered in the two columns opposite to one another and then on the debit side the balance is written as "To Balance b/d", to show cash balance in hand in the beginning of the next period.

Illustration 1

Enter the following transactions in simple cash book:

Date		Particulars	Rs.
2076	1	Cash in Hand	1,700
Shrawan	5	Received from Ram	300
	6	Paid to Bhairav	1,300
	8	Paid Rent	300
	10	Received from Khanal	2,000
	12	Sold goods for cash	500
	20	Received from Mukesh	3,500
	21	Purchase of goods for cash	800
	28	Purchases of Furniture	2,500
	31	Paid Wages	1,500
	31	Rent due, not yet paid, for the month	400

Solution:

Simple Cash Book

Dr. **Cr.**

Date	Particulars	L.F.	Rs.	Date	Particulars	L.F.	Rs.
2076 Shrawan				2076 Shrawan			
1	To, Balance b/d		1,700	6	By, Bhairav A/c		1,300
5	To, Ram A/c		300	8	By, Rent A/c		300
10	To, Khanal A/c		2,000	21	By, Purchase A/c		800
12	To, Sales A/c		500	28	By, Furniture A/c		2,500
20	To, Mukesh A/c		3,500	31	By, Wages A/c		1,500
				31	By, Balance c/d		1,600
			8,000				**8,000**
Bhadra 1	To, Balance b/d		1,600				

Above illustration shows that in simple column cash book only cash receipt and payment are recorded Since payment cannot exceed the available balance to spend, debit side of the cash book is always bigger than the credit side.

2.3.2 Double Column Cash Book

If along with columns for amounts to record cash receipts and cash payments another column is added on each side to record the cash discount allowed or the discount received, or a column on the debit side showing bank receipts and another column on the credit side showing payments through bank, it is a double column cash book.

Cash discount is allowance which often accompanies cash payments. For example, if a customer owes Rs. 1,000 but is promised that 5% will be deducted if payment is made with a certain period, the customer can clear his account by paying promptly Rs. 950. Cash received will be Rs. 950 and Rs. 50 will be the discount, for the firm receiving the payment discount is a loss; for the person making the payment it is a gain. Since cash discount is allowed only if cash is paid, it is convenient to add a column for discount allowed on the receipts side of the cash book and a column for discount received on the payment side of the cash book.

In the cash column on the debit side, actual cash received is entered; the amount of the discount allowed, if any, to the customer concerned is entered in the discount column. Similarly, actual cash paid is entered in the cash column on the payment side and discount received in the discount column. Also the bank column on the debit side records all receipts through bank and the same column on the credit side shows payments through bank.

Format

DOUBLE COLUMN CASH BOOK

DR. **CR.**

DATE	PARTICULARS	L.F	DISCOUNT	CASH	DATE	PARTICULARS	L.F	DISCOUNT	CASH
TOTAL AMOUNT					TOTAL AMOUNT				

Balancing: It should be noted that the discount columns are not balanced. They are merely totaled. The total of the discount column on the receipts side shows total discount allowed to customers and is debited to the Discount Account. The total of the column in the payments side shows total discount received and is credited to the Discount Account. The Cash/bank columns are balanced as in other ledger accounts the figure is called cash/bank balance. Thus a double column cash book should have two columns on each side comprising of either cash and discount transaction or cash and bank transactions.

Illustration2;

Prepare a two-column cash book (with cash and discount columns) from the following transactions of M/s. RK Trade Concern.

Date	Particulars	Rs.
2076Bhadra 1	Cash in hand	8,000
6	Cash purchases	4,000
10	Rent paid	1,000
11	Cash sales	12,000
12	Cash received from M/s Sky	4,500
	Discount allowed to M/s Sky	500
19	Cash paid to M/s M & Co.	5,400
	and discount received	600
27	Cash paid for utilities charges	800
28	Purchased goods for cash	4,000

M/s. RK Trade Concern

Dr. Double Column Cash Book Cr.

Date	Particulars	L.F	Discount Rs.	Cash Rs.	Date	Particulars	L.F	Discount Rs.	Cash Rs.
2076 Bhadra					2076 Bhadra				
1	To, Balance b/d			8,000	6	By, Purchase A/c			4,000
11	To, Sales			12,000	10	By, Rent A/c			1,000
12	To Sky A/c		500	4500	19	By, M & Co. A/c		600	5,400
					27	By, Utilities A/c			800
					28	By, Purchase A/c			4,000
					31	By Balance c/d			**9,300**
			500	**24,500**				**600**	**24,500**
Aswin 1	To, Balance b/d			**9,300**					

To summarize:
i. The discount columns in the cash book are not accounts
ii. They are not balanced
iii. Their totals are entered in the discount account in the ledger.

2.3.3 Three Column Cash Book

Three Column Cash Book has three amount columns (one for cash, one for Bank and one for discount) on each side. A firm normally keeps the bulk of its fund at a bank. Probably payments into and out of the bank are more numerous than strict cash transactions. There is only a little difference between cash in hand and money at bank. Therefore, it is very convenient if, on each side in the cash book, another column is added to record amount deposited at bank (on the receipt side of the cash book) and payment out of the bank (on payments side of the cash book).

For writing up the three column cash book the under mentioned facts to be noted

1. While commencing a new business, the amount is written in the cash column if cash is introduced and in the bank column if it is directly put into the bank with the description “Capital Account". If a new cash book is being started for an existing business, the opening balances are written as "To, Balance b/d".
2. All receipts are written on the receipts side; cash in the cash column and cheques in the bank column. If any discount is allowed to the party paying the amount, the discount is entered in the discount column. In the particulars column the name of the account in respect of which payment has been received is written.

3. All payments are written on the payments side, cash payment in the cash column and payments by cheques in the bank column. If some discount has been received from the party receiving the payment, it is entered in the discount column.
4. Often cash is withdrawn from bank for use in the office, in such a case the amount is entered in the bank column on the payments side and also in the cash column on the receipts side. In the reverse case of cash being sent to the bank, the amount is recorded in the bank column on the receipts side and in cash column on payments side. Against such entries, the letter "C" should be written in the LF column, to indicate that these are *contra entry* and no further posting in required for them.
5. If some cheques sent to the bank are dishonored, i.e. the bank is not able to collect the amount; it is entered in the bank column on the credit side with the name of the responsible party in the particulars column.
6. If some cheque issued by the firm is not paid on presentation, it is entered in the bank column on the debit side with the name of the party to whom the cheque as given.
7. In a rare case, a cheque received may be given to some other party, i.e. endorsed, on receipt; it must have been entered in the bank column on the debit side; on endorsement the amount will be written in the bank column on the credit side.

Balancing:

The discount columns are totaled but not balanced. The cash columns are balanced exactly in the same manner as indicated for the simple cash book. The process of balancing the bank columns is also similar. It is possible, however, 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 is bigger than the one on 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 to one another; the balance is then entered on the credit side as "By Balance b/d." However, the usual case is that payments into the bank will exceed the withdrawals or payments out of the bank. Then the bank columns are balanced just like the cash columns.

Posting from Cash Book:

The various items appearing on the debit side and credit side are posted as under:

Posting of items appearing on debit side

(a) All the receipts appearing on the debit side are posted to the credit of the respective ledger accounts in the ledger by writing " By, Cash/Bank A/c" in the particulars column since cash/cheque has been received in respect of them.

(b) An individual entry in the discount allowed column is posted to the credit of the respective personal accounts in the ledger by writing "By, Discount Allowed A/c" in the particulars column.

(c) The total of discount allowed column on the debit side is posted to the debit of the "Discount Allowed A/c" in the ledger by writing "To, Sundries as per Cash Book" in the particulars column.

Posting of items appearing on credit side

(a) All the payments appearing on the credit side are posted to the debit of the respective ledger accounts in the ledger by writing "To Cash/Bank A/c" in the particulars column since cash/cheques has been paid in respect of them.
(b) An individual entry in the discount received column is posted to the debit of the respective personal accounts in the ledger by writing “To, Discount Received A/c" in the particulars column.
(c) The total of discount received column is posted on the credit of the 'Discount Received A/c' in the ledger by writing 'By, Sundries as per Cash Book' in the particulars column.

Illustration 3

Prepare Three Column Cash Book of M/s. Thakur & Co. from the following particulars:

2076 Shrawan

1 Thakur and friends commenced business with cash Rs.20,00,000
2 Paid into Current Account maintained with Nepal Bank Ltd. Rs. 18,00,000
3 Bought goods from M/s Haris & Co. for Rs. 900,000 by issuing cheque.
4 Sold goods on credit to M/s Sharma & Co. for Rs. 500,000
5 Sold goods for cash Rs. 50,000
6 Bought goods on credit from M/s Supplies Trader for Rs. 10,00,000
7 Purchased furniture costing Rs. 40,000 on cash.
8 Cash withdrawn from bank for office use Rs. 5,000.
9 Purchase of vehicle for Rs. 15,00,000 by paying Rs. 500,000 through cheque as dawn payment and rest will be paid 4 installments annually.
10 Paid cash as an insurance premium of vehicle for one year for Rs. 12,000.
11 Received cheque form M/s Sharma & Co. amounting Rs. 300,000 as part payment.
12 Paid sundry expenses in cash for Rs. 5,000
13 Paid advance rent for one year @ 10,000 per month by cheque.
14 Cheque issued to M/s Supplies Trader amounting Rs. 500,000 as partly payment.
15 Received a cheque from M/s Sharma & Co amounting Rs. 175,000 as full settlement.
16 Purchase of computer costing Rs. 50,000 by issuing cheque.
17 Paid driver's over time allowance Rs. 1,500.
18 Loan taken from bank Rs. 10,00,000 @ 12 interest.
19 Purchase good from M/s Supplies Trader for Rs. 300,000 on cash by issuing cheque.
20 Settlement of amount owed to M/s Supplies Trader by paying cheque amounting 450,000.
21 Pays cash for stationery Rs. 15,000
22 Cash withdrawn by promoter Mr. Thakur for personal use Rs, 50,000.
23 Paid trade expenses Rs. 2,000 on cash.

24 Purchased an Office Equipment from Mercantile Traders for Rs. 50,000 and paid them by means of a bank draft purchased for Rs. 50,300.

25 Issued cheque for commission to agent for Rs. 5,000.

26 Sold goods to M/s K&K Co. for Rs. 100,000 and draw a bill of such amount and the same is accepted by the party.

27 Discounted the Bills of Exchange for 99,500.

29 Cheque received as commission from principal amounting Rs. 8,000

30 Paid salary for the month by issuing cheque of Rs. 65,000

31 Paid interest on bank loan by issuing cheque amounting Rs. 10,000.

M/s. Thakur & Co.
Three columns Cash Book

Dr. **Cr.**

Date	Particulars	L.F	Discount Rs.	Cash Rs.	Bank Rs.	Date	Particulars	L.F	Discount Rs.	Cash Rs.	Bank Rs.
2076 Shrawan						2076 Shrawan					
1	To, Share Capital contributed			2,000,000		2	By, Cash deposited	C		1,800,000	
2	To, Cash deposited	C			1,800,000	3	By, Purchase A/c				900,000
5	To, goods sold on cash			50,000		7	By, Furniture A/C			40,000	
8	To, Cash withdrawn	C		5,000		8	By, Cash withdrawn	C			5,000
11	To, M/s Sharma & Co.				300,000	9	By, Vehicle A/c-part payment				500,000
15	To, M/s Sharma & Co,)		25,000		175,000	10	By, Insurance Premium A/C			12,000	
18	To, Bank Loan A/c				1,000,000	12	By, Sundry Expenses A/c			5,000	
27	To, Bills Receivable		500		99,500	13	By, Prepaid Rent A/c				120,000
29	To, Commission Income A/c				8,000	14	By, M/s Supplies Trader				500,000
						16	By, Office Equipment				50,000
						17	By, Over time Exp. A/c			1,500	
						19	By, Purchase A/c				300,000
						20	By, M/s Supplies Trader		50,000		450,000
						21	By, Stationery Expenses			15,000	
						22	By, Drawings A/c			50,000	
						23	By, Trade Expenses A/c			2,000	
						24	By, Office Equipment A/c				50,000
						24	By, Bank Charges A/c				300
						25	By, Commission Exp, A/c				5,000
						30	By, Salary Expenses A/c				65,000
						31	By, Interest Expenses A/c				10,000
						31	By Balance c/d			129,500	427,200
			25,500	**2,055,000**	**3,382,500**				**50,000**	**2,055,000**	**3,382,500**
Bhadra 1	To, Balance b/d			**129,500**	**427,200**						

2.3.4 Petty Cash Book

In a business house a number of small payments, such as postage, carriage, cartage etc., have to be made. If all these payments are recorded in cash book, it will become unnecessarily heavy and unmanageable. Besides that, the main cashier will be overburden with work. Therefore, it is usual for business house to appoint a person as "Petty Cashier" to handle small payments and make necessary records. For this purpose some specific amount will be provided to him and reimburse from time to time. Later, on analysis, the respective accounts may be debited. The word 'petty' has its origin from the French word 'petit' which means small. The petty cash book is used to record items like carriage, cartage, entertainment expenses, office expenses, postage and telegrams, stationery, etc. The person who maintains this book is called the 'petty cashier'. The petty cash book is used by many business concerns to save the much valuable time of the senior official, who usually writes up the main cash book, to prevent over burdening of the main cash book with so many petty items and to find out readily and easily information about the more important transactions.

The amount required to meet out various petty items is estimated and given to the petty cashier at the beginning of the stipulated period say a fortnight or a month. When the petty cashier finds shortage of money, he has to submit the petty cash book, after making all the entries, to the chief cashier for necessary verifications. The chief cashier in turn, verifies all the entries with supporting vouchers and disburses cash or issues cheque for the exact amount spent.

2. 4 IMPREST SYSTEM OF PETTY CASH BOOK

In this system, the petty cashier is provided with a sum of cash which is termed as 'float' after taking into consideration the possible kinds of expenses which would be incurred for a specific period, viz., a week or a month. The petty cashier, at the end of such period, submits the petty cash book, with all entries passed, to the chief cashier. The chief cashier, in turn, will verify all the entries with the supporting vouchers and gives the actual amount spent on various petty items. This would bring the petty cash balance to the original amount with which system of petty cash begun. This system of maintaining the original amount of cash as such is known as 'Imprest System of maintaining Petty Cash Book'.

The system is very useful especially if Petty Cash Book is used. The book has one column to record receipt of cash and other columns to record payments of various types. The total of various column show why payments have been made and then the relevant accounts can be debited.

(i) The amount fixed for petty cash should be sufficient for the likely small payments for a relative short period, say for a week or a fortnight.
(ii) The reimbursement should be made only when petty cashier prepares a statement showing total payments supported by vouchers, i.e. documentary evidence and should be limited to the amount of actual disbursements.
(iii) The vouchers should be filed in order.
(iv) No payment should be made without proper authorization. Also, payments above a certain specified limit should be made by the main cashier.
(v) The petty cashier should not be allowed to receive any cash except for reimbursement.

2.4.1 Features of Petty Cash Book

The main features of petty cash book are as follows:

1. The amount of cash received from the main cashier is recorded on the left hand side column.
2. The payments of petty cash expenses are recorded on the right hand side in the respective columns.
3. It can never show a credit balance because the cash payments never exceed the cash receipts.

4. Recording is done on the basis of supporting documents which may be internal or external. Whenever external documents are not obtained (e.g. taxi fare, coolie charges, postage stamps etc.) that should be verified and approved by a person who is authorized to do so.
5. All the columns of expenses are totaled periodically and such periodic totals are individually posted to the debit side of the respective expenses account in the ledger by writing "By, Sundries as per Petty Cash Book" in the particulars column.
6. Petty Cash Book is both a book of original entry as well as a book of final entry.
7. At the end of specified period i.e. weekly, fortnightly or monthly the petty cash book is balanced and its balance represents unspent cash in hand. The method of balancing is the same as for the simple cash book.

2.4.2 Advantages of Petty Cash Book

The advantages of petty cash book are as follows:

1. Saving of Chief Cashier's time.
2. Saving of labor of in posting: There is saving in labor in posting because of the following two reasons:
   a. Limited number of accounts are opened for heads of petty expenses only,
   b. Periodical totals (say monthly) of each column of expenses are posted to the debit of the respective ledger accounts.
3. Controls over mistakes- The chances of mistakes are reduced since the chief cashier regularly examine the petty cash book.
4. Controls over petty expenses:- Petty expenses are kept within the limits of imprest since the petty cashier can never spend more than the available petty cash.
5. Controls over fraud- Misappropriation if any is always kept within the limits of imprest.
6. Benefits of specialization- The benefits of specialization are available since recording of cash transactions is divided between main cash book and petty cash book.

2.4.3 Posting the Petty Cash Book

In the ledger a petty cash account is maintained. As such when an amount is given to the petty cashier, the petty cash account is debited. Each week or fortnight, the total of the payments made is credited to this account. The petty cash account will then show the balance in the hand of the cashier; on demand he should be able to produce it for counting. At the end of the year, the balance is shown in the Statement of Financial Positon as part of cash balance.

All the heads of expenses (including miscellaneous) are totaled periodically (usually monthly) and such periodic total are either individually posted to the debit side of the concerned ledger accounts in the ledger by writing "To, Sundries as per petty cash book" in the particulars column or a journal entry may first be prepared on the basis of the petty cash book, debiting the accounts shown by the various analysis columns, and crediting the total of the payments of the petty cash accounts.

Illustration 4

Prepare a petty cash book on the imprest system from the following:

2019		Rs.
Jan 1	Received cash for petty cash	1,000
Jan 1	Paid Taxi fare	90
Jan 2	Paid for Postage and Telegraph	75
Jan 3	Paid for copier's bill	25
Jan 4	Paid wages for casual laborers	150
Jan 5	Paid for stationery	55
Jan 6	Bus Fare	12
Jan 6	Coolie	60
Jan 6	Refreshment to customers	110
Jan 6	Stationeries	79
Jan 6	Paid for repairing electric wiring	190
Jan 6	Paid labor charged for repairing bathroom's tab	150

(Refer to the following pages for solution)

Illustration 5

From the following transaction for the month of January, 2019, draw up a Petty Cash Book in analytical form with i. Postage and stamps; ii. Coolie and Cartage; iii. Printing and stationery; iv. Conveyance; v. Repairs; vi. Guest Entertainment; vii.Miscellaneous and viii.Ledger Account-Column.

1.	Petty Cash balance	220	1.	Reimbursement	3,780
1.	Bought Stamp	50	1.	Paid Bus Fare	12
2.	Paid postage	100	2.	Bought envelopes	30
2.	Paid for refreshment	140	3	Paid Shree Kumar, a creditor	620
5.	Paid Conveyance	180	9.	Postal stamp bought	45
10.	Paid for postage	20	11.	Paid taxi fare	150
14.	Paid Rakesh, a creditor	205	15.	Repairs	190
16.	Cost of blank papers	110	19	Tips given for extra work	50
20.	Entertainment	65			
21	Purchase memo-books	450	22	Paid to coolie for shifting furniture	100
23	Cash paid to Mr. Ram	285	27	Local traveling exp. reimbursed	40

29 The driver of the office car was given Rs. 150 to pay the "fine" for violation of traffic rules.

31 Postal charges for registering letter 120

(Refer to the following pages for solution)

Solution:

Illustration 4-

Petty Cash Book

Receipts	Date	V.No.	Particulars	Total	Carriage Inwards	Conveyance	Stationery	Postage	Repairs	Wages	Sundries
Rs.	2019			Rs.	Rs.	Rs.	Rs.	Rs.	Rs.	Rs.	Rs.
1,000	1-Jan		To, Cash								
	1-Jan	1	By, Conveyance	90		90					
	2-Jan	2	By, Postage and Telegraph	75				75			
	3-Jan	3	By, Stationery	25			25				
	4-Jan	4	By, Wages	150						150	
	5-Jan	5	By, Stationery	55			55				
	6-Jan	6	By, Conveyance	12		12					
	6-Jan	7	By, Carriage inward	60	60						
	6-Jan	8	By, General Expenses	110							110
	6-Jan	9	By, Stationery	79			79				
	6-Jan	10	By, Repairs	190					190		
	6-Jan	11	By, Repairs	150					150		
				996	60	102	159	75	340	150	110
			By, Balance c/d	4							
				1,000							
	7-Jan		**By, Balance b/d**	4							

Petty Cash Book

Receipts	Date	V.No.	Particulars	Total	Postage and Stamps	Coolie and Cartage	Printing & Stationery	Conveyance	Repairs	Wages	Guest Entertainment	Misc.	Ledger Account
	2019			Rs.	Rs.	Rs.	Rs.	Rs.	Rs.	Rs.	Rs.	Rs.	Rs.
220	1-Jan		To, Balance b/d										
3,780	1-Jan		To, Bank a/c										
	1-Jan	1	By, Postage and stamp	50	50								
	1-Jan	2	By Conveyance	12				12					
	2-Jan	3	By, Postage and stamp	100	100								
	2-Jan	4	By, Stationery	30			30						
	2-Jan	5	By, Guest entertainment Exp	140							140		
	3-Jan	6	By, Creditors	620									620
	5-Jan	7	By, Conveyance	180				180					
	9-Jan	8	By, Postage and Stamp	45	45								
	10-Jan	9	By, Postage and Stamp	20	20								
	11-Jan	10	By, Conveyance	150				150					
	14-Jan	11	By, Creditors-Rakesh	205									205
	15-Jan	12	By Repairs	190					190				
	16-Jan	13	By, Stationery	110			110						
	19-Jan	14	By, Miscellaneous	50								50	
	20-Jan	15	By, Guest Entertainment Exp	65							65		
	21-Jan	16	By, Stationery	450			450						
	22-Jan	17	By, coolie and Cartage	100		100							
	23-Jan	18	By, Creditors-Ram	285									285
	27-Jan	19	By, Conveyance	40				40					
	29-Jan	20	By, Miscellaneous	150								150	
	31-Jan	21	By, Postage and stamp	120	120								
				3,112	335	100	590	382	190	0	205	200	1,110
	31-Jan		By, Balance c/d	888									
4,000			Total	4,000									
			By, Balance b/d	888									

Summary

Cash book is a subsidiary book as well as a principal book. There are three kinds of cash books, viz Simple Cash Book, Double Column Cash Book and Three Column Cash Book . Simple Cash Book records cash transactions only. In Double column cash book in addition to cash transactions a memorandum is made regarding discount allowed and discount received. In Three-column cash book in addition to cash and discount transactions bank transactions are also recorded. In petty cash book, petty payments are recorded. Payments are shown at the right hand side of the cash book and receipts are shown on the left hand side of the cash book. Periodically cash book is balanced and cash book entries are posted to the appropriate ledger account. Balances of cash and bank shown by the cash book are the result of two accounts-cash and bank and so the cash book becomes a part of ledger.

Self-Examination Questions

I. Multiple Choice Questions (MCQs)

1. Cash book records
   (a) All cash Receipts (b) All cash payments
   (c) All cash receipts and payments (d) Cash and credit sale of goods

2. Which of the following is not a column of triple column cash book ?
   (a) Cash Column (b) Bank Column
   (c) Petty Cash Column (d) Discount Column

3. Rent due for the month of Ashad will appear
   (a) On the receipt side of cash book
   (b) On the payment side of the cash book
   (c) As a contra entry
   (d) Nowhere in the cash book

4. Contra entries are passed only when
   (a) Double column cash book is prepared
   (b) three column cash book is prepared
   (c) Simple Cash book is prepared
   (d) None of the above

5. The balance in the petty cash book is
   (a) an expense (b) a profit (c) an asset (d) a liability

6. If Manohar has sold goods for cash, the entry will be recorded
   (a) in the cash book (b) in the sales book
   (c) in the journal (d) in the stock book
7. Which is entered on the credit side of cash book

(a) Trade discount allowed (b) Trade discount received
(c) Cash discount allowed (d) Cash discount received

8. Discount column of cash book may show
(a) a debit balance (b) a credit balance
(c) either debit or a credit balance (d) None of the above

9. When a cheque is returned dishonored, it is recorded in;
(a) Cash column of cash book only (b) Cash column on the debit side
(c) Bank column of cash book (d) No where in cash book

10. If the imprest fund of the petty cash book is Rs. 4,000 and on 1.4.2070, Mr. Sohit, a petty cashier, has Rs. 550 in hand. How much he has to get reimbursement form main cashier?
(a) Rs. 4,000 (b) Rs. 550 (c) Rs. 3,450 (d) Rs. 4,550

11. Which of the following explains the imprest system of operating petty cash?
(a) Weekly expenditure cannot exceed a set amount
(b) The exact amount of expenditure is reimbursed at intervals to maintain a fixed float
(c) All expenditure out of the petty cash must be properly authorised
(d) Regular equal amounts of cash are transferred into petty cash at intervals

12. Cash Book is a type of………………. but treated as a ………. of accounts.
(a) Subsidiary book, principal book (b) Subsidiary book, subsidiary book
(c) Principal book, subsidiary book (d) Principal book, principal book

13. Which of the following transaction is posted in the ledger
(a) Cash deposited into bank (b) Cash withdrawn from bank for personal use
(c) Cash withdrawn from bank (d) None of these

II. Short Descriptive Questions (SDQs)

1. Discuss cash book and its various forms.
2. Discuss petty cash book and its advantage.

III. Practical Questions (PQs)

1. Enter the following transactions in Three Column Cash Book.

2075 Poush	Transactions	Rs.
1	Cash in Hand	10,000
1	Cash at Bank	200,000
2	Purchased goods by issuing cheque.	100,000
3	Stationery purchased in cash	1,000

4	Received cheque from Maya Enterprises	95,000
4	Discount allowed to Maya Enterprises	5,000
5	Paid to Sharma and Associates by cheque	55,000
5	Received discount from Sharma and Associates	5,000
6	Cash Sales	25,000
7	Salary advance to Mr. Hari paid in cash	14,000
8	Interest paid on bank deposit	2,000
9	Purchased furniture by cheque	12,000

2. Enter the following transactions in a simple cashbook.

June 1		Cash in Hand Rs. 3,650
"	1	Received from M/s. Biswas Store Rs. 16,350
"	2	Paid House rent Rs. 5,700
"	3	Sold Goods to Mr. A Rs. 11,250 and received partially Rs. 8,790
"	5	Paid to Mr. Z Rs. 1,305
"	9	Purchased Furniture Rs. 4,275
"	17	Paid Telephone charges Rs. 1,825
"	29	Paid Salary to Staff Rs. 6,485

3. From the following prepare cashbook with discount column for the month of Bhadra 2070:

1	Balance of Cash Rs. 18,750
1	Paid to Hari Chaudhary Rs. 4,080 after deducting Rs. 420 cash discount.
5	Purchased goods for Rs. 2,800 and paid Rs. 2,490 only.
7	Sold goods for Rs. 1,800
10	Received from A. Pandey Rs. 5,400 and allowed him discount of Rs. 600
11	Paid for stationery Rs. 750
15	Purchased goods for Rs. 5,500 and made partial payment of Rs. 3,000 to XYZ Traders.
19	Purchased goods for Rs. 2,000
20	Withdraw cash from Bank for private use Rs. 2,100 and for official use Rs. 2,900
22	Sold goods to R.P. Ghimire for Rs. 4,000
24	Made payment to XYZ Traders after receiving Rs. 500 as cash discount.
29	Paid rent Rs. 1,100 and salary Rs. 1,000
25	Purchased furniture for Rs. 1,800.

4. Enter the following transactions in triple column cashbook for the month of Jestha 2076

1 Balance of cash in hand Rs. 25,000 and Overdraft at bank Rs.89,000.
2 Received cheque of Rs. 157,000 from Tulsi Ram.
4 Received Cash from Krishna Rs. 33,500 after allowing discount of Rs. 1,500 to him.
7 Bought goods for cash Rs. 21,900.
9 Withdraw Rs. 35,000 from the bank.
12 Sold goods to Sumina for Rs. 8,000 and received a cheque.
15 Rent paid to Sakil (landlord) Rs. 10,500.
18 Bought goods for Rs. 15,000 and issued cheque for 13,500 for full settlement of transaction.
19 Cheque received from Sumina returned dishonored.
23 Sold goods for Rs. 28,000 and received cash after deducting 3 percent cash discount.
25 Rs. 25,000 deposited into bank.
26 Salary Paid to Staff Rs. 7,000 by cash and Rs. 13,000 by Cheque.
28 Purchase goods for Rs. 11,500 and paid in cash Rs. 5,000, by cheque Rs. 6,200 and received discount of Rs. 300.
29 Rs. 1,500 withdraws from bank for personal use.
30 Goods of Rs. 6,000 destroyed by fire and insurance company admit full claim in that respect.
31 Banked all cash keeping a balance of cash in hand only Rs. 5,000.

5. Mr. Bala maintains a columnar petty cash book on the imprest system. The imprest amount is Rs. 400. From the following transactions prepare petty cash book for the month of Baisakh:

1 Balance in hand Rs. 75 and received cash reimbursement to make up the imprest.
1 Postage Rs. 15 and Entertainment Rs. 60
2 Traveling Rs. 35 and Entertainment Rs. 23

4 Miscellaneous Expenses Rs. 39, Stationery Rs. 63, Travelling Rs. 45 and Repairs Rs. 22
6 Paid Wages Rs. 35
7 Postage and stamp Rs. 25 and Wages Rs. 40.
8 Electricity Charge Rs. 42 and Entertainment Rs. 33 and Repair Rs. 15

ANSWER

Multiple Choice Questions (MCQs)

1	c	6	a	11	b
2	c	7	d	12	a
3	d	8	d	13	c
4	b	9	c		
5	c	10	c		

CHAPTER- 2

Accounting Systems and Processes

UNIT 3:

Subsidiary Books

Learning Objectives

1. *Understand the concept of subsidiary books and its importance.*
2. *Understand the techniques of recording in Purchase Book, Sales Book, Returns Inward and Return Outward Book; Bills Receivable and Payable Books and study the technique of posting from subsidiary books to ledger.*
3. *Understand that journal entries are required even if subsidiary books are maintained. Subsidiary books only reduce the volume of journal entries to be prepared.*

3. INTRODUCTION

If we analyze carefully of the various business transactions entered into by an enterprise, we shall find that most of the transactions generally relate to receipts and payments of cash, sale of goods and their purchase. It is convenient to keep a separate register for each such class of transactions – one for receipts and payments of cash, one for purchase of goods and one for sale of goods. A register of this type is called a book of original entry or of prime entry. For transactions recorded in such books there will be no journal entry. The system by which transactions of a class are first recorded in the book, specially meant for it and on the basis of which ledger accounts are then prepared is known as the Practical System of Book Keeping or even the English System.

Students should particularly be careful that the maintenance of subsidiary book does not in any way the departure from the rules and the principles of the double entry book keeping system.

The books of original entry or prime entry are also called subsidiary books since ledger accounts are prepared on their basis and, without the further process of ledger posting at trial balance cannot be taken out. Normally, the following subsidiary books are used in a business.

1 Cash Book to records receipts and payments of cash, including receipts into and payments out of the bank. It records any transactions that involve the inflow (receipt) or outflow (payment) of money from your business.

2 Purchase Book/journal to record credit purchases of goods dealt in or of the materials and stores required in the factory.

3 Sales Book/journal to record the credit sales of the goods by the firm. It is a special journal designed to record a single type of frequently occurring transaction like credit sales.

4 Purchase Return Books to record the returns of goods and materials previously purchased.

5 Sales Returns Book to record the returns made by customers.

6 Bills Receivable Book to record the receipt of promissory notes from various parties.

7 Bills Payable Book to record the issue of the promissory notes to other parties.

Journal (Proper) to record the transactions which cannot be recorded in any of the seven books mentioned above..

3.1 ADVANTAGES OF SUBSIDIARY BOOKS

Subsidiary Books remove excessive details from general ledger; provide up-to-date information on customer or other specific account balances, aid in error identification for individual accounts help with division of labor (record-keeping tasks). The use of subsidiary books affords the following advantages:

i. *Division of works:* Since in the place of one journal there will be so many subsidiary books, the accounting work may be divided amongst a number of clerks.

ii. *Specialization and efficiency:* When the same work is allotted to a particular person over a period of time, he acquires full knowledge of it and becomes efficient in handling it. Thus the accounting work will be done efficiently.

iii. *Saving on time:* Various accounting processes can be undertaken simultaneously because of the use of a number of books. This will lead to the work being completed quickly.

iv. *Availability of information:* Since a separate register or book is kept for each class of transactions, the information relating to each class of transactions will be available at on place.

v. *Facility in checking*: When the trial balance does not agree, the location of the error or errors is facilitated by the existence of separate books. Even the commission of errors and frauds will be checked by the use of various subsidiary books.

3.2 PURCHASES BOOK

Purchase book (also known as invoice book/bought book) is one of the subsidiary books which is used for the purpose of recording the credit purchases of trading goods/ merchandise (i.e. the goods in which the enterprise deals in). All credit purchases of trading goods are primarily recorded in this book.

Content of Purchase Book:

1. Date of purchase,
2. Purchase Invoice Number
3. Particulars,
4. Page No. of the ledger on which supplier's account appears, and
5. Amount of purchase invoice net of trade discount (if any).

Notes*: In case the firm deals in taxable items, one additional column may be added to record the Value Added Tax (VAT) paid to suppliers.*

The recording of the particulars of item purchase is considered unnecessary because the details are available in the purchase invoices for which the serial number is given in the Purchase Book.

Format of Purchase Book:

PURCHASE BOOK

DATE	PURCHASE INVOICE NO	NAME OF CUSTOMER	L.F	DETAILS		AMOUNT	
				RS	P	RS	P

It should be noted that cash purchase are not normally entered in this book since cash purchase will be entered in the cash book and credit purchases of things other than trading goods or materials, such as office furniture or computers are journalized –they also are not entered in the purchases book.

3.2.1 Posting of Purchase book

The individual entries and the total of the book are posted into the ledger as follows:

i. Posting of individual amount: individual amounts are daily posted to the credit of Suppliers' Accounts by writing 'By Purchases A/C' in the particulars column.

ii. Posting of periodic Total: Periodic total is posted to the debit of Purchases Account by writing 'To, Sundries as per Purchase Book' in the particulars column.

iii. Particulars column is meant to record the name of the supplier and name of the articles (Types) purchased and the respective quantities. The amount in respect of each article is entered in the details column. After totaling the various amount included in a single purchase, the amount for packing, or other charges is added and the amount for trade discount is deducted from the total purchase made in a period.

Illustration 1

From the following transactions, prepare the Purchases Book of Raj & Co. and post the transactions recorded in the Purchases Book to Ledger.

Date	Invoice No.	Particulars
03.4.2072	401	Purchase on credit from Gopal Mills, Siddhartha Nagar – 55 polyester sarees @ Rs. 200 per unit less trade discount @ 15%
08.4.2072	800	Purchased for cash from Ganesh Mills- 50 Kota sarees @ Rs. 75 each.
15.4.2072	355	Purchased form Mishra Mills, Biratnagar- 10 Silk sarees @ Rs. 500 per unit Less trade discount @ 10%
30.4.2072	445	Purchased on credit from Bishal traders 2 computers @ Rs. 40,000

Solution:

Raj & Company

PURCHASE BOOK

Date	Purchase Invoice No.	Particulars	L. F.	Amount	
				Rs.	Rs.
03.4. 2072	401	Gopal Mills, Siddhartha Nagar			
		55 polyester sarees @ Rs. 200 per unit gross		11,000	
		Less: 15% Trade Discount		(1,650)	9,350

15.4. 2072	355	Mishra Mills, Biratnagar 10 Silk sarees @ Rs. 500 per unit gross Less: 10% Trade Discount		5,000 (500)	4,500
		Total			**13,850**

***Note**: Cash purchase of Kota Sarees will be recorded in the Cash Book and credit purchase of Computers will be recorded in the journal (Proper) since in the purchases book, only the credit purchases of merchandise (i.e. the goods in which the firm deals in) are recorded.*

Books of Raj & Co.
Ledger
Gopal Mills A/c

Dr. **Cr.**

Date	Particulars	Amount	Date	Particulars	Amount
31.4. 2072	To, Balance c/d	9,350	3.4. 2072	By, Purchase A/c	9,350
		9,350			**9,350**
			1.5. 2072	By, Balance b/d	9,350

M/s Mishra Mills A/c

Dr. **Cr.**

Date	Particulars	Amount	Date	Particulars	Amount
31.4. 2072	To, Balance c/d	4,500	15.4. 2072	By, Purchase A/c	4,500
		4500			**4,500**
			1.5. 2072	By, Balance b/d	4,500

Purchase A/C

Dr. **Cr.**

Date	Particulars	Amount	Date	Particulars	Amount
8.4. 2072	To, Cash A/C	3750	31.4. 2072	By, Balance c/d	17,600
31.4. 2072	To, Sundries as per Purchase Book	13,850			
		17,600			**17,600**

3.3 SALES BOOK

Sales book is a register used to record credit sales of trading goods dealt in by an enterprise.Cash sales by an enterprise are not recorded in a sales book. It is recorded only in the cash book.Credit sales of things other than the goods dealt in by an enterprise are not recorded sale book; they are journalized.

The transactions in the sales book are recorded in a similar manner as in the Purchase Book. The particulars column will record the name of the customers concerned together with particulars and quantities of the goods sold. For each item, the amount is entered in the details column; after totaling the amounts for one sale, charges for packing, etc. are added and the trade discount, if any, is deducted: the net amount is put in the outer column. The total of this column will show the total credit sales for a period.

Content of sales Book::

1. Date of sale.
2. Sales Invoice Number.
3. Particulars
4. Page number of the Ledger on which the Customer's accounts appears.
5. Amount of sales invoice net of trade discount (if any).

***Notes**: In case the firm deals in taxable items, one additional column may be added to record the Value Added Tax (VAT) recovered from customers.*

Format of Sales Book:

SALES BOOK

DATE	SALES INVOICE NO	NAME OF CUSTOMER	L.F	DETAILS		AMOUNT	
				RS	P	RS	P

Illustration 2

From the following transactions write up the Sales Book of M/s X & Co.

Jan 1. Sold to Prem Traders 100 bags of Rice @ Rs. 900 per bag, less 5/% trade discount.

Jan 2 Sold to, R & Co. 10 bags of milk power @ Rs. 1,500 per bag less 10% trade discount.

Jan 20 Sold to Tea king (P) Ltd. 10 chest of C.T.C tea @ Rs. 4,000 per chest, less 10% trade discount.

Jan 29 Sold old office furniture on credit to Modern Furniture for Rs. 5000.

Solution:

Sales Book

Date	Sales Invoice No.	Name of Customer	L. F.	Amount Rs.	Amount Rs.
Jan 1	506	M/s Prem Traders		90,000(	
		100 bags of Rice @ Rs. 900 per bag		4,500)	
		Less: Trade discount @ 5%			85,500
Jan 2	507	M/s R & Co.			
		10 bags of milk power @ Rs. 1500 per bag		15,000	
		Less: trade discount @ 10%		(1,500)	13,500
Jan 20	508	M/s Tea King (P) Ltd.			
		10 chest of C.T.C tea @ Rs. 4,000 per chest,		40,000	
		Less: trade discount @ 10%		(4,000)	36,000
		Total			**135,000**

Total for the period i.e. 135,000 is posted periodically to the credit of Sales Account. However, individual amount of each transaction shall have to be posted in respective individual customers' account by debiting that account. The sale of old office furniture required to be entered in journal proper.

3.3.1 Posting of Sales Book

The names appearing in the Sales Book are of those parties which have received the goods. The accounts of the parties have to be debited with the respective amounts by writing "To, Sales A/C". The total of sales book shows the credit sales made during the period concerned and that have to be posted in the credit of the Sales Account by writing "By, Sundries as per Sales Book" in the particulars column. In the above illustration Rs. 135,000 is credited to the Sales Account; Rs. 85,500 is debited to M/s Prem Traders, Rs.13,500 to M/s R & Co. and Rs. 36,000 to M/s Tea King. The amount put on the credit side is equal to the total of the amount put on the debit side. Thus the double entry principle is followed correctly.

3.4 PURCHASE RETURNS BOOK

It may be necessary to return some goods that the firm has bought on credit for a variety of reasons such as defective or excess quantity of goods supplied, etc. All returns of goods are recorded primarily in the Purchase Returns Book. Purchase Returns Book (also known as Return

Outward Book/Journal) is one of the subsidiary books which is used for the purpose of recording the returns of merchandise purchased on credit. Neither the return of goods purchased on cash basis nor the returns of any asset other than the merchandise are recorded in Purchase Returns Book. The entries in the purchase returns book are usually, made on the basis of debit notes issued to the suppliers or original credit notes received from the suppliers. When a firm returns some goods to its supplier, it prepares a 'Debit Note' and sends it along with the goods returned. The supplier, in turn, will prepare a 'Credit Note'. The original copy of 'credit note' will be sent to the firm. On receipt, all credit notes should be numbered consecutively and should be filed properly for future reference. Purchase Returns Book is prepared in the same way as purchase book, except that it should, in addition, include a brief description of the reason for the return in the remarks column.

Content of Purchase Returns Book:

1. Date of return,
2. Debit Note number,
3. Particulars,
4. Page number of the Ledger on which Supplier's A/c appears, and
5. Amount of goods returned to Supplier and reason thereof.

Note: *If some trade discount had been received at the time of original purchase and some expenses on purchase (e.g. cartage) had been charged by the supplier, the appropriate adjustment should be made so as to arrive at the correct value of goods retuned.*

Format of Purchase Returns Book::

PURCHASE RETURN BOOK

DATE	DEBIT NOTE NO	NAME OF CUSTOMER	L.F	DETAILS		AMOUNT	
				RS	P	RS	P

3.4.1 Posting of Purchase Returns Book

Once credit note issued by supplier on return of goods is received, individual amounts are daily posted to the debit of Suppliers' accounts by writing 'To, Purchase Returns A/c' in the particulars column. The total of Purchase Returns Book shows the total returns made. The periodic total is posted to the debit of Purchase Returns Account by writing 'By Sundries as per Purchase Returns Book', in the particular book.

Illustration 3

From the following information, write up Purchase Returns Book of M/s Agni & Co. and post them onto ledgers.

Feb 1 Returned to LG Television Co. Ltd. 4 Color T.V. @ Rs. 15,000 each and 3 Refrigerators @ Rs. 25,000 each.

" 2 Returned to Sykar Co. 2 Philips Color T.V @ Rs. 18,000.

" 10 Returned to National Electronics 2 pieces of Electric Heater @ Rs. 350 each.

" 11 Returned to TCL Co. 3 pieces of DVD @ Rs. 10,000 each.

Solution

Agni & Co.

Purchase Returns Book

Date	Dr Note No.	Particulars	L.F.	Amount Rs.	Amount Rs.
Feb 1.	302	M/s LG Television Co. Ltd.			
		4 Color T.V. @ Rs. 15,000 each		60,000	
		3 Refrigerators @ Rs. 25,000 each			
				75,000	135,000
		M/s Sykar Co.			
		2 Philips colour T.V @ Rs. 18,000			
2	303				
		M/s National Electronics			
		2 pieces of Electric Heater @ Rs. 350 each		36,000	36,000
10	304				
		M/s TCL Co.		700	700
		3 pieces of DVD @ Rs. 10,000 each.			
11	305				
				30,000	30,000
		Total			**201,700**

Books of Agni & Co
LEDGER
Sundry Creditors (LG Television Co. Ltd.) A/C

Date	Particulars	Amount	Date	Particulars	Amount
Feb 1	To, Purchase Returns A/C	135,000		By Bal. c/d	135,000

Sundry Creditors (M/s Sykar Co.) A/C

Date	Particulars	Amount	Date	Particulars	Amount
Feb 2	To, Purchase Returns A/C	36,000		By Bal. c/d	36,000

Sundry Creditors (M/s National Electronics) A/C

Date	Particulars	Amount	Date	Particulars	Amount
Feb 10	To, Purchase Returns A/C	700		By Bal. c/d	700

Sundry Creditors (M/s TCL Co.) A/C

Date	Particulars	Amount	Date	Particulars	Amount
Feb 11	To, Purchase Returns A/C	30,000		By Bal. c/d	30,000

Purchase Returns A/C

Date	Particulars	Amount	Date	Particulars	Amount
	To Balance c/d	201,700	Feb 28	By, Sundries as per Purchase Returns Book	201,700

3.5 SALES RETURNS BOOK

If customers frequently return the goods sold to them, it would be convenient to record the returns in a separate book, which is named as the Sales Returns Book or the Returns Inward Book. Goods may be returned by the customers for a variety of reasons such as wrong quantity and/or quality. All goods returned by the customers are primarily recorded in this book. When goods are returned by the customer, a 'Credit Note; is made out in his name. A Credit Note is prepared in duplicate. The original being sent to the customer for his information and record. The duplicate is preserved in the file for future reference. Duplicate credit note provides information for recording in the Sales Returns Book.

Contains of Sales Returns Book:

1. Date of return,
2. Credit note number,
3. Particulars,
4. Page number of ledger on which Customer's A/c appears, and
5. Amount of goods returned by the customer.

Note: *If some trade discount had been allowed and/or some expenses on sales (e.g. cartage) had been charged from the customer, the appropriate adjustment should be made so as to arrive at the correct value of goods returned.*

Format of Sales Returns Book:

SALES RETURN BOOK

DATE	CREDIT NOTE NO	NAME OF CUSTOMER	L.F	DETAILS		AMOUNT	
				RS	P	RS	P

3.5.1 Posting of Sales Returns Book

Individual amounts are daily posted to the credit of Customers' Accounts by writing 'By Sales Returns A/C' in particulars column and periodic total is posted to the credit of Sales Returns Account by writing 'To, Sundries as per Sales Returns Book' in particulars column.

Illustration 4

From the following information, write up a Sales Returns Book of Agni & Co. and post them into ledger:

Apr 1 Returned by Mr. Ramesh 4 pieces of Philips T.V Costing Rs. 20,000 each.
Apr 9 Returned by M/s. Capital Electronics 3 pieces of DVD costing 12,000 each.
Apr 29 Returned by M/s. K.B.& Co. 2 pieces of Refrigerators costing 18,000 each

Solution

Agni & Co.
Sales Returns Book

Date	Cr.Note No.	Name of Customers	L.F.	Rs.
1-Apr		Mr. Ramesh 4 pieces of Philips T.V Costing Rs. 20,000 each		80,000

9-Apr		M/s Capital Electronics - 3 pieces of DVD costing Rs. 12,000 each.		36,000
29-Apr		M/s K.B.& Co. 2 pieces of Refrigerators costing 18,000 each		36,000
Total				**152,000**

Books of Agni & Co.

LEDGER

Sundry Debtors (Mr. Ramesh) A/C

Date	Particulars	Amount	Date	Particulars	Amount
	To Balance c/d	80,000	Apr 1	By, Sales Returns A/c	80,000

Sundry Debtors (M/s Capital Electronics) A/C

Date	Particulars	Amount	Date	Particulars	Amount
	To Balance c/d	36,000	Apr 9	By, Sales Returns A/c	36,000

Sundry Debtors (M/s K.B.& Co.) A/C

Date	Particulars	Amount	Date	Particulars	Amount
	To Balance c/d	36,000	Apr 9	By, Sales Returns A/c	36,000

Sales Returns A/C

Date	Particulars	Amount	Date	Particulars	Amount
Apr 30	To, Sundries as per Sales Returns Book	152,000		By Balance c/d	152,000

3.6 BILLS RECEIVABLE BOOK AND BILLS PAYABLE BOOKS

For any organization, where a number of bills are drawn and/or accepted, bills are recorded in special subsidiary book. Bills Receivable Book is one of the subsidiary book which is used for the purposes of recording the details of bills receivable. The individual amounts are daily posted to the credit of the accounts of individual debtors from whom the bills are received. Periodic total (normally monthly total) is posted to the debit of "Bills Receivable Account" in the ledger by writing "To, Sundries as per B/R Book.

Similarly, Bills payable book is one of the subsidiary book which is used for the purpose of recording the details of bills payable accepted by the person. Individual amount are daily posted to the debit of the accounts of individual creditors to whom acceptances have been given. The periodic total (normally monthly total) is posted to the credit of Bills Payable Account in the ledger by writing "By, Sundries as per B/P Book.

Formats of Bills Receivable and Payable Books

BILL RECEIVABLE BOOK

S.NO	DATE OF RECEIPT	FROM WHOM RECEIVED	NAME OF DRAWER	NAME OF ACCEPTOR	DATE OF BILL DRAWN	TERM OF BILL	DATE OF MATURITY	WHERE RECEIVABLE	L.F	AMOUNT

BILL PAYABLE BOOK

S.NO	DATE OF RECEIPT	FROM WHOM RECEIVED	NAME OF DRAWER	NAME OF PAYEE	DATE OF BILL DRAWN	TERM OF BILL	DATE OF MATURITY	WHERE PAYABLE	L.F	AMOUNT

3.7 JOURNAL PROPER

Those transactions which cannot be recorded in any other subsidiary books such as purchase book, purchase return book, sales book, sales return book, cash book, bills receivable book and bills payable book are recorded in a special book called Journal Proper. Following are the entries which are included in journal proper book:

a. Opening Entry

An entry which is used to bring the balances of various assets, liabilities and capital appearing in the Statement of Financial Positon of the previous accounting period in the books of current accounting period is called opening entry. Because of opening entry we can write balance b/d in ledger accounts.

b. Closing Entry

An entry which is used to close the nominal (income and expenditure) accounts by transferring them to Trading and Statement of Profit or Loss is called closing entry. Further, at the end of the period we have to close all assets and liability account by writing balance c/d, this authority is also provided by closing entry. These are needed at the end of the accounting year when the financial statements are prepared.

c. Transfer Entry

An entry which is used to transfer amount from one account to another account is called transfer entry. For eg; at the end of the year total balance of drawings account should transfer to capital account.

d. Adjusting Entry

Adjusting entries are passed to bring into the books certain unrecorded items like closing stock, depreciation, outstanding and prepaid items. These entries are generally passed at the end of the period.

e. Rectification Entry

An entry which is passed to rectify errors and mistakes previously done is called rectification entry. These entries may be passed at any stage i.e. before preparation of trial balance, after preparation of trial balance or in next accounting year.

f. Miscellaneous Entries

- Credit purchase/sale of assets
- Goods/assets taken by proprietor for personal use
- Goods loss by fire and insurance company admit the claim
- Bad debts written off due to insolvency of a debtor, etc.

Illustration 5

From the following transactions of M/s. Shree Ram Co., prepare journal entries, subsidiary books, ledgers and a trial balance.

2076 Poush	**Particulars**
1	Vehicle Rs. 600,000; Cash Rs. 400,000; Capital; Rs. 1,000,000
2	Purchased goods from Mr. Raja Ram on credit Rs. 100,000 less 10% trade discount
4	Sold goods to Mr. Chandan on credit Rs. 100,000 less 5% tradediscount
5	Sold goods to Mr. Shyam for Rs. 20,000 on credit
8	25% of the goods sold to Mr. Shyam were returned.
11	Purchased goods from M/s. Gita & Co. by paying cash Rs. 200,000.

12	Cash sales Rs. 100,000.
13	Goods worth Rs. 20,000 returned to Mr. Raja Ram.
16	Purchased stationery on credit from M/s. Bikash Suppliers worth Rs. 5,000
19	Goods worth Rs. 25,000 returned to M/s. Gita & Co., refund yet to be collected.
22	Payment made to Mr. Raja Ram at 10% discount.
25	Cash received from Mr. Chandan at 10% discount.
27	Paid house rent worth Rs. 30,000.
30	Deposited cash into bank Rs.242,500
30	Salary paid to staffs by issue of cheque 42,500

Solution

Journal Entries

Date	Particulars		L.F	Debit (Rs.)	Credit (Rs.)
2076 Poush 1	Vehicle A/c	Dr.		600,000	
	Cash A/c	Dr.		400,000	
	To Capital A/c (Being opening balance carried forward)				1,000,000
16	Stationery A/c	Dr.		5,000	
	To M/s. Bikas Suppliers A/c (Being stationery purchased)				5,000

Note: Entries recorded in other subsidiary books have not been recorded in journal.

Sales Book

Date	Particulars	L.F	Details (Rs.)	Amount (Rs.)
2076 Poush				
4	Mr. Chandan : Goods Sold		100,000	
	Less: 5% Trade Discount		(5,000)	95,000
5	Mr. Shyam : Goods Sold			20,000
				115,000

Purchase Book

Date	Particulars	L.F	Details (Rs.)	Amount (Rs.)
2076 Poush				
2	Mr. Raja Ram : Goods Purchased		100,000	
	Less: 10% Trade Discount		(10,000)	90,000
				90,000

Sales Return Book

Date	Particulars	L.F	Details (Rs.)	Amount(Rs.)
2076 Poush				
8	Mr. Shyam : 25% Goods returned			5,000
				5,000

Purchase Return Book

Date	Particulars	L.F	Details (Rs.)	Amount (Rs.)
2076 Poush				
13	Mr. Raja Ram : Goods Return			20,000
19	Gita & Co. : Goods Return			25,000
				45,000

Triple Column Cash Book

Dr. **Cr.**

Date	Particulars	L.F.	Discount	Cash	Bank	Date	Particulars	L.F.	Discount	Cash	Bank
2076 Poush						2076 Poush					
1	To Balance b/d			400,000		11	By Purchase A/c			200,000	
12	To Sales A/c			100,000		22	By Raja Ram A/c		7,000	63,000	
25	To Mr. Chandan A/c		9,500	85,500		27	By House Rent A/c			30,000	
30	To Cash A/c	c			242,500	30	By Bank A/c	c		242,500	
						30	By Salary A/c				42,500
						30	By Balance c/d			50,000	200,000
			95,00	**585,500**	**242,500**				**7,000**	**585,500**	**242,500**
2076 Magh											
1	To Balance b/d			50,000	200,000						

Capital A/c

Date	Particulars	Amount	Date	Particulars	Amount
			2072Poush		
			1	By Balance b/d	1,000,000
	To Balance c/d	1,000,000			
		1,000,000			1,000,000

Vehicle A/c

Date	Particulars	Amount	Date	Particulars	Amount
2072Poush					
1	To Balance B/d	600,000			
				By Balance c/d	600,000
		600,000			600,000

Mr. Raja Ram

Date	Particulars	Amount	Date	Particulars	Amount
2076 Poush			2076 Poush		
13	To Purchase Return A/c	20,000	2	By Purchase A/c	90,000
22	To Cash A/c	63,000			
22	To Discount Received A/c	7,000			
		90,000			90,000

Mr. Chandan

Date	Particulars	Amount	Date	Particulars	Amount
2072Poush			2072Poush		
4	To Sales A/c	95,000	25	By Cash A/c	85,500
			25	By Discount Paid A/c	9,500
		95,000			95,000

Mr. Shyam

Date	Particulars	Amount	Date	Particulars	Amount
2072Poush			2072Poush		
5	To Sales A/c	20,000	8	By Sales Return A/c	5,000
				By Balance c/d	15,000
		20,000			20,000

Purchase A/c

Date	Particulars	Amount	Date	Particulars	Amount
2072Poush					
11	To Cash A/c	200,000			
30	To Sundries (as per purchases book	90,000		By Balance c/d	290,000
		290,000			290,000

Sales A/c

Date	Particulars	Amount	Date	Particulars	Amount
			2072Poush		
	To Balance c/d	215,000	12	By Cash A/c	100,000
			30	By Sundries (as per Sales Book)	115,000
		215,000			215,000

Sales Return A/c

Date	Particulars	Amount	Date	Particulars	Amount
2072Poush					
30	To Sundries (as per Sales Return Book)	5,000		By Balance c/d	5,000
		5,000			5,000

Purchase Return A/c

Date	Particulars	Amount	Date	Particulars	Amount
			2072 Poush		
	To Balance c/d	45,000	30	To Sundries (as per Purchases Return Book	45,000
		45,000			45,000

Gita & Co. A/c

Date	Particulars	Amount	Date	Particulars	Amount
2072Poush			2072Poush		
19	To Purchase Return A/c	25,000		By Balance c/d	25,000
		25,000			25,000

Discount Received A/c

Date	Particulars	Amount	Date	Particulars	Amount
2072Poush			2072Poush		
	To Balance c/d	7,000	22	By Raja Ram A/c	7,000
		7,000			7,000

Discount Paid A/c

Date	Particulars	Amount	Date	Particulars	Amount
2072Poush					
25	To Mr. Chandan A/c	9,500		By Balance c/d	9,500
		9,500			9,500

Stationery A/c

Date	Particulars	Amount	Date	Particulars	Amount
2072 Poush					
16	To Mr. Bikash A/c	5,000		By Balance c/d	9,500
		9,500			9,500

Bikash Supplier's A/c

Date	Particulars	Amount	Date	Particulars	Amount
			2072 Poush		
	To Balance c/d	5,000	16	By Stationery A/c	5,000
		5,000			5,000

Stationery A/c

Date	Particulars	Amount	Date	Particulars	Amount
2072 Poush					
16	To Mr. Bikash A/c	5,000		By Balance c/d	5,000
		9,500			5,000

House Rent A/c

Date	Particulars	Amount	Date	Particulars	Amount
2072 Poush					
27	To Cash A/c	30,000		By Balance c/d	30,000
		30,000			30,000

Salary A/c

Date	Particulars	Amount	Date	Particulars	Amount
2072 Poush					
27	To Bank A/c	42,500		By Balance c/d	42,500
		42,500			42,500

Trial Balance
As at Poush 30, 2072

S.No.	Particulars	L.F.	Debit (Rs.)	Credit (Rs.)
	Capital A/c		-	1,000,000
	Vehicle A/c		600,000	
	Shyam A/c		15,000	
	Purchase A/c		290,000	
	Sales A/c			215,000
	Purchase Return A/c			45,000
	Sales Return A/c		5,000	
	Gita & Co. A/c		25,000	
	Discount Received A/c			7,000
	Discount Paid A/c		9,500	
	Stationery A/c		5,000	
	Bikash A/c			5,000
	House Rent A/c		30,000	
	Salary A/c		42,500	
	Cash A/c		50,000	
	Bank A/c		200,000	
	Total		**1,272,000**	**1,272,000**

Summary

In this unit we have studied that the Purchase Book and Sales Book are maintained by an enterprise to facilitate credit purchases and credit sales respectively of trading goods. We are able to understand that such books does not entertain the cash purchases, cash sales as well as purchase and sale of assets other than goods dealt with by an enterprise. Further, when purchase return and sales return are frequent in nature such returns are entered into "Return Outward Book and Return Inward Book respectively. Bills payable and receivable books are maintained to keep records of incoming and outgoing bills and promissory notes. Journal proper is a residual book in which transactions not included in other subsidiary books are recorded.

Subsidiary books facilitates in reducing the volume of journal entries to be raised. However, it should be noted that such books does not all in all negate the need for the journal entries. Journal entries are required for the transactions which are not covered by the subsidiary books.

Self-Examination Questions

I. Multiple Choice Questions (MCQs)

1. The debit note issued are used to prepare
   (a) Sales Return Book (b) Purchase Return Book
   (c) Sales Book (d) Purchase Book

2. A second hand motor car was purchased on credit from BB Enterprises for Rs. 23,000. This should be recorded in
   (a) Purchase Book (b) Sales Book
   (c) Journal Proper (d) None of the above

3. Credit purchase of stationery worth Rs. 5,000 by a stationery dealer
   (a) Cash Book (b) Purchase Book
   (c) Journal Proper (d) Sales Book

4. Unpaid salary for Rs. 3,400 is to be provided for in the accounts
   (a) Bills Receivable Book (b) Pruchase Book
   (c) Journal Proper (d) Purchase Return
5. Purchases day book records
   (a) All cash purchases (b) All credit purchases
   (c) Credit purchase of trading goods (d) None of the above

6. Accounting for partial recovery from Mr. Subiku of an amount of Rs. 2,000 earlier written off as bad debt
   (a) Sales Book (b) Journal Proper
   (c) Purchase Book (d) Cash Book

7. When the goods are purchased from a supplier
   (a) An invoice is received from him (b) A debit note is received from him
   (c) A credit note is received from him (d) None of the above

8. Purchase of machinery by Mr. Gopal, a dealer in machinery, for Rs. 300,000 in credit is recorded in
   (a) Cash book (b) Sales Book
   (c) Purchases Book (d) Journal Proper

9. Closing Entry should be recorded in
   (a) Cash book (b) Sales Book
   (c) Purchases Book (d) Journal Proper

10. A dishonored of a discounted bills receivable is recorded in
   (a) Bills Receivable Book (b) Journal Proper
   (c) Triple Column Cash Book (d) None of the above

11. When a customer returns the goods:
   (a) an invoice is sent to him (b) a invoice is received from him
   (c) a debit note is sent to him (d) a credit note is sent to him

12. The credit notes received are used to prepare:
   (a) Purchase book (b) Sales return book
   (c) Sales book (d) Purchase return book

II. Short Descriptive Questions (SDQs)

1. What are the different types of subsidiary books? What are their advantages?
2. Differentiate between sales book and purchase book.
3. Write short note on:
   a. Return Outward Book
   b. Journal Proper
   d. Sales Book
4. State whether the following statements are correct or not.
   i. The Purchases Book records all the credit purchases.
   ii. The periodic totals of purchase book are posted to the credit side of purchase account.
   iii. The periodic totals of the sales book is posted to the debit side of the sales account.
   iv. The Sales Return Book records the return of goods sold.
   v. The Sales Book records the credit sales of goods dealt with by an enterprise.

III. Practical Questions (PQs)

1. From the following record of Shrestha & Co., prepare purchase book and relevant ledgers:

2070 Bhadra 2	Purchased from Bigbazar of Dharan on credit
	30 Shirts @ Rs. 150 each and 20 Pants @ Rs. 350 each
2070 Bhadra 7	Purchased for cash from Nabin Fashion, Baneshwor
	35 Hats @ Rs. 90 each
2070 Bhadra 10	Purchased from Sharma Design of Newroad on credit
	40 Bags @ Rs. 210 each and 25 Shirts @ Rs. 180 each

2. XYZ & Co. is a dealer of electric goods, enter the following transactions:

2068 Ashad 5	Purchased from Matrix Store Co., Putalisadak
	150 Transistors Radio sets @ Rs. 750 each

	95 Electric clocks @ Rs. 375 each
	Less: Trade discount 12 % on all items
2068 Ashad 7	Purchased from Monica Suppliers, Birgunj
	145 Electric Razors @ Rs. 425 each
	185 Battery Torches @ Rs. 90 each less trade discount 7.5%.
2068 Ashad 9	Purchased Maruti Van from AVCO International for Rs. 725,000
2068 Ashad 11	Purchased from Sound House, Kumaripati
	5 Color TV @ Rs. 19,750 each and 23 B/W TV @ Rs. 12,500 each
2068 Ashad 13	Purchased 1500 light bulbs @ Rs. 25 each from ABC Enterprises on cash.

3. Prepare purchase outward book of Shrestha & Co.

2070 Bhadra 3	Goods Returned to Bigbazar of Dharan
	7 Shirts @ Rs. 150 each and 2 Pants @ Rs. 350 each
2070 Bhadra 11	Goods returned to Sharma Design of Newroad
	5 Bags @ Rs. 210 each

4. Enter the following transactions in the book of XYZ & Co.

2068 Ashad 6	Returned to Matrix Store Co. Putalisadak
	7 Transistors Radio sets and 8 Electric clocks
2068 Ashad 8	Returned to Monica Suppliers, Birgunj
	13 Electric Razors and 15 Battery Tourches
2068 Ashad 14	375 light bulbs returned to ABC Enterprises.

5. From the following information prepare the sales book of Jugal & Co.

May 1	Sold on credit to Ram & Co., Banepa
	20 Sarees @ Rs. 875 each
May 5	Sold for Cash to Neha Traders, Birtamod
	30 Kurthas @ Rs. 1150 each
May 11	Sold to Mohan Brothers, Nepalgunj
	55 Sarees @ Rs. 825 each and 35 Kurthas @ Rs. 985 each
May 15	Sold 2 typewriters @ Rs. 11,500 each to Becon Enterprises, Newroad

6. Enter the following transactions in the books of Furniture world:

June 3	Sold on credit to Palpa Traders of Bhaktapur
	286 Tables @ Rs. 435 each
	135 Chairs @ Rs. 245 each
	Less trade discount @ 17.50 %
June 7	Sold to Bikram Woods of Chabahil
	45 Cabinets @ Rs. 2250 each less trade discount 15 %

	30 Stools @ Rs. 125 each
June 10	Sold a old Machine for Rs. 8,500 to Kumar Cycle of Birgunj on credit.
June 12	Sold to Hirakaji and Bros. of Baneswor
	15 tables @ Rs. 350 each
	32 Revolving Chairs @ Rs. 1250 each.
June 19	Sold on cash to Prajita Makers of Nayabazer
	9 Beds @ 3250 each
	11 Computer tables @ Rs. 950 each

7. Enter following transactions in the book of Jugal & Co.

May 3	3 Sarees returned by Ram & Co.
May 6	7 Kurthas retured by Neha Traders
May 12	11 Sarees and 4 Kurthas returned by Mohan Brothers

8. From the following prepare return inward book of Furniture world.

June 4	Returned by Palpa Traders of Bhaktapur
	17 Tables and 22 Chairs
June 8	8 Stools and 5 Cabinets returned by Bikram Woods of Chabahil
June 13	2 tables and 6 revolving chairs retuned by Hirakaji and Bros. of Baneswor
June 20	2 beds returned by Prajita Makers.

9. From the following prepare necessary subsidiary books and accounts.

Baisakh 1	Purchased from M/s. Warm Coolers of Tinkune
	35 table fans @ Rs. 1,650 each and 24 ceiling fans @ Rs. 625 each
Baisakh 3	Sold to Hulas House of Kalimati
	11 table fans @ Rs. 2,075 each less trade discount 9%
	9 Ceiling fans @ Rs. 945 each.
Baisakh 3	Purchased from Gauri Mohan Enterprises of Pokhara
	48 Pressure Cookers @ Rs. 1,850 each
	35 Rice Cookers @ Rs. 2,300 each
	Less trade discount 15%
Baisakh 5	3 table fans and 1 ceiling fan returned to Warm Coolers.
Baisakh 6	2 Table fans and 3 Ceiling fans returned by Hulas House.
Baisakh 9	Sold to Binayak Traders of Butwal
	17 Pressure Cookers @ Rs. 2,475 each
	12 Rice Cookers @ Rs. 3,050 each less trade discount 18 %.
Baisakh 11	Binayak Traders returned 2 Rice Cookers
Baisakh 19	Purchased from Samyak Traders of Tindhara

10 Pressure Cookers @ 1,900 each
7 Ceiling fans @ Rs. 700 each

Baisakh 27 Sold to Hanuman Traders of Kumaripati on cash
5 Pressure Cookers @ Rs. 2,500 each
3 Rice Cookers @ Rs. 3,000 each less trade discount 15%
5 Ceiling fans @ Rs. 1,000 each.

10. Pass the necessary journal entries:

a. Pass opening entry from the followings:

Cash in hand Rs. 15,150; Prepaid Salary Rs. 1,150; Stock Rs. 13,175; Loan from Hari Rs. 6,750; Outstanding Rent Rs. 2,700; Plant and Machinery Rs. 37,000

b. Purchased a plant for Rs. 185,000 from ABC Traders.

c. Prepaid insurance expired to the extent of Rs. 25,000.

d. Outstanding commission income for the year is Rs. 15,000.

e. Rs. 15,000 paid for furniture purchase was debited to office expenses account.

f. Salary paid to Mr. Karki Rs. 4,000 has wrongly been debited to his personal account.

g. Depreciate Furniture of Rs. 180,000 by 25%.

h. Goods costing Rs. 3,500 lost by fire but insurance company admitted claim to the extent of 75% only.

ANSWER

Multiple Choice Questions (MCQs)

1	b	6	d	11	d
2	c	7	a	12	d
3	b	8	c		
4	c	9	d		
5	c	10	c		

CHAPTER- 2

Accounting Systems and Processes

UNIT 4:

Control Accounts and Suspense Accounts

Learning Objectives

1. *Try to understand the concepts of control accounts and its use.*
2. *Understand how the use of control accounts help in keeping general ledger free of details as well as provide a correct balance for the preparation of financial statements.*
3. *Gain an understanding of suspense accounts and their use while maintaining the accounts in an enterprises.*
4. *Understand the types of suspense accounts.*
5. *Analyze the limitations or problems created by the suspense accounts.*

4. INTRODUCTION

We normally buy a shirt, a pair of jeans or anything else from store. Our purchase is just one of hundreds or thousands of transactions of that store had to record that day. In large business such as *McDonalds, KFC, Pizza Huts* hundreds or thousands of transactions occur hourly. With so much activity, it might seem easy to lose track of one or two transactions. Even one lost transaction could have effect on a company's account and may lead to some serious consequences. As a result, accountants must record these transactions in a systematic manner. For this purpose several accounts have to be opened or maintained. However, it does not mean that you have to open account for each and every transaction for recording such transaction and opening as many as accounts for each and every transaction leads to mess of information which cannot be used properly in decision making process. So, we need to open such number of accounts which are manageable as well as to facilitate recording transaction in proper way.

4.1 CONTROL ACCOUNT

A control account is a summary account in the general ledger containing the aggregate of all credit and debit postings of a number of related accounts which are maintained in Subsidiary Ledgers.(e.g. Total debtors account, Creditors, sales, purchase etc. appearing in general ledger). The details that support the balance in the summary account are contained in a subsidiary ledger—a ledger outside of the general ledger. The control is achieved by comparing the balance in the related accounts on any date with the aggregate balance of all individual debtors account balances in the Subsidiary ledger (Debtors ledger, Creditors ledger, sales and purchase book) on that date.

The purpose of the control account is to keep the general ledger free of details, yet have the correct balance for the financial statements. For example, the Accounts Receivable account in the general ledger could be a control account. If it were a control account, the company would merely update the account with a few amounts, such as total collections for the day, total sales on account for the day, total returns and allowances for the day, etc.

The details on each customer and each transaction would not be recorded in the Accounts Receivable control account of the general ledger. Rather, these details of the accounts receivable activity will be recorded in the Accounts Receivable Subsidiary Ledger. This works well because the employees working with the general ledger probably do not need to see the details for every sale or every collection transaction. However, the sales manager and the credit manager will need to know detailed information on individual customers, including whether a customer recently reduced their account balance. The company can provide these individuals with access to the Accounts Receivable Subsidiary Ledger and can keep the general ledger free of a tremendous amount of detail. A control account is an account that holds summarized information obtained from sub-accounts. The accounts receivable control ledger is a control account with the accounts receivable subsidiary ledger being the sub-account. The Account receivable control ledger contains summarized information from the Account Receivable Subsidiary Ledger, which contains specific details like the names of clients, when they paid, how much they paid, which invoice they are paying, etc.

For a small firm, the trial balance alone may prove sufficient in providing a check on the numerical accuracy of the ledger accounts. Whilst still useful, the trial balance will not necessarily speed up the location of errors.

If a firm operates ledgers for sales, purchases and general accounts then control accounts can be used as a further check on the accuracy of the ledgers. In effect, a control account is like a trial balance for each of the sales and the purchases ledger. If the control account does not tally with the accounts in each ledger, then an error will exist in that ledger.

There are mainly two control accounts. These are:

a. Sales ledger control account (also known as the total debtors account)
b. Purchases ledger control account (also known as the total creditors account)

Each control is a summary total of the respective ledger. It has the totals for all balances and all entries as found in the sales or the purchases ledger. It is easier to imagine them as an overall debtor account (for the sales ledger account) or an overall creditor account (for the purchases ledger account).

4.1.1 Preparation of Control Accounts

The information for preparing each control accounts are taken from both the personal accounts of debtors and creditors, and daybooks (e.g. sales daybook for total of credit sales). The main sources of information are found in the following locations:

a. Information for Sales Ledger Control Account

Information needed:	**Information located:**
Opening balance of debtors	Debtor accounts in sales ledger
Credit sales	Sales daybook
Returns inwards	Returns inwards daybook
Money received from customers	Cashbook
Discounts allowed	General ledger or cashbook (3rd column)
Closing balance of debtors	Debtor accounts in sales ledger

b. Information for Purchase Ledger Control Account

Information needed:	**Information located:**
Opening balance of creditors	Creditor accounts in purchases ledger
Credit purchases	Purchase daybook
Returns outwards	Returns outwards daybook

Money paid to the Supplier/Creditors	Cashbook
Discounts received	General ledger or cashbook (3rd column)
Closing balance of creditors	Creditor accounts in purchases ledger

A control account will appear as if it is a personal account - with amounts relating to purchases and sales, returns, discounts as well as payments made and received. The examples below shows the debtor account and creditor account

Debtors accounts	
Balance owing to us at start	Cash/cheques received
Credit sales made during period	Returns inwards
-	Discounts allowed
-	Balance owing to us at end (*1)

(*1 this is a debit balance but it is initially carried down from the credit side when the account is balanced off)

Creditor Accounts	
Cash/Cheques paid	Balance owing by us at start
Returns outwards	Credit purchases made during period
Discounts received	-
Balance owing by us at end (*2)	-

(*2 this is a credit balance but it is initially carried down from the debit side when the account is balanced off)

4.1.2 Benefits of Control Accounts

If the control accounts are kept purely as memorandum records then they are not necessary for the double entry system to function fully. However the control accounts will still have some uses for the firm and these are as follows:

If the control accounts do not balance then a mistake has taken place in the respective ledger. This will save time in the locating of the error. If we relied on the trial balance alone then we would have to check all the three main ledgers as well as the cashbook.

Control accounts can be kept by a person who is not the same person who maintains the personal accounts of debtors and creditors. In this case, fraud is less likely to occur (unless both the ledger clerks and the person maintaining the control accounts are in collaboration together!).

The debtors and creditor figures can be ascertained more speedily for preparation of the trial balance, rather than balancing each individual personal account in the sales and purchases ledgers.

4.2 SUSPENSE ACCOUNT

Suspense accounts are temporary holding accounts for financial information on the general ledger. They are used to book large entries quickly or hold certain items that will be broken down at a later time. Suspense accounts may be reconciled each month to ensure that all the financial information posted will be properly disbursed to other accounts.

A "suspense" account is a separate category of account code opened to record expenditure and/or income which, for the time being at least, cannot be properly allocated to specific budget related expenditure or income account code. By definition, entries in suspense accounts are transitional and there is a presumption that there is no adequate authority for any items that remain in the suspense account over a period of time. For this reason, individual entries in suspense accounts must be capable of identification and the balances in suspense account must be reviewed regularly to confirm that their retention in suspense account is justified.

Business areas would be expected to have resolved the accounting for purposes of preparing the resource accounts for the year. Any balance held on a suspense account at the end of a financial year falls to be recorded in the resource accounts whether it is in the nature of an asset, or a liability. It is essential therefore that any balances can be fully supported and justified to the external auditors.

Suspense accounts can be used for a variety of purposes. Most frequently, where the debit side of the trial balance doesnot tally with the credit side of trial balance, difference in debit side and credit side are recorded by opening suspense account. If the error or errors which have caused this cannot easily be found, a suspense account is opened as a temporary measure to balance the trial balance pending the discovery of the errors. In this situation, suspense account will be shown in trial balance as well as in Statement of Financial Positon. Following the trial balance or Statement of Financial Positon, there would be a list of errors discovered after the trial balance or Statement of Financial Positon date. It require making the necessary corrections to the accounts and to amend or close the suspense account. It may include the preparation of suspense account, correcting trial balance, amend respective accounts heads in order to make corrected Statement of Financial Positon and find out the corrected net profit.

It should be particularly noted that some of the errors may not affect the suspense account. There may be corresponding errors affecting to existing accounts and they should also be corrected through the journal.

4.2.1 Uses of Suspense Accounts

1. It is an account which are used to post any difference on the trial balance pending the discovery of errors.When the errors are found suspense account are corrected by debiting

and crediting the suspense account. Ultimately, the balance of the suspense account should be nil after the proper transfer to the correct accounts.

2. It is an account to which one side of the transaction can be posted until its correct destination is known. This one side can be a debit or a credit entry.

Say for example, that a bookkeeper saw a bank receipt of Rs. 10,000 in the company's bank statement, but due to insufficient information, he does not know whether this money is from a customer who is paying up its outstanding account or it's the receipt for the sale of its fixed assets. Hence, the bookkeeper can temporarily post this transaction into a suspense account until he can discover the true nature of the transaction.

Illustration:

Date	**Particluar**	**Debit Amount**	**Credit Amount**
	Bank account Dr. To, Suspense account (Being the initial creation of a suspense account to accommodate this unidentifiable item)	10,000	 10,000

Subsequently, the next step is to reverse this suspense account:

Date	**Particluar**	**Debit Amount**	**Credit Amount**
	Suspense Account Dr To, Customer A's account (Being clearance of suspense account and transfer to the proper account)	10,000	 10,000

4.2.2 Salient Points to Note

a. Suspense accounts must be minimized. The clearance of the suspense account must be done to add credibility to the financial statement.

b. The longer the clearance of suspense accounts means that there might be items of revenue expenditure which should be charged to the Income Statement which have not been done. Suspense account can then become a time-bomb.

c. Important to note that accounting fraud can be perpetuated by consistently suspending certain material revenue expenditure

We have seen that suspense accounts are still in use. In reality Suspense is really another word for "Mystery" and/or "Procrastination". Suspense accounts are placeholders for unidentified "no clue" transactions. We don't know how or why the transaction exists. Therefore, we don't know how to code or account for them. Experience indicates that suspense transactions are created from:

- Lack of communication;
- Lack of effective processes;
- Lack of internal controls; and/or
- An underlying training issue.

Either way suspense accounts cost us time and money on analysis and reclassification entries.

When errors are made, they will have an effect on the final accounts of the firm, possibly giving us an incorrect picture of position and operation. Understandably, it is important to correct these errors as soon as they are found.

In double entry bookkeeping, the trial balance can be used to check the accuracy of the ledger accounts. If the totals of the debit column and the credit column of the trial balance disagree (are not the same) then mistakes must have been made in the entries. However, even the totals agree (both columns total the same figure) mistakes may still have been made. There are various ways in which entries can be made which follows basic rules of double entry (one debit and one credit entry - both same amounts) but still produce mistakes. The errors that do not affect the trial balance agreement are normally classified as follows:

Name of error	Description of error
1. Error of Omission	Double entry is missed out (omitted) completely from ledgers.
2.Error of Commission	One half of entry is made in wrong personal account.
3. Error of Principle	One half of entry is made in wrong type of account.
4. Error of original entry	Incorrect amount is entered in both halves of entry.
5. Complete reversal of entries	Debit entry is credited and vice versa - in correct accounts and correct amounts.
6. Compensating error	Two or more errors cancel each other out in terms of their effect on the trial balance.

Once an error has been located, it will need to be corrected with both an entry in the journal (regardless of the original transaction) and also in the ledger accounts.

When we refer to incorrect amounts being entered in accounts, we often use the words 'overcast' to refer to when too much has been entered in an account, and 'undercast' when too little has been placed in an account.

4.2.3. Suspense Accounts and Correction of Errors

Many errors that are made will affect the trial balance agreement. These errors will normally consist of:

- Entering different amounts in both entries of the transaction.

- Making two debit entries (or two credit entries) for a transaction.
- Only entering one entry for a transaction.

If any of these errors are made (one or more) then the trial balance totals will not agree. In this case, the errors should be located. However, this may take time - days, weeks or even months - the more errors that have been made, the longer their location will take. If the trial balance does not agree, then we would not be able draw up the Statement of Profit or Loss and Statement of Financial Positon correctly.

As a part solution to this (finding the errors should always be a priority), a firm can, in effect, make the trial balance agree by entering the amount needed to make the two columns agree again. The difference between the two columns of the trial balance is filled with the creation of a new entry **-** this is entered in the suspense account.

4.2.4 Types of Suspense Accounts

Suspense accounts can be used as journal entry to offsets for debit and credit balances. Cash, payroll, expense and prepaid items can all have suspense accounts linked to the initial journal entries. While most suspense accounts maintain a zero balance each month, some may carry a balance if necessary. The suspense accounts must be grouped with the proper accounts i.e asset or liability, on the financial statements; this is determined by the remaining debit or credit balance in the account.

4.2.5 Problems Created By Suspense Accounts

Suspense accounts can create several problems if not balanced correctly. Carrying a balance in the suspense account each month can cause financial information to become overlooked and unallocated to the proper account. If the suspense account has a high volume of transactions, reconciling the account to find out where the remaining balance goes can be time-consuming.

Additionally, having a suspense account presented on the financial statements with a balance can weaken the statements to outside investors. Suspense accounts are viewed negatively, since the information contained in the suspense account is an unallocated amount.

Summary

In this unit we have studied control accounts as a summary account in the general ledger containing the aggregate of all credit and debit postings of a number of related accounts which are maintained in Subsidiary ledgers. The purpose of the control accounts is to keep the general ledger free of details and yet have the correct balance for the financial statements. Control account help correct errors committed during the recording of transaction as well as help to prepare financial statements.

Further we have studied the Suspense Account which is the temporary nature account and opened to locate the error as well as rectifying the errors by analyzing the respective transactions. The suspense account most frequently found in recoding of transactions is where the debit side of the trial balance does not agree with the credit side. If the error or errors which have caused this cannot easily be found, a suspense account is opened as a temporary *measure to balance the trial balance pending the discovery of the errors. In this situation, suspense account will be shown in trial balance as well as in Statement of Financial Positon.*

Self-Examination Questions

I. Multiple Choice Questions (MCQs)

1. A purchases ledger control account is also known as:
   (a) A total debtors account
   (b) A creditors suspense account
   (c) A debtors suspense account
   (d) A total creditors account

2. Which of the following transactions should appear on the credit side of a purchases ledger control account?
   (a) Purchases returns
   (b) Discounts received
   (c) Credit purchases
   (d) Payments made to suppliers

3. Which of the following items can be found in both a sales ledger control account and a purchases ledger control account?
   (a) Discounts allowed
   (b) 'Contra' Entries
   (c) Discounts received
   (d) Returns inward

4. At the beginning of April the total debtors figure for A Firm Ltd. was Rs.30,100. During April the following transactions took place: Credit sales Rs. 6,500; Sales returns Rs. 600; Receipts from debtors Rs. 5,800 including a cheque for Rs.400 which was subsequently dishonoured; Discounts allowed Rs.200. What is the total debtors figure at the end of April?
   (a) Rs.30,400
   (b) Rs.30,000
   (c) Rs.29,600
   (d) Rs.30,800

5. At the beginning of April the total creditors figure for B & R Ltd. was Rs.18.500. During April the following transactions took place: Credit purchases Rs.4,200. 'Contra-Entries' amounts offset against debtors' ledger Rs.300. Payments to creditors Rs.1,600. Discounts received Rs.200. What is the 'total creditors' figure at the end of April?
   (a) Rs.21,200
   (b) Rs.20,600

(c) Rs.21,000
(d) Rs.23,800

6. Dad & Sons' sales ledger control account showed the following information for the month of June: Opening debtors Rs.42,500. Returns in Rs.1,200. Receipts from debtors Rs.6,800. Discounts allowed Rs.300. Closing debtors Rs.40,900. What was the total credit sales made to debtors?

   (a) Rs.5,900
   (b) Rs.6,100
   (c) Rs.6,700
   (d) Rs.4,300

7. When the purchases ledger control account of Markhu Ltd was drawn-up, the balance was Rs. 17,610 (credit). It was later discovered that: 1. A page in the purchases day book was undercast by Rs.890. 2. A supplier had given a discount of Rs.130 to Markhu, but this had not been entered in the cash book. What should the correct balance be on the control account?

   (a) Rs.16,590 cr.
   (b) Rs.18,370 cr.
   (c) Rs.18,630 cr.
   (d) Rs.16,850 cr.

8. Which of the following provides a check on the accuracy of the balances in suppliers' accounts?

   (a) Purchases account
   (b) Purchases Ledger Control Account
   (c) Purchases returns account
   (d) Sales ledger control account

9. When the sales ledger control account of Tara Ltd was drawn-up, the balance was Rs.33,900 (debit). It was later discovered that: 1. a page in the sales returns day book was undercast by Rs.550. 2. A debt owed by Man Bahadur, value Rs.240, had been written-off. Unfortunately the journal entry for this was for Rs.420. Which of the following statements are definitely true?

   (a) The correct balance on the control account should be Rs.33,530
   (b) Bad debts written-off are overcast by Rs.180
   (c) Man Bahadur's account will be in credit.
   (d) The correct balance on the control account should be Rs.33,170

10. The sales ledger control account of Baby Ltd. showed a 'debit' balance b/d on 1st May of Rs.43,200. On the same date the purchases ledger control account showed a 'credit' balance b/d of Rs.29,100. However, these balances did not take account of the following transaction: On 27thApril an amount of Rs.1,300 owing by Gama Ltd. was part-offset against an amount of Rs.800 owing to the same company. Which of the following statements is / are true?

(a) The revised sales ledger control account balance should be Rs.42,500
(b) The revised sales ledger control account balance should be Rs.41,900
(c) The revised purchases ledger control account balance should be Rs.28,300
(d) The revised purchases ledger control account balance should be Rs.27,800

11. Kent Ltd. had a purchases ledger control account balance of Rs.55,300. However when the individual creditors account balances were totaled the figure came to Rs.56,500. Which of the following statements is / are true?
    (a) There is at least one error in one of the creditors' accounts.
    (b) There is at least one error in the control account
    (c) There is at least one error either in one of the creditors' accounts or in the control account
    (d) A journal entry will be necessary to correct the error.

II. Short Descriptive Questions (SDQs)

1. Define control accounts. What are its advantages?
2. Write short note on:
   a. Suspense Account
   b. Control Account

ANSWER

Multiple Choice Questions (MCQs)

1	d	6	c	11	c
2	d	7	b		
3	b	8	b		
4	a	9	a		
5	b	10	c		

CHAPTER- 2

Accounting Systems and Processes

UNIT 5:

Consumable and Non Consumable Inventory

Learning Objectives

1. *Understand the nature of Consumable and Non Consumable Inventories.*
2. *Be familiar with the types of records maintained recording the movement of consumable and non-consumable inventories.*

5.1 CONSUMABLE INVENTORY

Consumable inventories are assets held by an enterprise for:

(a) Incorporating in the production process, including raw materials or processed materials (e.g., work-in-process, finished goods); and

(b) Reissue/reuse/resale as part of its ongoing operations (e.g., stationery, maintenance parts).

5.1.1 Consumable Inventory Ledger

Consumable inventory ledger is a record maintained for tracking the movement of consumable inventories, including purchases, issues and balance. Generally such ledger contains at a minimum the following data elements:

1) Description of the consumable inventory
2) Acquisition date
3) Quantity
4) Acquisition cost
5) Cost per unit
6) Location (see following section)
7) Purchase Order Number
8) Date removed from inventory
9) Inventory balance

Format of General Consumable Inventory Leger

CONSUMABLE INVENTORY LEDGER

S.NO	DESCRIPTION OF CONSUMABLE INVENTORY	QUANTITY	ACQUISITION COST	COST PER UNIT	LOCATION	PURCHASE ORDER NO	DATE REMOVED FROM INVENTORY	INVENTORY BALANCE

A "Proper recording of inventory" is the act of accounting for, and the accurate verification of, information on file for each piece of consumable inventory. In accounting and verification process, emphasis is placed on the following aspects pertaining to each item:

1. Physically locating the consumable inventory maintained on the consumable inventory ledger, for the specific agency or activity.
2. Verifying that the location information on file for the consumable inventory is accurate.
3. Verifying that consumable inventory in existence is reported in the consumable inventory property ledger.
4. Verifying that the consumable inventory description is accurate.
5. Verifying that the consumable inventory is in good condition. If the consumable inventory is not in good condition, report the matter to the appropriate personnel for proper action.
6. If the consumable inventory is not being used, determine whether it is surplus to the agency's needs or obsolete and dispose of appropriately.

5.2 NON-CONSUMABLE INVENTORY

When Non-consumable inventories are the assets held by an enterprise to facilitate the operation of business and not consumed within a single accounting period. Non-consumable inventories are expected to be used for more than one accounting period and are not intended for resale in ordinary course of business. They have normally the following features:

1. Retain their original shape and appearance with use.
2. Are non-expendable - that is, if the article is damaged or some of its parts are lost or worn out, it is usually more feasible to repair it rather than replace it with an entirely new unit.
3. Do not lose their identity through incorporation into a different or more complex unit or substance.
4. Represent an investment of money, which makes it feasible or advisable to account for the items.
5. Represent equipment with its own serial number fixed to the item.
6. Have a useful life of more than one year.

Students may note that the non-consumable inventories are used for an enterprise's operational activities, for instance machineries used in production. As such the cost of such use is charged to the production by way of depreciation.

Non-consumable inventory may contain following items

- Cutting / Hand Tools
- Assemblies - Physical grouping of tools, such as holders, retention knobs, face mills, boring bars, clips, setscrews

5.2.1 Non Consumable Inventory Ledger

Entity is required to maintaining separate individual ledgers for each type of non-consumable items as a subsidiary ledger, which will help to control and proper utilization of these assets. All the individual totals of these subsidiary legers will be shown in control ledger as a main account/ledger. If an entity has large numbers of various types of non-consumable inventory records can be maintain by keeping registers for each category of item. These register is known as Non Consumable Assets Register (literally known as Fixed Asset Register). Such registers are designed in such a way to provide required information about the related assets:

- Name of Asset
- Physical Location
- Date of acquisition,
- Original Cost
- Addition and Deletion
- Transfer / Issue/Write Offs
- Depreciation Rate, Accumulated and Current Period's Depreciation
- Net Book Value etc.

Format of Non Consumable Inventory Ledger

NON CONSUMABLE INVENTORY LEDGER

S.NO	NAME OF ASSETS	LOCATION	DATE OF ACQUISITION	ORIGINAL COST	ADDITION/ DELETION	TRANSFER/ ISSUE/ WRITE OFF	DEPRECIATION	NET ASSET

Summary

In this unit we have studied the consumable and non-consumable inventories with examples. Consumable inventories are acquired with a primary purpose of consumption in the production purpose or for reissue, reuse and resale. Non consumable inventories are assets expected to be used for more than one accounting period. The costs of use of non-consumable inventories are charged through depreciation. The enterprises are required to maintain a systematic record of both the kinds of the inventories so as to record their movement such as acquisition, issue and balance.

Self-Examination Questions

I. Short Descriptive Questions (SDQs)

1 What is consumable and non consumable inventory? Illustrate with example.

2. Discuss the records used to track the movement of such inventories.

CHAPTER- 2

Accounting Systems and Processes

UNIT 6:

Bank Reconciliation Statement

Learning Objectives

After studying this chapter, you will be able to:

1. *State the meaning and need for the preparation of bank reconciliation statement;*
2. *Identify causes of difference between bank balance as per cash book and Bank Statement;*
3. *Prepare the bank reconciliations statement;*
4. *Ascertain the correct bank balance as per cash book.*
5. *Have enough knowledge about nature of pending items.*

6.1 INTRODUCTION

Banks are important institution in the business society. Banks collect fund form people and lend to those who need. Those who deposit the money are able to withdraw it according to the set terms and conditions of the bank. In Nepal, Nepal Rastra Bank (NRB) give license to banks to operate their function.

In business environment, every entity should open bank accounts to deposit amount for safety and to follow systematic practice of the business transactions. An entity may open bank account as per its need. Further, there are legal compulsions to conduct transactions through cheque beyond prescribed limit. As per Income Tax Act 2058, every business entity should issue the cheque for payment in excess of Rs. 50,000. It will be easier for entity to verify its records with the records maintained by the bank.

Banking Transactions and its recording

Particulars	Books of Entity	Books of Bank
1. Amount deposited with Bank	Bank Account Dr. To Cash Account	Cash Account Dr. To Entity's Account
2. Amount withdraw from Bank by issuing cheque	Cash Account Dr. To Bank Account	Entity's Account Dr. To Cash Account
3. Interest provided by Bank	Bank Account Dr. To Interest Income	Interest Expense Account Dr. To Entity's Account
4. Interest and Bank Charges Collected by bank	Interest/Bank Charge A/C Dr. To Bank Account	Entity's Account Dr. To Interest/Bank Charge A/c
5. Telephone expense paid directly by the bank on behalf of entity	Telephone Expense A/C Dr. To Bank Account	Entity's Account Dr. To Cash Account
6. Dividend Income collected by the bank on behalf of entity	Bank Account Dr. To Dividend Income A/C	Cash Account Dr. To Entity's Account
7. Direct deposited by debtor into bank account of entity	Bank Account Dr. To Debtor's Account	Cash Account Dr. To Entity's Account

From the above we can see that recording in entity's books will be just reversed of recording in bank's book. If entity debited the bank account then bank will credit the entity's account and vice versa. Hence, the receivable of entity from the bank should be equal to the payable to the entity in bank's book. For summary:

- Debit side of Cash Book = credit of Bank Statement
- Credit side of Cash Book = debit of Bank Statement
- Receipt side of Cash Book = credit side of Bank Statement
- Payment side of Cash Book = debit side of Bank Statement
- Withdrawal side of Bank Statement = credit side of Cash Book
- Deposit side of Bank Statement = debit side of Cash Book

Refusal of Payment

The bank will refuse to make payment on the cheque in the following circumstances;

a. If the cheque is presented before its date or six months after the date of the cheque.
b. If the customer or the drawer has instructed the bank to stop payment of the cheque.
c. If the bank comes to know of the death of the customer
d. If the bank has notice of the insolvency of the customer.
e. If the bank comes to know that the customer has become a lunatic
f. If the bank has received an order from the other bank for not making the payment

6.2 BANK RECONCILIATION STATEMENT (BRS)

It is a statement which contains a complete and satisfactory explanation of the differences in balances as per Cash Book and Bank Statement. It reconciles the bank balance as per cash book by showing all causes of differences between two. The purpose of preparing Bank Reconciliation Statement is to reconcile the bank balance with balance as per Cash Book by showing all causes of differences between the two and to take a necessary follow-up action. The preparation of Bank Reconciliation Statement is not a part of the double entry bookkeeping system. It is just a procedure to prove the Cash Book Balance.

6.3 IMPORTANCE OF BANK RECONCILIATION STATEMENT

Bank reconciliation is usual and valued practice of almost all business concern. Valued in the sense, it is an important mechanism of internal control of cash inflow and outflow. Both of them must tally as per cash book with bank statement. This brings into focus error and irregularities, if any. Normally, preparation of reconciliation statement and recording of cash transaction shall assign to two separate persons that will help to detect error and omissions as well as fraudulent activities.

The main advantages of such reconciliation are:

i. The reconciliation will bring out any errors that may have been committed either in the cash book or in the pass book;
ii. Any undue delay in the clearance of cheques will be shown up by the reconciliation; and
iii. A regular reconciliation discourages the staff of the customer or even that of the bank from embezzlement. There have been many cases when the cashier merely made entries in the cash book but never deposited the cash in the bank; they were able to get away it only because of lack of reconciliation.

6.4 ASCERTAINING THE CAUSES OF THE DIFERENCE IN THE BALANCES

To find out the correct balances each and every item in the bank statement and that in cash book have to be compared with one another. To explain the process of identifying causes of differences we will one take example which is given as follows:

M/s Big Enterprises

Teku, Kathmandu, in account with Everest Bank Ltd, Teku Branch

Bank Statement as on 31st January 2015

Date	Particulars	Withdrawals	Deposit	Dr/Cr	Balance
2015					
2-Jan	By Cash		6,000	Cr.	6,000
4-Jan	To, Furniture Land	900		Cr.	5,100
4-Jan	To. Dev & Co.	1,875		Cr.	3,225
10-Jan	By, Janardan & Co.		525	Cr.	3,750
12-Jan	To, Raj and Jagat	1,500		Cr.	2,250
15-Jan	By, Bishnu & Co.		1,140	Cr.	3,390
16-Jan	By, Cash		450	Cr.	3,840
20-Jan	To, Cash	750		Cr.	3,090
26-Jan	By, Rakesh & Co.'s Cheque		645	Cr.	3,735
31-Jan	To, Premium paid instructions	375		Cr.	3,360
	To, Bank charges	15		Cr.	3,345
	By, Interest collected on Govt. Securities		300	Cr.	**3,645**

Cash Book (Bank column only)

Date	Particulars	Amount Rs.	Date	Particulars	Amount Rs.
2015			2015		
2-Jan	To, Cash	6,000	2-Jan	By, Furniture Land	900
2-Jan	To, Janardan & Co.	525	2-Jan	By, Raj and Jagat	1,500
8-Jan	To, Bishnu & Co.	1,140	2-Jan	By, Dev & Co.	1,875
10-Jan	To, Cash	450	4-Jan	By. K. Nepal & Co.	1,095
16-Jan	To, Rakesh & Co.	645	17-	By, Cash	750
20-Jan	To, Madan & Co.	1,575	20-	By, Bishnu & Co.	1,170
22-Jan	To, Nanu & Bros.	510	31-	By, Balance c/d	**3,555**
		10,845			**10,845**
1-Feb	To, Balance b/d	**3,555**			

It will be seen that whereas the bank statement shows a balance of Rs. 3,645, the bank column of cash book shows a balance of Rs. 3,555. We shall compare the two to establish the reasons for the difference.

If we compare the debit side of the cash book with the deposits column of the bank statement, we find that the following cheques have been sent to the bank but not yet credited by the bank:

Madan & Co.	Rs. 1,575
Nanu & Bros	Rs. 510
Total	**Rs. 2,085**

If these two accounts had been entered in the deposits column of the bank statement also, the bank statement's balance would be Rs. 5,730 i.e. Rs. 3,645+ Rs. 2,085.

Looking at the withdrawals column of the bank statement and the credit side of the cash book, we find that under mentioned two cheques have not been paid by the bank:

K. Nepal & Co.	Rs. 1,095
Bishnu & Co.	Rs. 1,170
Total	**Rs. 2,265**

If these cheques had been presented and paid, the balance at the bank would have been Rs. 3,465 i.e. Rs. 5,730- Rs. 2,265.

In addition to above, two amounts appear in the withdrawals column of the bank statement but not on the credit side of the cash book; these are Rs. 375 premium, and Rs. 15 bank charges. If these amounts have been omitted from the withdrawals column also, the balance at the bank would have been Rs. 3,855 i.e. Rs. 3,465+ Rs. 390.

There is one amount Rs. 300, interest collected, which has been entered in the deposit column of the bank statement but not on the debit side of the cash book. Omission of this amount from the bank statement also would reduce the balance to Rs. 3,555 i.e. Rs. 3,855-300. This agrees with the cash book balance.

This process shows that the difference between the two balances arise only because there are some entries made in the cash book but not in the bank statement and some entries which are made in the bank statement but not in the cash book. A comparison of the two shows up such entries and then, on that basis, the reconciliation is prepared.

Presentation:
Bank Reconciliation Statement shall clearly show the causes of differences between two balances. Taking the example given above the statement may be prepared as follows.

(a) Ascertainment of balance of Cash Book on the basis of balance shown by bank statement

Bank Reconciliation Statement

As on 31st January 2015

Particular	**Rs.Rs.**	**Amount**
Balance as per bank statement		3,645
Add: Cheques paid but not yet credited		

Madan & Co.	1,575	
Nanda & Bros	510	2,085
Add: Premium paid and bank charges entered in		
bank statement but not yet entered in the cash book		390
Less: Cheques issued but not yet presented		6,120
K. Nepal & Co.	1,095	
Bishnu & Co.	1,170	2,265
		3,855
Less: Interest Credited by bank but not yet entered in cash book	300	
Balance as per Cash Book.		**3,555**

(b) Ascertainment of balance of bank statement on the basis of balance shown by Cash Book

Bank Reconciliation Statement

As on 31st January 2015

Particular	**Rs**	**Rs**
Balance as per Cash Book		3,555
Add: Cheques issued but not yet presented		
K. Nepal & Co.	1,095	
Bishnu & Co.	1,170	2,265
		5,820
Add: Interest Credited by bank but not yet entered in cash book	300	
		6,120
Less: Cheques paid but not yet credited		
Madan & Co.	1,575	
Nanda & Bros	510	2,085
Less: Premium paid and bank charges entered in		
bank statement but not yet entered in the cash book		390
Balance as per Bank Statement		**3,645**

Preperation of Reconcilation statement on Columnar Format

Another way to prepare reconciliation statement is a columnar format. The statement has two columns, one to record amounts which increase the balance and the other to record those amounts which reduce the balance. The statement given above is redrawn as shown below

Bank Reconciliation Statement

As on 31st January 2015

Particulars		**Plus**	**Minus**
Balance as per bank statement		3,645	
Cheques paid but not yet credited			
Madan & Co.	1,575		
Nanda & Bros	510	2,085	
Premium paid and bank charges entered in bank statement but not yet entered in the cash book		390	
Cheques issued but not yet presented			
K. Nepal & Co.	1,095		
Bishnu & Co.	1,170		2,265
Interest Credited by bank but not yet entered in cash book			300
Balance as per Cash Book			3,555
		6,120	**6,120**

6.5 RECONCILIATION PROCESS AND CAUSES OF DIFFERENCE

A business concern can open an account with the bank by paying an initial sum of money. The customer may deposit cash or cheque with the aid of a "paying-in-slip" and can withdraw money by means of a cheque. Since, the banker is the trustee of the customer, the bank provides to its customer a Bank Statement at regular intervals, which summarizes payments as well as deposits and other charges for the period. In fact, Bank Statement is a copy of the customer's account in the Bank's Ledger.

To ascertain the bank balance, a concern has two sources of information:

1. Bank Column of Cash Book; and
2. Bank Statement/Pass Book

Strictly speaking, there should be no difference between the balances shown by the bank statement and the cash book. This is so, if all the entries are recorded in both properly and accurately. However, on a particular date it is possible that some entries may have been recorded in the cash book but not in the bank's record and vice versa. On this account, the cash book and bank statement may difference balances on a particular date. Causes of differences are as follows:

1. Timing:

There may be time gap between recording transactions in the customer's book and the bank book. For example, when a cheque is issued to a party, it is recoded immediately in the customer's book but the bank will record it only when it makes payment against that cheque. Similarly, when a cheque is deposited, it is recorded in the cash book immediately, but the bank will record it only when it collects money in respect of that cheque.

2. Transactions:

For some transactions, the bank has prior knowledge and it adjusts its record before the business records the transcation. Some differences may arise from the bank's actions that have not been intimated to the customer. For example, interest credited by the bank, bank charges and commissin debited by the bank. The customer comes to know of these transactions only when he receives the bank statement.

3. Errors:

Some differences in balance may arise owing to errors committed by the bank or by the person responsible for preparing the cash book. For the first two reasons, discussed above, neither of the parties is wrong nor would it be a mistake to 'correct' them. But for the present reason, the books are to be properly rectified.

On the basis of above discussion we can trace out some items that frequently causes of differences:

i. ***Cheque issued but not yet presented for payment:*** The entry in the cash book is made immediately on issue of cheque to the party and this has the effect of reducing the balance in the customer's book. But, entry will be made by the bank only when the cheque is presented for payment. Thus, there will be a gap of some days between the entry in the cash book and in the bank statement.

   Example: XYZ Ltd issued a cheque in favor of a creditor on 28th Ashad 2071 for the sum of Rs 8,000. The cheque is presented for payment at bank on 3rd shrawan 2071. Bank statement up to 31st Ashad 2071 shows the balance of Rs 38,000 while the cash balance as per cash books as on 31st Ashad 2071 is Rs 30,000. The Bank reconciliation statement is prepared as under

Bank Reconciliation Statement as on 31st Ashad 2071

Particular	**Amount**
Balance as per Cash book	30,000
Add: Cheque issued but not yet presented for payment till 31st Ashad 2071	8,000
Balance as per Pass Book	38,000

ii. ***Cheques paid into bank but not yet cleared/collected:*** As soon as cheques are sent to the bank, entries are made in the bank column on the debit side of the cash book. But usually banks credit the customer's account only when they have received the payment from the bank concerned – in other words, when the cheques have been cleared.

Example: ABC Ltd deposited a cheque on 28th Ashad 2071 for the sum of Rs 8,000 for sales made to ABC Ltd. The cheque is collected by bank only on 3rd shrawan 2071. Bank statement up to 31st Ashad 2071 shows the balance of Rs 22,000 while the cash balance as per cash books as on 31st Ashad 2071 is Rs 30,000. The Bank reconciliation statement is prepared as under

Bank Reconciliation Statement as on 31st Ashad 2071

Particular	Amount
Balance as per Cash book	30,000
Less: Cheque deposited but not yet collected till 31st Ashad 2071	8,000
Balance as per Pass Book	22,000

iii. ***Interest allowed by bank:*** If bank has allowed interest to the customer, the entry will be normally made in the customer's account when due as per bank's internal rules and later shown in bank statement. The customer usually comes to know of the amount of the interest by perusing the bank statement and only then makes relevant entry in the cash book.

Example: Bank credited XYZ Ltd account for interest amounting Rs 8,000 on 28th Ashad 2071. Bank statement up to 31st Ashad 2071 shows the balance of Rs 38,000 while the cash balance as per cash books as on 31st Ashad 2071 is Rs 30,000. The Bank reconciliation statement is prepared as under

Bank Reconciliation Statement as on 31st Ashad 2071

Particular	Amount
Balance as per Cash book	30,000
Add: Interest Allowed by bank but not yet recorded in cash book till 31st Ashad 2071	8,000
Balance as per Pass Book	38,000

iv. ***Interest and expenses charged by the bank:*** The bank charges some amount from each customer by way of incidental charges, collection charges, and debits his account for this reason from time to time. As soon as these charges are made, the bank debits the customer's account in its own books and reduces the bank balance. But the customer learns about these charges only, when he receives the bank statement and then he credits Bank Account in his own books. Until then, the bank balance as per the bank statement would be less than the bank balance as per the cash book or bank account.

Example: Bank debited XYZ Ltd account for its interest and other charges amounting Rs 8,000 on 28th Ashad 2071. Bank statement up to 31st Ashad 2071 shows the balance of Rs 22,000 while the cash balance as per cash books as on 31st Ashad 2071 is Rs 30,000. The Bank reconciliation statement is prepared as under

Bank Reconciliation Statement as on 31st Ashad 2071

Particular	Amount
Balance as per Cash book	30,000
Less: Bank charge levied by the bank but not recorded in the cash book till 31st Ashad 2071	8,000
Balance as per Pass Book	22,000

v. ***Interest and dividend collected by the bank:*** Sometimes investments are left with the bank in the safe custody; the bank itself sees to it that the interest or the dividend collected on the due dates. Entries are made by the bank on receipt of such amount but customer will make an entry only on received of advice from bank statement.

vi. ***Direct payments by the bank:*** The bank may be given standing instructions for certain payments such as for insurance premium, utility bills etc. In this case also, the customer may come to know of the payment only on seeing the bank statement. The entries in the bank's record and in the cash book may thus be on different dates.

Example: Bank made a payment of insurance premium under the standing instruction of XYZ Ltd amounting Rs 8,000 on 28th Ashad 2071. Bank statement up to 31st Ashad 2071 shows the balance of Rs 22,000 while the cash balance as per cash books as on 31st Ashad 2071 is Rs 30,000. The Bank reconciliation statement is prepared as under

Bank Reconciliation Statement as on 31st Ashad 2071

Particular	Amount
Balance as per Cash book	30,000
Less: Direct payment by bank but not yet recorded in cash book till 31st Ashad 2071	8,000
Balance as per Pass Book	22,000

vii. ***Direct payment into the bank by a customer:*** If such payment is received by the bank, it will be entered in the customer's account and also in the bank statement; the account-holder may come to know of the amount only when he sees the bank statement.

Example: Customer directly deposited Rs 8,000 in the bank account of XYZ Ltd through wire transfer on 28th Ashad 2071. Bank statement up to 31st Ashad 2071 shows the balance of Rs 38,000 while the cash balance as per cash books as on 31st Ashad 2071 is Rs 30,000. The Bank reconciliation statement is prepared as under

Bank Reconciliation Statement as on 31st Ashad 2071

Particular	Amount
Balance as per Cash book	30,000
Add: Direct payment into the bank but not yet recorded in cash book till 31st Ashad 2071	8,000
Balance as per Pass Book	38,000

viii. ***Dishonour of a bill discounted with the bank*:** If the bank is not able to receive payment on promissory notes discounted by it, it will debit the customer's account together with any charges that it may have incurred. The customer will naturally make the entry only when he sees the bank statement.

Example: A discounted bill dishonored for Rs 8,000 on 28th Ashad 2071. Bank statement up to 31st Ashad 2071 shows the balance of Rs 22,000 while the cash balance as per cash books as on 31st Ashad 2071 is Rs 30,000. The Bank reconciliation statement is prepared as under

Bank Reconciliation Statement as on 31st Ashad 2071

Particular	Amount
Balance as per Cash book	30,000
Less: Discounted Bill receivable dishonored but not yet recorded in cash book till 31st Ashad 2071	8,000
Balance as per Pass Book	22,000

ix. ***Bill collected by the bank on behalf of the customer:*** If goods are sold, the documents may be sent through the bank. If the bank is able to collect the amount, it will credit customer's account. The customer may make the entry only on receiving the bank statement.

Example: Bank collected a Bill Receivable of Rs 8,000 under the standing instruction of XYZ Ltd on 28th Ashad 2071. Bank statement up to 31st Ashad 2071 shows the balance of Rs 38,000 while the cash balance as per cash books as on 31st Ashad 2071 is Rs 30,000. The Bank reconciliation statement is prepared as under

Bank Reconciliation Statement as on 31st Ashad 2071

Particular	Amount
Balance as per Cash book	30,000
Add: Direct payment collected by bank but not yet recorded in cash book till 31st Ashad 2071	8,000
Balance as per Pass Book	38,000

x. ***An error committed by the bank side or customer's side:*** A bank rarely commits an error but, if it does, the balance shown in bank statement will differ from that shown in the cash book. Similarly, if customer did mistake it effect will be seen.

If none of the circumstances mentioned in causes of differences as above exist, the balance shown by the bank statement and that shown by the cash book will agree. If they disagree, it will be because of some of the reasons mentioned above. At certain interval, two balances should be compared and, if there is disagreement, exact reasons for it should be established. In other words, the two balances must be fully reconciled.

Illustration 1

M/s. Lumbini Pvt. Ltd. provides you the following information as at 31st Ashad 2072:

1.	Balance as per Cash Book	200
2.	Cheque issued but not presented for payment	2,500
3.	Cheqe deposited but not yet collected by the bank	1,500
4.	Interest allowed in the bank statement only	100
5.	Insurance premium paid directly by the bank under the standing advice	500
6.	Bills Receivables directly collected by the bank	2,000
7.	A wrong debit given by the bank in bank statement	3,800
8.	A wrong credit given by the bank in bank statement	400
9.	Direct payment by a customer into the bank but not recorded in cash book	700

Prepare a bank reconciliation statement as at 31st Ashad 2072 to ascertain the balance as per bank statement.

Solution:

Bank Reconciliation Statement
as on 31st Ashad 2072

Particular	**Rs.**	**Rs.**
Balance as per Cash Book		**200**
Add: Cheque issued but not presented for payment	2,500	
Interest allowed in bank statement only	100	
Bills receivable directly collected by bank	2,000	
A wrong credit given by the bank in bank statement	400	
Direct payment by a customer into bank but not recorded in cash book	700	5,700
Less: Cheque deposited into bank but not collected by the bank	1,500	
Insurance premium paid directly by bank as per standing instruction	500	
A wrong debit given by Bank in bank statement	3,800	(5,800)
Overdraft balance As per Bank Statement/Passbook		**100**

Illustration 2

On 31st December 2019 the Cash Book of M/s Nepal Trading Concern shows an overdraft balance of Rs. 50,000 in respect of the account with Nepal Bank Ltd. After scrutiny, it is found that:

(i) Two cheques totaling Rs. 8,000 were issued within 31st December 2019 but were not presented for payment within the said date.

(ii) Five cheques totaling Rs. 60,000 were depositedduring the month; but were not credited by the bank

(iii) The bank credited Rs. 5,000 on account of interest collected; but there was no entry in the cash book in that respect.

(iv) The bank statement shows debit entries on different dates for bank charges amounting to Rs. 250 but there was no entry in the cash book in respect of the same.

a. You are required to prepare a statement to explain why there is a difference between the balances shown by the two books.

b. Further , Prepare the Bank Reconciliation Statement based on columnar format

Solution

a. Bank Reconcilation Statement on General Format

M/s Nepal Trading Concern
Bank Reconciliation Statement
As on 31St December 2019

Particular	**Rs**	**Rs**
Balance as per Cash Book		**(50,000)**
Add: Cheques issued but not yet presented	8,000	
Interest directly collected by bank	5,000	**13,000**
Less: Cheques deposited but not yet credited	60,000	
Bank Charges debited in bank statement	250	(60,250)
Balance as per Bank Statement		**(97,250)**

b. Bank Reconcilation statement on columnar format for "Plus" and "Minus"

M/s Nepal Trading Concern
Bank Reconciliation Statement
As on 31st December 2019

Particulars	**Plus**	**Minus**
Overdraft as per cash book		**50,000**
Cheques issued but not yet presented	8,000	

Bank charges entered in bank statement but not yet entered in the cash book		250
Cheques deposited but not yet credited		60,000
Interest Collected by bank but not yet entered in cash book	5,000	
	13,000	110,250
Overdraft Balance as per Bank Statement		**97,250**

Illustration 3

From the following particulars of Miss. Rojina, prepare bank reconciliation statement as on March 31, 2015 .

1. Bank balance as per Cash Book Rs. 50,000.
2. Cheques issued but not presented for payment Rs. 6,000.
3. The bank had directly collected dividend of Rs. 8,000 and credited to bank account but was not entered in the cash book.
4. Bank charges of Rs. 400 were not entered in the cash book.
5. A cheques for Rs. 6,000 was deposited but not collected by the bank.

Solution:

Bank Reconciliation Statement of Miss. Rojina

as on March 31, 2015

Particulars	**Rs.**	**Rs.**
Balance as per Cash Book		**50,000**
Add: Cheques issued but not presented for payment		6,000
Dividends collected by the bank		8,000
		64,000
Less: Cheque deposited but not credited by the bank	6,000	
Bank charges debited by the bank	400	6,400
Balance as per Bank Statement		**57,600**

Illustration 4

On Ashad 31, 2072, Mr. Rakesh had on overdraft of Rs. 8,000 as shown by his cash book. Cheques amounting to Rs. 2,000 had been paid in by him but were not collected by the bank. He issued cheques of Rs. 800 which were not presented to the bank for payment. There was a debit in his passbook of Rs. 60 for interest and Rs. 100 for bank charges. Prepare bank reconciliation statement.

Solution:

Bank Reconciliation Statement of Rakesh

as on Ashad 31, 2072

Particulars	**Rs.**	**Rs.**
Overdraft as per cash book		8,000
Add: Cheques deposited but not yet Credited	2,000	
Bank charges charged by the bank	60	
Interest charged by the bank	100	2,160
		10,160
Less: Cheques issued but not presented for payment		800
Balance as per bank passbook (overdraft)		**9,360**

Illustration 5

On March 31, 2015 the bank column of the cash book of M/s Agrahari Traders showed a credit balance of Rs. 118,100 (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 Rs. 12,400.
2. Payment received from a customer directly by the bank Rs. 27,300 but no entry was made in the cash book.
3. Cheques issued for Rs. 175,200 not presented for payment.
4. Interest of Rs. 8,800 charged by the bank was not entered in the cash book. Prepare bank reconciliation statement.

Solution

Bank Reconciliation Statement
of M/s Agrahari Traders
as on March 31, 2015

Particulars	**Rs.**	**Rs.**
Overdraft as per Cash Book		**(118,100)**
Less: Cheques received but not sent to the bank for collection	12,400	
Interest on bank overdraft debited by the bank	8,800	(21,200)
		(139,300)
Add: Payment received from the customer directly		
Credited in the bank a/c but not entered in the cash book	27,300	
Cheques issued but not presented for payment	175,200	202,500
Balance as per the passbook (favourable balance)		**63,200**

Illustration 6

From the following particulars of M/s Alpha & Co. prepare a Bank Reconciliation Statement on December 31, 2012.

	Rs.
Overdraft as per passbook	20,000
Interest on Overdraft	2,000
Insurance Premium paid by the bank	200
Cheque issued but not presented for payment	6,500
Cheque deposited but not yet cleared	6,000
Wrongly debited by the bank	500

Solution

Bank Reconciliation Statement of Alpha & Co
as on December 31, 2012

Particulars	Rs.	Rs.
Overdraft as per pass book		**(20,000)**
Less: Cheque issued but not presented for payment	6,500	(6,500.00)
Add: Interest on overdraft	2,000	
Insurance premium paid by the bank	200	
Cheques deposited but not yet cleared	6,000	
Wrongly debited by the bank	500	8,700.00
Balance as per the cash book (overdraft)		**17,800**

Illustration 7

Following information is provided to prepare a bank reconciliation statement of M/s ABC Enterprises as on March 31, 2015 .

(a) Debit balance as per Cash Book is Rs. 10,000.
(b) A cheque for Rs. 1,000 deposited but not recorded in the Cash Book.
(c) A cash deposit of Rs. 200 was recorded in the cash book as if there is not bank column therein.
(d) A cheque issued for Rs. 250 was recorded as Rs. 205 in the cash column.
(e) The debit balance of Rs. 1,500 as on the previous day was brought forward as a credit balance.
(f) The payment side of the Cash Book was undercast by Rs. 100.
(g) A cash discount allowed of Rs. 112 was recorded as Rs. 121 in the bank column.
(h) A cheque of Rs. 500 received from a debtor was recorded in the cash book but not deposited in the bank for collection.
(i) One outgoing cheque of Rs. 300 was recorded twice in the Cash Book.

Solution

Bank Reconciliation Statement
as on March 31, 2008.

Particulars	**Rs.**	**Rs.**
Debit Balance as per Cash Book		**10,000**
Add: Error in carrying forward	3,000	
Cheque recorded twice in cash book	300	
Cheque deposit not record in bank column	200	
Cheque deposit but not recorded	1,000	4,500
		14,500
Less: Under casting of payment side	100	
Cheque issued but recorded in cash column	250	
A cash discount wrongly recorded in bank column	121	
Cheque recorded but not deposited	500	(971)
Credit Balance as per Bank Statement		**13,529**

6.6 PREPARATION OF ADJUSTED CASH BOOK

The causes of difference may affect in cash book or in bank statement as per their nature and entry passed in the books. We can only pass necessary entry for rectification/ adjustment for those transactions which are related with cash book. Only the banker can adjust/rectify causes of difference in its book. Taking the help of those entries which can be adjusted in cash book, we can prepare adjusted or amended cash book and then only reconcile the balance of adjusted cash book with the balance of pass book. According to nature of the causes of differences we can classify pending items into two categories as follows;

1. **Adjustable Causes**

   Those causes which can be adjusted in cash book by passing entry are called adjustable causes. We can adjust those items which are not recorded in cash book and which are in control of the company. These are part of adjusted cash book. So, we should pass necessary journal entries to record these transactions. Eg;

   Interest provided by bank but not recorded in cash book

   Interest and bank charges collected by the bank

   Amount directly deposited by the debtors in company's bank account

   Errors committed by the cashier etc.

2. **Un-adjustable Causes**

   Those causes which cannot be adjusted in cash book by passing entry are called un-adjustable causes. In other words, those transactions which are already recorded in cash book or which needn't be recorded in cash book are called un-adjustable causes. We cannot adjust those items by passing journal entries because those are not in control of the company. So these are part of reconciliation statement only. Eg;

Cheque issued but not presented for payment

Cheque deposited but not credited by the bank

Errors committed by the banker

Illustration 8

According to the cashbook of Gopi, there was a debit balance of Rs. 44,500 on 30th June 2019. On investigation you find that:

- Cheques amounting to Rs. 60,000 issued to creditors have not been presented for payment till that date.
- Cheques paid into bank amounting to Rs. 105,000 out of which cheques amounting to Rs. 55,000 only collected by the bank upto 30th June, 2019.
- A dividend of Rs. 4,000 and rent amounting to Rs. 6,000 received by the bank and entered in the passbook but not recorded in the cashbook.
- Insurance premium (upto 31st December, 2019) paid by the bank Rs. 2,700 not entered in the cashbook.
- The payment side of the cashbook had been undercast by Rs. 50.
- Bank charges Rs. 50, shown in the passbook had not been entered in the cashbook.
- A bill payable for Rs. 2,000 has been paid by the bank but is not entered in the cashbook and bill receivable for Rs. 1,000 has been discounted with the bank at a cost of Rs. 100, which has also not been recorded in cashbook.

You are required to prepare adjusted cash book and bank reconciliation statement reconciling it with the pass book.

Solution:

Adjusted Cash Book

Particular	Rs.	Particular	Rs.
To Balance b/d	44,500	By Insurance Premium A/c	2,700
To Dividend Income A/c	4,000	By Suspense A/c (error in casting)	50
To Rental Income A/c	6,000	By Bank Charges A/c	50
To Bills Receivable A/c	1,000	By Bills Payable	2,000
		By Bank Charge (discounting charge)	100
		By Balance c/d	50,600

Bank Reconciliation Statement
as on 30.6.2019

Particular	Rs.	Rs.
Balance as per Adjusted Cash Book		50,600
Add: Cheque issued but not presented for payment		60,000
Less: Cheque deposited into bank but not collected by the bank		(50,000)
Balance As per Pass Book		**60,600**

Illustration 9

On 30th September 2012, the bank account of Mr. Pandey, according to the bank column of the cash book, was overdraft to the extent of Rs. 4,062. On the same date the bank statement showed a balance of Rs. 1,400 in favor of Mr. Pandey. An examination of the Cash Book and Bank Statement reveals the following:

1. A cheque for Rs. 1,140 deposited on 29th September was credited by the bank only on 3rd October.
2. A payment by cheque for Rs. 160 has been entered twice in the Cash Book.
3. On 29th September, the bank credited an amount of Rs. 1,740 received from a customer of Mr. Pandey, but the advice was not received till 1st October.
4. Bank charges amounting to Rs. 58 had not been entered in the Cash Book.
5. On 6th September, the bank credited Rs. 2,000 to Mr. Pandey's account in error.
6. A bill of exchange for Rs. 1,000 was discounted by Mr. Pandey with his bank. This bill was dishonored on 28th September, but not entry had been made in Cash Book.
7. Cheques issued upto 30th September, but not presented for payment upto that date totaling Rs. 3,760.

You are required:

(a) To show the appropriate adjustments required in the Cash Book of Mr. Pandey, to arrive at the correct balance on 30th September, 2012; and

(b) To prepare a Bank Reconciliation statement as on that date.

Solution:

(a) Adjusted Cash Book (Bank Column only)

Date	Particulars	Rs.	Date	Particulars	Rs.
2012	To, Party A/c-rectification	160	2012	By, Balance b/d	4,062
Sep.30	To, Customer A/c (Direct deposit)	1,740	Sep.30	By, Bank charges	58
	To, Balance c/d	3,220		By, Customer A/c (B/R dishonored)	1,000
		5,120			5,120

(b) Bank Reconciliation Statement as on 30th Sep 2012

Particular	Rs.
Overdraft as per Adjusted Cash Book	3,220
Add: Cheques deposited but not collected up to 30th Sep, 2012	1,140
	4,360
Less: Cheques issued but not yet presented	3,760
Credited by bank erroneous on 6th September	2,000
Balance as per Bank Statement	**1,400**

Illustration 10

The following is the summary of a Cash Book for Chaitra, 2072.

Cash Book (Bank Column)

	Rs.		Rs.
Receipts	13,221	Balance b/d	6,849
Balance c/d	4,986	Payments	11,358
	18,207		18,207

All receipts are banked and payments are made by cheques. On investigation the following are observed:

1. Bank charges of Rs. 1,224 entered in the bank statement have not been entered in Cash Book.
2. Cheques drawn amounting to Rs. 2,403 have not been presented to the bank for payment.
3. Cheques received totalling Rs. 6,858 have been entered in the cash book and deposited in the bank, but have not been credited by the bank until Baisakh, 2070.
4. A cheque for Rs. 198 has been entered as a receipt in the cash book instead of as payment.
5. A cheque for Rs. 225 has been debited by the bank in error.
6. A cheque received for Rs. 720 has been returned by the bank and marked "No funds available". No adjustment had been made in the cash book.
7. All dividends receivable are credited directly to the bank account. During Chaitra, an amount of Rs. 558 was credited by the bank and no entry is made in the cash book.
8. A cheque drawn for Rs. 54 has been incorrectly entered in the cash book as Rs.594.
9. The balance brought forward should have been Rs. 6,399.
10. The bank statement as on Chaitra 31, 2072 showed an overdraft of Rs. 10,458.
    (a) You are required to prepare an amended Cash Book, and
    (b) Prepare a Bank Reconciliation statement as on Chaitra 31, 2072.

Solution

Amended Cash Book (Bank column only)

Dr. **Cr.**

Date	Particulars	Rs.	Date	Particulars	Rs.
	Dividends received	558		Balance b/d	4,986
	Adj. for cheque drawn for Rs. 54 entered as Rs. 594	540		Bank Charges	1,224
	Adj. of balance brought forward	450		Adj. regarding cheque entered as receipt	396
	Balance c/d	5,778		Ad j. regarding cheque returned	720
	Total	7,326		Total	7,326
				Balance b/d	5,778

Bank Reconciliation Statement as on Chaitra 31, 2072

Particular	Rs.	Rs.
Overdraft as per Bank Statement		10,458

Add: Cheque issued but not yet presented for payment		2,403
		12,861
Less:Cheques deposited but not yet credited	6,858	
Cheque debited in error	225	7,083
Balance as per Adjusted Cash Book (Overdraft)		**5,778**

Summary

In this unit we have discussed the techniques of verifying the cash book records and bank statement and resolve the difference between cash book balance and bank statement balance. A businessman generally opens account with bank. Banks are providing a range of services for promoting business activities. It collects cheques and make payments on behalf of the clients,like pays insurance premium, utility bills,collects interest, dividend on behalf of its clients.

Some transactions occur for which either banks or its clients are informed but not both of them at the same time for which there may be time gap for recording transactions in the Cash Book or in the Bank Statement. Some errors may also cause differences between the Cash Book balance and Bank statement balance of bank account. Bank Reconciliation Statement is prepared to sort out the differences at periodic interval. Nature of causes of difference are of two types; adjustable and un-adjustable.

Self-Examination Questions

I. Multiple Choice Questions (MCQs)

1. A bank reconciliation statement is prepared by:
   (a) Creditors (b) Bank
   (c) Account holder in a bank (d) Debtors

2. A bank reconciliation statement is prepared with the balance:
   (a) Bank Statement (b) Cash book
   (c) Both Bank Statement and cash book (d) None of these

3. Bank Statement is a copy of:
   (a) Copy of customer Account (b) Bank column of cash book
   (c) Cash column of cash book (d) Copy of receipts and payments

4. Unfavorable bank balance means:
   (a) Credit balance in Bank Statement (b) Credit balance in cash book
   (c) Debit balance in cash book (d) None of these

5. Favorable bank balance means:
   (a) Credit balance in the cash book (b) Credit balance in Bank Statement
   (c) Debit balance in the cash book (d) Both (b) and (c)

6. When money is withdrawn from bank, the bank :
   (a) Credits Customers A/c
   (b) Debits Customer's A/c
   (c) Credits and Debits Customer's A/c
   (d) None of these

7. Which of these types of error are not detected during Bank Reconciliation:
   (a) Cash embezzlement by cashier
   (b) Cheques deposited but not credited by bank
   (c) Casting mistakes in bank column of cash book
   (d) Interest or commission charge by the bank not accounted in cash book

8. In arriving at adjusted cash balance which of the following is not taken into account:
   (a) Amount deposited by our customer directly in our account
   (b) Error in the Cash Book
   (c) Error in the Pass Book
   (d) All of these

9. A cheque received from a debtor for Rs 112 recorded as Rs 121 in the cash book (Note; Bank has collected and credited this cheque) . when the balance as per cash book is the starting point
   a) Rs 113 to be added
   b) Rs 121 to be added
   c) Rs 9 to be substracted
   d) Rs 112 to be substracted

10. When overdraft as per Cash book is the starting point, a cheque of Rs. 500 deposited into bank but not recorded in cash will be :
    (a) Added by Rs 500
    (b) Deducted by RS. 500
    (c) Added by RS. 1,000
    (d) Deducted by Rs. 1,000

11. Which of the following item is to be apper in the bank reconciliation statement if the balance as per amemded cash book is taken as the starting point;
    (a) Bank Charges and interest charged by the bank
    (b) Interest allowed and direct payments by bank
    (c) Direct payment by our debtors into the bank
    (d) A wrong entry in the bank statement

12. Which of the following item is to be adjusted in the amended cash book
    (a) Uncollected cheques (b) Unpresented cheque
    (c) A wrong entry passed in bank statement (d) Interest given by bank

13. Deposit column of Pass book showed a wrong entry of Rs 112. When the balance as per cash book is the starting point
    a) Rs 112 to be added
    b) Rs 112 to be substrated
    c) No adjustment is required
    d) None of the above

14. While preparing a bank reconciliationstatement taking the balance as per cash book as the starting point. Debit balance of Rs 112 brought forward as credit balance of Rs 121 is
    a) Rs 112 to be added
    b) Rs 121 to be added
    c) Rs 233 to be added
    d) Rs 112 to be substracted

II. Short Descriptive Questions (SDQs)

1. What are the causes of difference between cash book and bank statement?
2. In what circumstances bank may refuse to give payment from bank account.
3. Explain the process of preparing bank reconciliation statement with amended cash balance.
4. Write Short Note
   (a) Bank Reconciliation Statement
   (b) Amemded Cash
   (c) Adjustable and unadjustable causes
5. State whether each of the following statements is True or False
   a) Bank Statement is the statement of account of the customer maintained by the bank.
   b) A business firm periodically prepares a bank reconciliation statement to reconcile the bank balance as per the cash book with the Bank Statement as these two show different balances for various reasons.
   c) Cheques issued but not presented for payment will reduce the balance as per the Bank Statement.
   d) Cheques deposited but not collected will result in increasing the balance of the cash book when compared to Bank Statement.
   e) Direct collections received by the bank on behalf of the customers would increase the balance as per the Bank Statement when compared to the balance as per the cash book.

III. Practical Questions (PQs)

1. From the following particulars, prepare a, bank reconciliation statement as at March 31, 2015 .

(i) Balance as per cash book	Rs. 3,200
(ii) Cheque issued but not presented for payment	Rs. 1,800
(iii) Cheque deposited but not collected upto March 31, 2015	Rs. 2000
(iv) Bank charges debited by bank	Rs. 150

2. The bank statement shows a balance of Rs. 7,800. On comparing the cash book with bank statement the following discrepancies were noted:

(a) Cheque deposited in bank but not credited	Rs. 3,000
(b) Cheque issued but not yet present for payment	Rs. 1,500
(c) Insurance premium paid by the bank	Rs. 2,000
(d) Bank interest credit by the bank	Rs. 400
(e) Bank charges	Rs. 100
(d) Directly deposited by a customer	Rs. 4,000

3. On comparing the cash book with bank statement of Laxman it is found that on March 31, 2015 , bank balance of Rs. 40,960 showed by the cash book differs from the bank balance with regard to the following:
   (a) Bank charges Rs 100 on March 31, 2015 , are not entered in the cash book.
   (b) On March 21, 2015 , a debtor paid Rs. 2,000 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.
   (c) Cheques totaling Rs. 12,980 were issued by the company and duly recorded in the cash book before March 31, 2015 , but had not been presented at the bank for payment until after that date.
   (d) A bill for Rs. 6,900 discounted with the bank is entered in the cash book with recording the discount charge of Rs. 800.
   (e) Rs. 3,520 is entered in the cash book as paid into bank on March 31, 2015 , but not credited by the bank until the following day.
   (f) No entry has been made in the cash book to record the dishonor on March 15, 2015 of a cheque for Rs. 650 received from Bhanu.

   Prepare a reconciliation statement as on March 31, 2015 .

4. Prepare bank reconciliation statement as on December 31, 2012. On this day the bank statement of Mr. Himansu showed a balance of Rs. 7,000.
   (a) Cheques of Rs. 1,000 directly deposited by a customer.
   (b) The bank has credited Mr. Himanshu for Rs. 700 as interest.
   (c) Cheques for Rs. 3,000 were issued during the month of December but out of these cheques for Rs. 1,000 were not presented during the month of December.
   (d) Two cheques of Rs. 2,000 and Rs. 5,000 were paid into bank in December, 2012 but were not credited by the bank in the month of December.
   (e) A cheque of Rs. 800 which was received from a customer was entered in the bank column of the cash book in December 2012 but was omitted to be banked in December, 2012.
   (f) Cheques for Rs. 10,000 were paid into bank in December 2012 but not credited by the bank till January 31, 2015 .
   (g) Interest on investment Rs. 1,000 collected by bank appeared in the passbook.

   Required: adjusted Cash Book and Bank Reconciliation Statement.

5. The cash book of a trader showed on overdraft balance of Rs. 33,000 on 31st Ashad 2067. On scrutiny of the cash book and pass book, it was discovered that:
   a. On 22nd Ashad, sundry cheques totaling Rs. 6,500 were sent to bank for collection out of which a cheque for Rs. 1,500 was wrongly recorded on the credit side of the cash book

and cheque amounting to Rs. 3,300 could not be collected by the bank till 6th Shrawan next month.

b. A cheque for Rs. 4,000 was issued to a supplier on 28th Ashad. The cheque was not encashed till 10th Shrawan.
c. Bank had debited Rs. 2,000 towards interest on overdraft and Rs. 600 for charges. But the bank advice was sent on 15th Shrawan.
d. Credit side of the bank column of the cash book was undercast by Rs. 100
e. Cheques for Rs. 2,000 drawn for office expenses were not encashed till 2nd Shrawan.
f. A cheque for Rs. 1,000 was issued to a creditor on 27th Ashad and was omitted to be entered into cash book. It was, however, presented to bank on 31st Ashad.
g. Dividends amounting to Rs. 500 had been collected directly by the bank and not entered in cash book.

6. According to the cashbook of Sadhana, there was a balance of Rs. 44,500 standing to his credit in bank on 30th April 2009. On investigation you find that:

- Cheques amounting to Rs. 65,000 issued to creditors have not been presented for payment till that date.
- Cheques paid into bank amounting to Rs. 130,000 out of which cheques amounting to Rs. 55,000 only collected by the bank upto 30th April, 2009.
- A dividend of Rs. 4,000 and rent amounting to Rs. 6,000 received by the bank and entered in the passbook but not recorded in the cashbook.
- Insurance premium paid by the bank Rs. 2,500 not entered in the cashbook.
- The received side of the cashbook had been overcast by Rs. 150.
- Bank charges Rs. 50, shown in the passbook had not been entered in the cashbook.
- A bill payable for Rs. 2,500 has been paid by the bank but is not entered in the cashbook and bill receivable for Rs. 6,000 has been discounted with the bank at a cost of Rs. 150, which has also not been recorded in cashbook. You are require:

a. To make the appropriate adjustments in the Cash book, and
b. To prepare a statement reconciling it with the bank passbook.

7. On 30th September 2012, the bank account of X, according to the bank column of the cash book, was overdrawn to the extent of Rs. 4,062. An examination of the cash book and bank statement revels the following:

- A cheque for Rs. 1,140 deposited on 29th September, 2012 was credited by bank only on 3rd October 2012.
- A payment by cheque for Rs. 160 has been entered twice in the cash book.
- On 29th September 2012, the bank credited an amount of Rs. 1,740 recived from a customer of X, but the advice was not received by X until 1st October 2012
- Bank Charges amounting to Rs. 58 had not been entered in the cash book.
- On 6th September 2012, the bank credited Rs. 2,000 to X in error.
- A bill of exchange for Rs. 1,000 was discounted by X with his bank. This bill was dishonored on 28th September 2012 but no entry had been made in the books of X.

- Cheques issued upto 30th September 2012 but not presented for payment upto that date totaled Rs. 3,760.

You are required:

a. Adjusted Cash book as on 30th September 2012 to show the correct balance of cash book

b. Bank Reconciliation statement as on that date.

8. The April 30 bank statement for Binay Company showed a balance ofRs. 6,873.40 On this date the Cash Account in the company's ledger was Rs 2,994.70. Your review reveals:
   i) Cheque under collection on April 30: Rs. 298.70.
   ii) Outstanding cheques: Rs. 1,718.
   iii) A cheque for Rs 2,194.90 issued to a supplier was recorded by the bank as Rs. 2,914.90.
   iv) A bill receivable of Rs 5,000 and interest of Rs 300 collected by the bank have not been recorded in the company's accounts.
   v) A cheque for Rs. 730.60 received from a customer was returned by the bank owing to lack of funds with the bank.
   vi) Bank service charges: Rs. 90.
   vii) In accordance with the company's standing instruction, on April 23 the bank paid insurance premium of Rs. 1,300 for the company's car.

   Prepare a Bank Reconciliation Statement for Binay Company for April.

ANSWER

Multiple Choice Questions (MCQs)

1	c	6	b	11	d
2	c	7	a	12	d
3	a	8	c	13	a
4	b	9	c	14	c
5	d	10	b		

CHAPTER- 2

Accounting Systems and Processes

UNIT 7:

Adjustments Before Preparation of Financial Statements

Learning Objectives

After studying the chapter you should be able to:

1. *Understand the role of adjustment in accrual basis of accounting.*
2. *Make adjustments for expiration or consumption of assets.*
3. *Make an adjustment for recognition of unearned revenues and recording of unrecorded expenses and revenues.*
4. *To understand the method of adjusting entries and their effect on related accounts.*
5. *To understand the usual items that requires adjustment in the books of account.*

7. INTRODUCTION

Most entries to be made in the accounts are original entries. However, some events that affect the accounts are not evidenced by the documents associated with original entries. The effects of these events are recorded at the end of the accounting period by means of adjusting entries. The purpose of the adjusting entries is to modify account balances so that they reflect fairly the situation as of the end of the period.

7.1 RATIONALE FOR ADJUSTMENTS

The important considerations in the preparation of Financial Statements with adjustments are as under:

(a) Revenue recognition principle which requires that generally the revenue should be recognized in the period in which the sale is deemed to have occurred.

(b) Matching principle which requires that the expenses should be recognized in the same period as associated revenues. That means all expenses that relates to one accounting period have to be accounted for in that period itself. Expenses recognition is tied to revenue recognition. All incomes, expenditures and losses of revenue nature are shown in the Trading and Statement of Profit or Loss. In order to prepare the Statement of Profit or Loss on accrual basis, generally the following facts should to be taken into account:

   (i) Of the many important adjustments that have to be made before closing the books of accounts, adjustment of expenses is also important. This adjustment also covers adjustments of prepaid expenses as well. Any expenditure which has already been paid but pertains to the succeeding period(s) is excluded.

   (ii) Any expenditure which pertains to the current accounting period whether paid in cash or not, is included.

   (iii) Any Income or receipt which pertains to the current accounting period whether received in cash or not, is included.

7.2 CONTINUOUS TRANSACTIONS

Most adjusting entries are made in connection with events that are, in effect, continuous transactions. Consider a fuel purchased for Rs. 100,000. On the day of delivery, Rs. 100,000 of fuel oil was an asset. But each day thereafter, some fuel oil was consumed in the furnace, whereupon part of Rs. 100,000 became an expense. Rather than record this consumption daily, a single adjusting entry is made at the end of the accounting period to show how much of the fuel oil is still an asset at that time and how much has become expense during the period. For example, if Rs. 60,000 was consumed and hence became an expense, Rs. 40,000 remains as an asset.

There are two ways of handling these events, both of which give the same result. Under one method, Rs 100,000 expenditure is originally recorded as an asset, Fuel Inventory, as in the following entry;

Fuel Inventory	
100,000	

Accounts Payable	
	100,000

At the end of the accounting period, the asset account is adjusted by subtracting the cost of fuel oil consumed, thus

Fuel Expense	
60,000	

Fuel oil inventory	
40,000	

Under the other method, the Rs. 100,000 expenditure for fuel oil is originally recorded in an expenses account (instead of an inventory account). Then the fuel oil remaining at the end of the period is subtracted from expense and shown as an asset, thus;

Fuel oil inventory	
40,000	

Fuel Expense
60,000

Although neither method reflects the correct facts within the period (with the trivial exception that the first method does reflect the facts on the day the oil was delivered), both reflect a correct statement of the facts as of the end of the accounting period. Since accounting focuses on deriving the proper amounts for the statements that are prepared at the end of the accounting period, the choice between these methods depends solely on which is more convenient.

7.3 ACCRUALS AND PREPAYMENT ADJUSTMENT

Accruals and prepayment adjustment covers adjustment of unrecorded expenses as well as prepaid expense. The first one is the expense incurred during the period, but no record of them has yet is made and later one is recorded costs to be apportioned among two or more accounting periods.

Accrual means outstanding or due. Accrued liabilities mean expenses that are required to be booked in the account so that the operating expenses could be arrived at a realistic figure.

Following are the likely heads of expense which may require making adjustment for preparing final Financial Statements. Therefore, an accountant must be careful regarding adjustment of these expenses heads. The list is just for example. Other expense head may also be there according to the nature of the business.

1. Excise duty:	Excise is payable on production or unit sold basis and becomes due as and when delivery documents is issued/sales bill raised. Therefore, the last day's delivery documents have to be verified with excise liabilities.

2. Rent	Rent on office, lease of factory site & building, go-downs etc. may not be paid upto the last date of F.Y.
3. Salary/Wages	For the last month of F.Y. salary or wages may be pending for some staffs on leave/deputation. Also, if the firm is following a policy of paying salary on the 1st day of the next month, the last months' liabilities has to be accounted a day earlier.
4. Water, Electricity, Telephone etc.	These are the utility charges and entries are to be made when the concerned bill have been received. Normally the bill of these utilities charges pertaining to the last month of F.Y. is received after the closure of the F.Y. so these become liability in the month for which they are related to.
5. Traveling:	Some time Traveling undertake in one accounting year, bills may be submitted in another year. These expenses relate to the period when the traveling was undertaken.
6. Audit fees:	Audit fees are normally paid after the completion of the same and completion of audit work is normally done after the closure of the F.Y. However, the fee is an expense for the accounting year for which the audit is being carried out.
7. Pending Bills:	Bills submitted by other parties for payment concerning jobs done for the firm, has to be cleared or provided for.
8. Interest	Interest charges on loans and advances upto last date of F.Y. shall be provided.

7.3.1 Accounting Methods

a. As per the accrual accounting system, the method to book liabilities for expenses is to debit the respective Expense Accounts head and credit Liabilities for Expenses A/c (Such as Rent Payable, Salary Payable, Utilities charges Payable etc.). Since, these accounts have credit balance that will appear in the liabilities side of the Statement of Financial Positon and debiting the respective account heads will increase the actual expenses to be shown in the debit side of the P/L A/c. Therefore, where the expenses are not paid during the accounting period, the provision made for expenses would result in increased liabilities.

b. The method to show the 'liabilities for expenses' in the Statement of Financial Positon may differ according to the practice followed by a particular concern. For example, some may credit the amount under 'sundry creditors' group by crediting individual creditors A/c in subsidiary ledger. This practice is mostly used since the firm will be in position to know that what amount to be owed to a particular party.

The common situation for outstanding and prepaid expenses are related to

1.	Expenses & Liabilities	i.e. Unpaid Salaries, Rent, utility charges etc.
2.	Revenues & Assets	i.e. Interest Receivable, Rent Receivable etc.

3. Expenses & Assets i.e. Prepaid Insurance Premium, Subscription etc.
4. Revenue & Liabilities i.e. Unearned subscription revenue, Unearned rent etc.

CASE 1: Expenses and Liabilities (Journal Entries)

1.	Salary Expenses A/c	Dr.	20,000	
	To, Salary Payable			20,000
2.	Rent Expenses Dr. A/c	Dr.	9,000	
	To, Rent Payable			8,550
	To, Tax deduction At Source (liabilities)			450

CASE 2. Revenue and assets (Journal entries)

1.	Interest Receivables A/c	Dr.	8,000	
	To, Interest Income			8,000
2.	Rent Receivables	Dr.	6,500	
	To Rent Income			6,500

(**Note:** *The Rent/Interest Receivables may be posted in ledger separately or both of them may be term under other receivables and accumulate all accrued receivable under it).*

CASE 3 Expenses and assets (Journal entries)

Alternative 1

1.	Prepaid Insurance A/c	Dr.	15,000	
	To, Insurance Expenses			15,000

This entry is correct if earlier at the time of payment, Insurance Expenses A/c had been debited in full. But, if advance payment (e.g. prepaid expenses) A/c itself is debited while paying, the expense account has not been affected, the entry required to be passed is to reverse the already existing "Prepaid Expenses" for the amount which relates to the accounting period.

Alternative 2

Insurance Expenses	Dr.	90,000	
To, Prepaid Insurance			90,000

(Reversal of previously debited "Prepaid" to expenses account and the remaining balance of this accounts head will be shown in assets side of Statement of Financial Positon under current assets).

CASE 4 Revenue and liabilities (Journal entries)

Rent Income A/c	Dr.	15,000	
To, Rent Received in Advance			15,000

(Where previously whole rent received is credited @ Rs. 5,000 per month to income).

Example

Mr. Kenneth took a house on rent from May 1 @ Rs. 15,000 p.m. Three months' rent shall have to be paid in advance. Rent becomes due on 1st of May, Aug., Nov., and Feb.

The Entries would be;

On 1st May: House Rent Dr.	45,000	
To, Cash/Bank		45,000
(For the month of May, June, July @ Rs. 15,000 p.m.)		
On 1st Aug.: House Rent Dr.	45,000	
To, Cash/Bank		45,000
(For the month of Aug., Sept., Oct., @ Rs. 15,000 p.m.)		
On 1st Nov.: House Rent Dr.	45,000	
To, Cash/Bank		45,000
(For the month of Nov., Dec., Jan. @ Rs. 15,000 p.m.)		

The book has to be closed at 31st December. The Ledger of House Rent expenses would show:

House Rent A/c

Date	Particulars	Dr.	Cr.	Balance
1st May	To, Bank (May-July)	45,000	-	45,000
1st Aug.	To, Bank (Aug.-Oct.)	45,000	-	90,000
1st Nov.	To, Bank (Nov.-Jan.)	45,000	-	135,000

Now, you note that the actual home rent payable is only for 8 months (May-Dec.) in the F.Y. and at Rs. 15,000 p.m. that amounts Rs. 120,000 only. The rent for Jan. pertains to next year which has already been paid and need to be reversed at year end.

Therefore, adjustments are as follows:

31st Dec.	Prepaid House rent Dr.	15,000	
	To, House rent Expenses		15,000

When this entry is posted in the credit side of House rent ledger, the actual house expenses will come down to 120,000.

House Rent A/c

Date	Particulars	Dr.	Cr.	Balance
1st May	To, Bank (May-July)	45,000	-	45,000
1st Aug.	To, Bank (Aug.-Oct.)	45,000	-	90,000
1st Nov.	To, Bank (Nov.-Jan.)	45,000	-	135,000
31st Dec.	By, Prepaid Rent A/c-(adjustment of Jan of next year)		15,000	120,000

On January the prepaid entry would be reversed as:

House rent Dr. 15,000
To, prepaid expenses 15,000

The House Rent A/c ledger in next F. Y. would be as follows.

House Rent A/c

Date	Particulars	Dr.	Cr.	Balance
Jan. Feb.	To, Prepaid Exp (Jan)	15,000	-	15,000
May	To, Bank (Feb., March, Apr.)	45,000	-	60,000
Aug.	To, Bank (May-July)	45,000	-	105,000
Nov.	To, Bank (Aug.-Oct.)	45,000	-	150,000
Dec.	To, Bank (Nov.-Jan)	45,000	-	195,000
	To, Prepaid (Jan)		15,000	180,000

However, if the Nov. payment is not made, then the House rent expenses ledger will show only a balance of Rs. 150,000. In that case, it will be clear that two months is (Nov. & Dec.) rent is outstanding i.e. Rs. 30,000. To provide for such liability, the following entry has to be posted.

House Rent a/c Rs. 30,000
To, Rent Payable (Liabilities for expenses) Rs. 30,000

(Once this is posted, the actual rent expenses will exhibit Rs. 180,000 debit balance).

7.4 DEPRECIATION

Depreciation is the usage value of a long-term asset in an accounting year. All long term assets purchased by a firm has its useful life. Amount spent in acquisition of fixed assets is definitely an expense but since the assets are to be used for more years, the cost of such assets has to be apportioned over its useful life. If depreciation is not to be provided at all, the amount spent on acquisition will not be charged to Profit & Loss A/c and hence the cost of use of such assets would not be reflected. Similarly, if the purchase price is debited to expense A/c as a whole in the year of purchase, the Profit & Loss A/c will have large amount as its expenses while in the following year, there will not be any expenses though the benefit of the asset is still being received.

7.4.1 Accounting Method

Depreciation is a charge to Profit & Loss A/C. Therefore, at the year-end; depreciation has to be calculated for each & every items of fixed assets. The adjusting journal entry for total depreciable amount has to be as follow.

Depreciation Expense A/C Dr.
To, Building A/C
To, Furniture A/C
To, Office Equipment A/c
To, Plant and Machineries A/C

The effect of the above entry is that, the value of assets will be reduced and depreciation expenses will be debited to Profit & Loss A/C.

Another method followed is not to credit the assets A/C directly for depreciation amount. Instead, a separate Depreciation Provision A/C is created. The purpose of this system is to shown the fixed assets at then cost and accumulated deprecations separately.

Depreciation Expense A/C Dr.

To, Accmulated Depreciation A/C

Whichever method is followed, the Statement of Financial Positon is normally drawn showing block fixed assets by deducting accumulated depreciation amount up to Statement of Financial Positon date. The further discussion regarding depreciation will be made in relevant chapter.

7.5 PROVISION FOR UNCOLLECTIBLE RECEIVABLES AND ADVANCES

Granting credit entails both costs and benefits. The main benefit is the increase in sales and profit that a company generates when it extends credit. Many potential customers would not buy if credit was unavailable, or they would buy from a competitor that offered credit. However, cost of providing the credit is administration and collection cost of the credit amount. Before a company grants credit, it reviews the customer's credit and payment history to decide whether to accept the customer. It must then track what a customer owes, send periodic bills, deposit payment, record the payment in the customer's account, and so forth. These steps require clerical time and effort. Another cost is the delay in receiving payment. The seller must finance its activities in other ways while awaiting payment. Perhaps the most significant cost is uncollectible accounts or bad debts- receivables that some credit customers are either unable or unwilling to pay. Accountants often label this major cost of granting credit that arises from uncollectible accounts as bad debts expense.

The extent of nonpayment of debts varies. It often depends on the credit risks that managers are willing to accept. For instance, many smaller local establishments will accept a higher level of risk than will larger national stores. The small store, normally know their customer personally.

The extent of a non-payment can also depend on the industry. Competition and industry practice affect whether and how companies offer credit. The final decision is based on cost-benefit trade-offs. In other words, companies offer credit only when the additional earnings on credit sales exceed the costs of offering credit. Suppose 5% of credit sales are bad debts, administrative costs of a credit department are Rs. 5,000 per year, and Rs. 20,000 of credit sales (with earnings of Rs 8,000 before credit costs) are achieved. Assume that none of the credit sales would have been made without granting credit. Offering credit is worthwhile because the earnings of Rs. 8,000 exceeds the credit costs of Rs. 6,000 [(5% of Rs. 20,000)+Rs. 5,000]

Uncollectible accounts require special accounting procedures and thus deserve special attention here. Consider an example, Suppose company has credit sales of Rs. 10,00,000 (200 customers averaging Rs, 5,000 each) during the year 20X1. Collections during 20X1 were Rs. 600,000. The December 31, 20X1 accounts receivable of Rs. 400,000 includes the accounts of 80 different customers who have not yet paid for their 20X1 purchases. During 20X1, there were no bad debts, but turns out that 40% of the year's sales are still unpaid at year-end and some may never be paid. How should company account for these receivables? Should we assume they will all be collected? If we assume some will not be, how do we decide which are collectible and which are not?

There are two basic ways to record uncollectible: by waiting to see which ones are unpaid or by making estimates today of the portion that will not be collected. The method is called the specific write-off (bad debt) method and the allowance method (provision).

7.5.1 Specific Write-Off method

A company that rarely experiences a bad debt might use the specific write-off method, which assumes that all sales are fully collectible until proved otherwise. If uncollectible are small and infrequent, this practice will not misstate the economic situation in a material way. When company identifies a specific customer account as uncollectible, it will reduce the Account Receivable. Because, company deems no specific customer's account to be uncollectible at the end of the year, it's December 31, 20X1, Statement of Financial Positon would simply show Accounts Receivable of Rs. 400,000. Now assume that during the next year, 20X2, company identifies some customers amounting to Rs. 20,000 who are not expected to pay. When the chances of collection from specific customers become dim, company recognizes the amount in the particular accounts as bad debts expense that will reduce the balance of Accounts Receivable and increase expenses as bad debt.

Unfortunately, the specific write-off method has been justifiably criticized because it fails to apply the matching principle of accrual accounting. The Rs. 20,000 bad debts expense recorded using the specific write-off method in 20X2 is related to (caused by) the Rs. 10,00,000 of 20X1 sales. Matching requires recognition of the bad debts expense at the same time as the related revenue, that is, in 20X1, not 20X2. As a result of not matching expenses to revenues, the specific write-off method produces two errors in reported earnings. First, 20X1 income is overstated by Rs. 20,000 because no bad debts expense is charged to that year. Second, 20X2 income is understated by Rs. 20,000 why? Because 20X1's bad debts expense of Rs. 20,000 is charged in 20X2. Equally, important, the account receivable balance in 20X1 overstates the real asset by Rs. 20,000.

The principal arguments in favor of the specific write-off method are based on cost-benefit concerns and materiality. Basically, the method is simple and extremely inexpensive to use. Moreover, no great error in measurement of income or accounts receivable occurs if amounts of bad debts are small and similar from one year to the next.

7.5.2 Provisioning Methods

Most accountants do not use the specific write-off method because it violates the matching principle and bad debts are neither small nor similar from year to year. Instead, accountants use an alternate method that estimate the amount of uncollectible accounts to be matched to the related revenue and appropriately measures the amount of the accounts receivable that will be collected. Provision or allowances are required normally against the likely loss of assets e.g. receivables, advance and Fixed assets, etc. Provisions (allowances) are made to cover up some uncertain but likely liabilities based on the circumstances prevailing on the closing date of the account. Providing for provisions are required so that the Statement of Profit or Loss may be prepared in more realistic manner duly taking into consideration the likely liabilities or impair in the value of assets.

Provisions are charged to Profit and it should not be confused as 'reserves' which is an appropriation of profit for special purposes. Basically, Provisioning is required under the 'accrual basis of accounting.' The receivable appearing in the Statement of Financial Positon are the assets which are realizable from customer against goods sold or services rendered and its recognition into revenue or reduction in liabilities has already been accounted for. For example, trade debtors appear because sales revenue has already been credited previously. Now, if there is any possibility that the receivables would not be collected, the doubtful portion has been provided for.

Provisioning (allowances) for doubtful debts is not to be confused with bad debts (Specific write-off). A bad debt is where receivable had become uncollectible. In that case, the receivables have to be written off from the books. But provisioning is simply a prudential norm to be in safe side and by providing for it, no book balance is written off.

This method, known as the provisional method, has two basic elements:

(1) an estimate of the amounts that will ultimately be uncollectible;
(2) a contra account, which contains the estimated uncollectible amount and is deducted from the total accounts receivable.

We usually call the contra account provision for uncollectible accounts (or Provision (allowance) for doubtful accounts, allowance for bad debts, or reserve for doubtful accounts). When we discuss about provision for liabilities or expenses, this is also a sort of provisioning on expenses due. Provision for likely loss of assets or expenses has to be provided. However, in the case of receivables, provisioning does not mean that this assets need to be written off in the books. Instead, an amount is set aside from the profit to provide cushion against future contingency. The principle is that receivables are written off only when the fact is established about its uncollectibility.

7.5.3 Accounting for Provision

In order to understand clearly, let us return to our example; assume that company knows from experience that it will not collect about 2% of sale. Therefore, we can estimate that 2% X Rs. 10,00,000 = Rs. 20,000 of the 20X1 sales will be uncollectible. However, on December 31, 20X1, we do not know which customers will fail to pay their accounts. (Of course, all Rs. 20,000 must be among the Rs. 400,000 of accounts receivable at year-end because company has already collected the other Rs. 600,000.). Here, though a trend is set, but unless some debt really goes bad, the account cannot be written off. Hence, out of the sales revenue, it is required that a suitable amount is provided to cover the loss which may arise from the non recoverable of debtor. This would facilitate separation of revenue to cover any possible loss due to "unpaid" debtors.

Let us take another example, say, the Statement of Financial Positon of a company exhibits Rs.10,00,000 as Accounts Receivable and company's experience shows that 2% of total receivable is likely to be uncollected. The entry to provide for the same would be as follows;

Profit & Loss A/C	Dr.	Rs. 20,000	
(estimated amount charged)			
To, Provision for Bad/Doubtful Debts			Rs. 20,000

The Rs. 20,000 debited to Profit & Loss A/C would result in reducing the profit. However, in doing so, no particular Accounts Receivables Balance is affected. The credit entry 'Provision for Bad/doubtful debts' will stand as a separate contra account.

Since, the provision is created against contingent loss arising from "non-payment" debtors; the balance in the 'Provision (Allowance) for uncollectible A/c' is shown by deducting against the total amount of Accounts Receivables (debtors). The effect of this treatment is twofold. One, no particular debtors' account is touched, and second, the whole debtors' amount is shown at a reduced amount in Statement of Financial Positon. The principle arguments favoring the provision method are its superiority in measuring accrual accounting income in any given year and in measuring the accounts receivable asset realistically. The provision or allowance method relies on historical experience and information about economic circumstances (growth versus recession, interest rate levels, and so on) and customer composition., Companies revise the estimates when conditions change.

7.5.4 Actual Bad Debts

When a receivable from a debtor (say Rs. 5,000) Amar goes bad or not been collected, that may be accounted in one of the following two ways;

a) <u>Debiting the bad debts written-off A/c</u>

Bad Debts (Profit & Loss) A/c Dr.	5,000
To, Sundry Debtor's A/c	5,000

b) <u>Charging the provision A/c already provided</u>

Where the 'Provision' A/c for likely bad debts exists, the same may be utilized as:

Provision for Bad/doubtful A/c Dr.	5,000
To, Sundry Debtor’s A/c	5,000

The first entry is made where company follows specific write-off method and no practice of providing provision. The bad debt is written off by charging to Profit & Loss A/c directly. However, this entry may be passed even in the case where provision balance does exist. In such a case, a provision of a certain percentage of receivable is always maintained and excess/deficit in the account is written back/off to the profit & loss A/c.

For example, continuing above illustration, in the next year, the Accounts Receivables balance is Rs. 950,000, 2% of which comes to Rs. 19,000 which requires provisioning. However, since we already have a credit balance of Rs. 20,000 in the provision as above the excess Rs. 1,000 has to be written back as follows:

Provision for Bad/doubtful debts:	1,000	
To, Profit & Loss A/c		1,000

In the case of (b), when the provision A/c itself is debited, the balance in the account would come down to Rs. 15,000. Taking the figures as in above, the provision A/c has deficit of Rs. 4,000 (Rs. 15,000 balance – Rs. 19,000 required). This deficit has to be provided as follows:

Profit & Loss A/c Dr.	4,000	
To, Provision for Bad/debts		4,000

The net effect of either way of adjustment is the same. In the first case, we debit Profit & Loss (Bad/Debts) by Rs. 5,000 and again credited Rs. 1,000 (the excess provision). The actual debit to Profit & Loss is Rs. 4,000. This is also the case in second case.

7.6 PROVISION FOR SLOW-MOVING, NON-MOVING AND OBSOLETE INVENTORY

It is essential for a business firm to detect slow-moving and non-moving or obsolete items. Obsolete materials become useless or obsolete due to change in product, process, design or method of production. Obsolete materials are different from slow-moving materials. Slow-moving stocks move at a slow rate. In case of slow and non-moving materials, capital remains locked unnecessarily and cost of storing continue to be incurred if these materials are stored in excess requirement. Thus, management should take steps to minimize losses arising there from. For that purpose, management should prepare regular report to examine the situations relating to these stocks so that useless stocks could be disposed off or used in some profitable work and effective steps could be taken to increase the movement of slow moving stocks. If management fails to manage their stock properly it will affect the financial position of the company as well.

As per accounting practices, inventories should be classified into slow-moving (no issues for more than one year but less than three years), non-moving (no issues for more than three years) and surplus. The stores were declared as surplus if materials were specific to individual products which have neither been manufactured during the year nor were planned for production during the ensuing year and/or materials in excess of maximum stock level wherever these had been fixed. The classification was intended primarily for purposes of corrective action to regulate unexecuted purchase orders/work orders, for fixing maximum, minimum and reorder levels.

Similarly, as per generally accepted accounting principles, inventory should be valued at the lower of cost or net realizable value and any diminution in the value should be provided for in the books of accounts. For this purpose, management should determine first the cost of inventory and their net realizable value according to categories. Normally, net realizable value of slow-moving and non-moving inventories is less than their costs and should provide provision for these inventories.

Basic criterion involved in this regards are:

1. Marketability
2. Order in Hand
3. Future Perception etc.

The criteria depend upon the movement. If the inventory is non-moving, then the problem is simpler. Make an assessment why it is non-moving. If the problem is of temporary nature, due to lack of order, but the market is likely to revive then it can be retained after a thorough review. But if the non-movement is due to obsolescence and lack of market then the stocks may be written off and disposed off at the realizable value. If the stock is just slow moving, then market value of the stock is assess periodically and provide only for diminution in value.

Method 1: General Provision Based on as percentage of closing stock

This method is normally called general provision for stock obsolescence. The term 'general ' is because there is NO SPECIFIC identification of the stock which has really turns back. This estimate is based on past trend or management in-depth understanding of the industry.
Example

Say, at Year End Closing Stock Balance is Rs. 50,00,000

Based on experience, Management decided to create a provision of 1% on the year end Closing Stock balance =1% x Rs. 50,00,000 = Rs. 50,000

Provision for Stock Obsolescence (Income Statement) Dr. Rs. 50,000
To, Provision for Stock Obsolescence (Statement of Financial Positon) Rs. 50,000

Being 1% general provision created based on year end closing stock balance

Method 2: General Provision Based on as percentage of whole year purchases

Under this method, provision for the stock are based on the whole year purchases. This estimate is based on past trend or management and depth understanding of the industry. This method is rarely used.
Example:

Say, whole year purchase is Rs. 1,00,00,000

Based on experience, we create a provision of 0.5% of the whole year purchase:

0.5% x Rs.1,00,00,000 = Rs. 50,000 :

Provision for Stock Obsolescence (Income Statement) Dr. Rs. 50,000
To, Provision for Stock Obsolescence (Statement of Financial Positon) Rs. 50,000

Being 0.5% general provision created based on whole year's purchases

Method 3: As specific provision by identifying specific stock that turned bad

The word 'specific' means that this provision is created based on reviewing the individual stock items. Assuming that the company has a total number of 100 stock items, management managed to identify 20 stock items needed for Stock Obsolescence provision.

Unlike the general provision, this is a specific provision which is created based on solid reasons like change in fashion, monthly sales trend showing zero movement, stock almost near to their expiry date. This necessitates the requirement to create this specific provision.

The accounting treatment is same as the general provision. (Refer: Example above)

Method 4: Based on detailed stock ageing schedule

In this case, this provision for Stock Obsolescence is creating from the AGEING Stock Schedule. Every month, management is presented with such AGEING schedule which reflects the AGE of these stocks. Based on company's internal policy/procedures, the provision for Stock Obsolescence is created.

Example:

Assuming that Company A has the following accounting policy & procedure for provision for Stock Obsolescence:-

Stock >120 days – 10% of stock amount
Stock >180 days old – 50% of stock amount
Stock >365 days – 100 % of stock amount

Basically, provision for decline in value of inventories should be determined on an item-by-item basis. However, in some circumstances, for instance if items of inventories have similar purposes or end uses and relate to the same product line produced and marketed in the same geographical area, and cannot be practicably evaluated separately from other items in that product line, provision for decline in value of inventories may be determined on an aggregate basis for that group of similar or related items of inventories. For large quantity and low value items of inventories, provision may be made based on classes of inventories.

A new assessment is made of net realizable value of inventories in each subsequent period. When the circumstances that previously caused inventories to be written down below cost no longer exist, the amount of the write-down should be recovered. The reversal should be limited to the original amount provided and reduce the amount of provision for decline in value of inventories.

Summary

As per the accrual basis of accounting and matching principle all the expenses incurred to generate income, whether paid in cash or not should be taken in to account in order to preparation of fair financial statements. There are some usual items which require adjustment at end of the year before preparation of final account. Improper treatment or omission will affect the fair presentation of financial statements because it may inflate income and assets or deflate expenses and liabilities. Therefore, accountants are required to pay more attention on these items while preparing final accounts.

The main source of revenue in many businesses is the sale of merchandise to customers on credit. These sales may involve a single payment, or they may involve a series of payments. This give rises to the income as sales revenue and asset as, accounts receivable. These accounts, in turn,may give rise to losses when customers do not pay the amount they owe. Hence every credit sale may have some cost and the most significant cost is uncollectible accounts or bad debts- receivables that some credit customers are either unable or unwilling to pay. The final decision of whether to sale on credit or not is based on cost-benefit trade-offs. In other words, companies offer credit only when the additional earnings on credit sales exceed the costs of offering credit. There are two basic ways to record uncollectible which are called the specific *write-off (bad debt) method and the allowance method (provision). The first method does not comply the accrual basis of accounting and matching principle so it is general practice to follow provisioning method. Similarly, company should also provide provision for slow-moving, non-moving and obsolete inventories at the end of accounting year.*

Self-Examination Questions

I. Short Descriptive Questions (SDQs)

1. State the difference between accruals and prepayments.
2. Wirte provision regarding slow moving and non-moving inventory.

III. Practical Questions (PQs)

1. Prepare any necessary adjusting entries
   a. Rs. 3,000 purchase of equipment on December 30 was erroneously debited to Accounts Payable. The credit was correctly made to Cash.
   b. A business made several purchases of oil. Some purchases (Rs.800) were debited to Fuel expense, where other (Rs.100) was charged to an asset account. An oil gauge revealed Rs. 400 of fuel on hand at the end of the year. There was no fuel on hand at the beginning of the year. What adjustment was necessary on December 31.
   c. On April 1, a business took out a fire insurance policy. The policy was for 2 years, and the full premium of Rs. 1,600 was paid on April 1. The payment was debited to insurance Expense on April 1. What adjustment was necessary on December 31?
   d. On December 1, Rs. 6,000 was paid in advance to the landlord for 5 months rent. The tenant debited Prepaid Rent for Rs. 6,000 on December 1. What adjustment is necessary on December 31 on the tenant's books?
   e. Machinery is repaired and maintained by an outside maintenance company on an annual fee basis payable in advance. Rs 9,000 fee for the year beginning October 1 was paid and charged to Repairs and Maintenance Expense. What adjustment is necessary on December 31?
   f. On November 16, Rs. 800 for machinery was purchased, Rs. 200 cash was paid down, and a 90-day, 5 percent note payable was signed for the balance. The November 16 transaction was properly recorded. Prepare the adjustment for the interest.
   g. A publisher sells subscription to magazines. Customers pay in advance. Receipts are originally credited to Unearned Subscription Revenue. On June 1, Rs. 24,000 in 1-year subscriptions were collected and recorded. What adjustment was necessary on December 31?
   h. A 120-day, 8 percent Rs. 20,000 cash loan was made to customer on November 1. What adjustment was necessary on December 31?

2. Record the appropriate adjusting entries for the following situation. Assuming that the accounting period ends on December 31, 2012 and so all adjustment entries are made as of date.

(a) A physical count of office supplies indicates that Rs. 25,000 worth of office supplies were used during the accounting period.
(b) Rent totaling Rs. 25,000 for the month of November and December has not been paid by December 2012.
(c) You received a bill from the Kantipur for advertisements placed in the newspaper during the second week of November. The bill is for Rs. 12,000, not to be paid until January 15, 2015 .
(d) On December 1, 2012, you borrowed Rs. 10,00,000 from Nepal Bank Ltd. The bank charges you interest at an annual rate of 10% on the obligation, and interest is not to be repaid for 90 days. Record the adjusting entry to recognize the interest expense on the loan from December 1 to December 31, 2012.
(e) On July 1, 2012, you took out a fire insurance policy on the business premises. At that time you recorded the insurance premium in an asset account entitled "Prepaid Insurance" for the amount of the yearly premium of Rs. 36,000. On December 31, 2012 record the adjusting entry for this asset.
(f) Salaries are paid on January 1, 2015 for the month of December 2012 amounting Rs. 150,000. Record the adjusting entry necessary to recognize expense for the last month of 2012.

3. Record the following adjusting entries to reflect the accrual and deferral of expenses and revenue for the calendar year 2012.
(a) Recognized the interest income accumulated on a Rs. 50,000 note bearing interest of 9% dated November 2.
(b) Recorded an adjusting entry to recognize that income from commissions previously received but not yet earned to the extent of 40% of the Rs. 8,000 commission.
(c) Determined that the balance in the ledger account for office supplies was Rs. 9,900, but that an inventory showed only Rs. 2,600 of office supplies remaining.
(d) Accrued salaries for the last month in the previous year amounting to Rs. 150,000.
(e) Showed a balance of Rs. 2,270 in the prepaid insurance account. Insurance records indicate that Rs. 1,245 of the insurance expired during the year.

CHAPTER- 2

Accounting Systems and Processes

UNIT 8:

Rectification of Errors

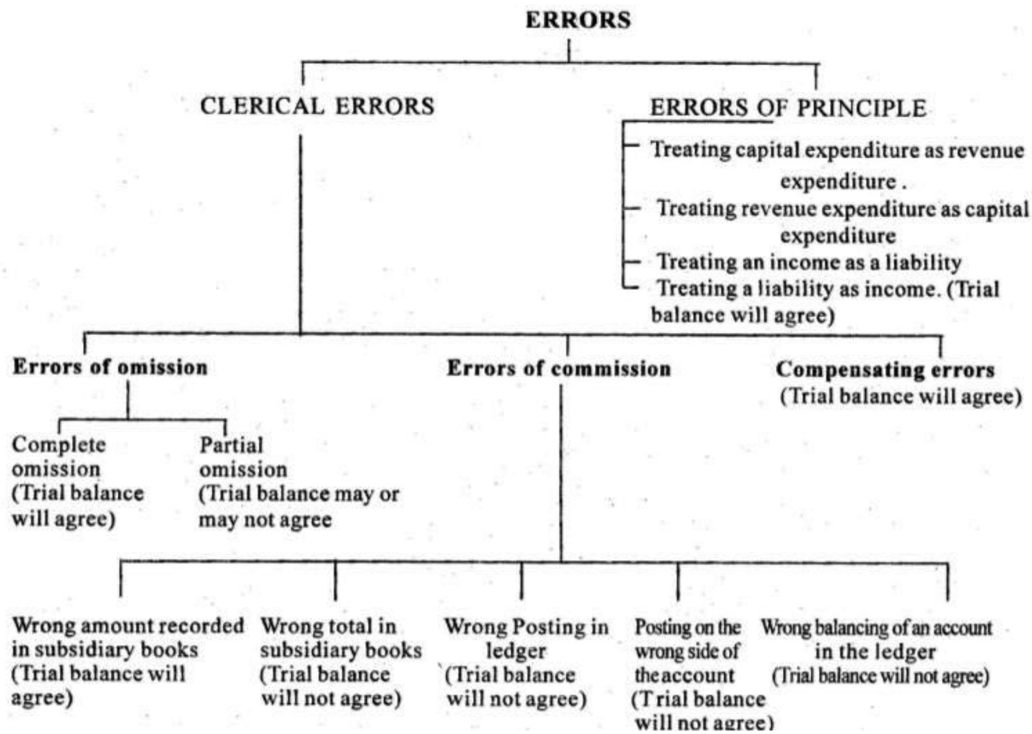
Learning Objectives

1. *Understand different types of errors which may occur in course of recording transactions and events;*
2. *Be familiar with the steps involved in locating errors;*
3. *Try to learn the nature of one-side errors and two-sides errors;*
4. *Understand why suspense account is opened for rectification of errors;*
5. *See how errors are cumulated to affect the Trial Balance;*
6. *Understand the technique of correcting errors of one period in the next accounting period.*

8. INTRODUCTION

Accountants prepare trial balance to check the correctness of accounts. If total of debit balances does not agree with the total of credit balances, it is a indication that certain errors have been committed while recording the transactions in the books original entry or subsidiary books. It is the utmost duty of the professional accountants to locate these errors and rectify them, only then preperation of final accounts begins .All the types of errors are not revealed by trial balance as some of the errors do not affect the total of trial balance. So these cannot be located with the help of trial balance. An accountant should locate both types of errors and rectify them before preparing Statement of Profit or Loss and Statement of Financial Positon. Because if these are prepared before rectification these will not give us the correct result and profit and loss disclosed by them, shall not be the actual profit or loss.

We have seen that after preparing ledger accounts a trial balance is taken out where debit and credit balances are separately listed and totalled. If the two totals do not agree, it is definite that there have been some errors. We shall now study the types of errors which may be committed and how they may be rectified.



8.1 TYPES OF ERRORS

All errors of accounting procedure can be classified as follows:

i. ***Errors of Principle:*** When a transaction is recorded in contravention of fundamental accounting principles, like revenue expenditure is treated as capital expenditure or vice versa i.e. treating the purchase of an asset as an expense, it is as error of principle. In this case, there is no effect on the trial balance since the amounts are on the correct side, though in a wrong account.

ii. ***Clerical Errors:*** These errors arise because of committed in the ordinary course of the accounting work. These types of errors arise due to negligence of accounting staff and lack of internal control system. These errors can be sub-divided as follows:

a. ***Errors of Omission:*** When a transaction is either wholly or partially not recorded in the books or if a transaction is completely or partially omitted from the books of account, it will be a case of omission. The case of partial omission reveals by the Trial Balance but the case of full omission doesn't reveal by the Trial Balance because it will not disturb the agreement of the trial balance. Examples would be: not recording a credit purchase of furniture for Rs. 10,000 either in Furniture Account or in Sundry Creditors Account. This will short fall of total of trial balance by Rs. 10,000 only.

b. ***Errors of Commission:***Error of commission takes place when an transcationis incorrectly recorded in books of account Such error include amount posted in the wrong account, recorded on the wrong side, the total is wrong or a wrong balances are recorded. Some of the errors of commission affect the trial balance whereas others do not. Preparing a trial balance can reveal errors affecting the trial balance.

c. ***Compensating Errors:*** Sometimes an error is counter-balanced by another error in such a way that it is not disclosed by the trial balance. These are a group of errors, the total of which is not reflected in the Trial Balance. These errors are of a neutralizing nature, i.e. one error is compensated by another error or by errors of an opposite nature. In other words, if the effect of the errors committed cancel out, the errors will be called compensating errors. The trial balance will agree even if these types of errors are made in books of accounts.

From the point of view of rectification of the errors, these can be divided into two groups:

(i) Those that affect the Trial Balance – because of the errors, that trial balance do not agree. These are:

(a) Wrong casting of the subsidiary books.

(b) Wrong balancing of an account.

(c) Posting an amount on the wrong side.

(d) Wrong posting, i.e., writing the wrong amount.

(e) Omitting to post an amount from a subsidiary book.

(f) Omitting to post the totals of subsidiary books in the ledger.

(g) Omitting to write the cash book balances in the trial balance.

(h) Omitting to write the balance of an account in the trial balance.
(i) Writing the balance in the wrong column of the trial balance.
(j) Totaling the trial balance wrongly.

(ii) The errors that do not affect the Trial Balance are the following:

1. Omitting an entry altogether from the subsidiary book.
2. Making an entry in the wrong subsidiary book.
3. Posting an amount in a wrong account but on the correct side, e.g. an amount to be debited to A is debited to B, the trial balance will still agree.
4. Recording in the books of account which was against the principle of accounting suppose on the purchase of a Computer, the office expenses account is debited; the trial still agree.
5. The effect of an error is cancelled by the effect of some other error that the trial balance will naturally agree. Suppose an amount of Rs.10,000 received from A is not credited to his account and total of the sales book is Rs.10,000 in excess. The omission of credit to A's account will compensated by the increased credit to the sales Account; which will not have any effect on the trial balance.

8.2 LOCATING THE ERRORS

Such errors, which have been discussed in above, should, first of all, be located and rectified. These are rectified either with the help of journal entry or by giving an explanatory note in the account concerned. Even if there is only a very small difference in the trial balance, the errors leading to it must be located and rectified. A small difference may be the result of a number of errors.

(i) The two columns of the trial balance should be totaled again. If in place of a number of accounts, only one amount has been written in the trial balance, the list of such accounts should be checked and totaled again. List of debtors is the example from which Sundry debtors balance is derived.

(ii) It should be seen that the cash and bank balance have been written in the trial balance.

(iii) The exact difference in the trial balance should be established. The ledger should be gone through; it is possible that a balance equal to the difference has been omitted from the trial balance. The difference should also be halved; it is possible that balance equal to half the difference has been written in wrong.

(iv) The ledger accounts should be balanced again.

(v) The casting of subsidiary books should be checked again, especially if difference is Rs.1, Rs 10, Rs 100 etc.

(vi) If the difference is very big, the balance in various accounts should be compared with the corresponding accounts in the previous period. If the figures differ materially the cases should be seen; it is possible that an error has been committed. Suppose the sales account for the current year shows a balance of Rs. 32,53,000 whereas it was Rs.36,45,000 last year; it is possible that there is an error in the sales account.

(vii) Posting of the amounts equal the difference or half the difference should be checked. It is possible that an amount has been omitted to be posted or has been posted on the wrong side.

(viii) If there is still a difference in the trial balance, a complete checking will be necessary. The posting of all the entries including the opening entry should be checked. It may be better to begin with the nominal accounts.

Some additional tips to locate errors

Following are four suggested aids in detecting errors revealed by differences between the debit and credit totals of the trial balance in a manual system. Since computerized systems are usually programmed to reject entries that would create a debit-credit imbalance.

1. If the difference between the totals is 0.01, 1.00, 100, 1000 and so forth, the error is probably in addition. Such an error is usually detected by re-adding the columns of the trial balance or, if necessary, the columns in the ledger accounts.
2. Where the discrepancy is an even number, the error may be the result of making a debit entry in a credit column, of vice versa. Divide the difference in totals by 2 and look through first the trial balance and then the ledger accounts for an amount corresponding to this quotient. The difference is divided by 2 because an item placed in the wrong column results in a difference of twice its amount.
3. If the difference is divisible by 9, the error is probably either a transposition or a trans-placement, and the search can be narrowed down to numbers where these errors might have been made. A transposition occurs when 79 is written for 97, 318 for 813, and so on. A trans-placement, or slide, occurs when the digits of the number are moved to the left or right, as when Rs. 6,328.00 is written as Rs. 632.80 or Rs. 63.28.
4. When the source of error is not readily noticeable, it is advisable to check the trial balance against the ledger to determine whether all the account balances have been copied properly. This check may reveal that certain accounts have been omitted. As a last resort, it may be necessary to additions and subtraction in several accounts.

If it is not possible to locate the errors in spite of the above steps, the difference in the trial balance is transferred temporarily to an account known as "Suspense Account" which has been discussed in previous chapter. The trial balance can now be totaled up and balanced. Afterward, when errors have been located, they can be corrected through suspense account.

8.3 RECTIFICATION OF ERRORS

Errors should never be corrected by overwriting. If immediately after making an entry, it is clear that an error has been committed, it may be corrected neatly crossing out the wrong entry and making the correct entry. If however the errors are located after some period of accounting year, the correction should be made by making another suitable entry, called rectification entry. In fact the rectification of an error depends on which stage it is detected. An error can be detected at any one of the following stages:

(a) Before preparation of the Trial Balance.
(b) After Trial Balance but before the Final Accounts are drawn.
(c) After Final Accounts, i.e. in the next accounting period.

8.3.1 Before Preparation of Trial Balance

8.3.1.1 One-Sided Errors

There are some errors which affect one side of an account or which affect more than one account in such a way that it is not possible to pass a complete rectification entry. In other words, there are some errors which can be corrected, if detected at this stage, by making rectification statements in the side appropriate side(s) of concerned accounts(s). It is important to note here that such errors may involve only one account or more than one account. The various examples of one-sided errors are as follows:

(a) Errors due to partial omission
(b) Errors of casting
(c) Errors in carrying forward
(d) Errors in totaling of balancing of an account
(e) Errors of posting (other than an error of posting a correct amount in the wrong account but on the correct side)
(f) Omission of posting the total of a subsidiary book
(g) Omission of an account from trial balance
(h) Entering the balance of an account in the wrong amount column of the trial balance
(i) Wrong totaling of the trial balance

Read the following illustration:

(i) The sales book for May is undercast by Rs. 500. The effect of this error is that the sales account has been credited short by Rs. 500. Since, the account is posted by the total of the sales book; there is no error in the accounts of the customers because they are posted with the amounts of individual sales. Hence, only sales account is to be corrected. This will be done by making an entry for Rs. 500 on credit side:'By undercasting of sales book for May Rs. 500.

(ii) While posting the discount column on the debit side of the cash book the discount of Rs. 100 has not been posted. There is no error in the cash book; the total of the discount column presumably has been posted to the discount account on the debit side. The error is not crediting party's account by Rs. 100. This should now be done by the entry "By Omission of posting of discount on ----- Rs. 100.

(iii) Received amount of Rs. 5,000 has been entered by mistake on the debit side of party's account. Since the cash book seems to have been correctly written, the error is only in the sundry debtors' account that should have been credited and not debited . Not only is the wrong debit to be removed but also a credit of Rs. 5,000 is to be given. This can be done now by entering Rs. 10,000 on the credit side of respective party's account. The entry will be "By, Posting on the wrong side on ------- Rs. 10,000.

(iv) Rs. 5,000 was received from customer Mr. Mohan and entered on the debit side of cash book but was not posted to his account. By the error, which effect only the account of Mohan, Rs.5,000 has been omitted from the credit side of his account. The rectification will be by the entry 'By Omission of posting on------ Rs. 5,000.

(v) Rs. 91 paid to Mr. Rakesh has been posted as Rs. 19 to the debit side of his account. Mr. Rakesh has been debited short be 72. The rectifying entry is "To, Mistake posting on ----- Rs. 72.

(vi) Goods sold to Mr. Ramesh for Rs. 1,000 was wrongly posted from sales day book to the debit of purchase account. Ramesh has however been correctly debited. Here the error affects two accounts, viz., purchases account and sales account but we cannot pass a journal entry for rectification because both the accounts need to be credited. The rectification will be the entry 'By Wrong posting on-------- Rs. 1,000' in the credit of purchases account and also 'By Omission of posting on –Rs. 1,000' in the credit of sales account.

(vii) Bill receivable from Mr. Awatar of Rs 1,500 was posted to the credit of Bills Payable Account and also credited to Mr. Awatar's Account. Here also although two accounts are involved we cannot pass a complete journal entry for rectification. The rectification will be by the entry 'To, wrong posting on ---- Rs. 1,500 in the debit of Bills Payable account and also 'To, omission of posting on ----- Rs. 1,500 in the debit side of Bills Receivable Account.

(viii) Goods purchased from Miss. Malika for Rs. 10,000 was wrongly credited to Miss. Balika's account by Rs. 1,000. Again we cannot pass a complete journal entry for rectification even though two accounts are involved. The rectification will be done by entry "To, wrong posting on – Rs, 1,000 in the debit of Miss. Balika's account and "By, omission of posting on- Rs, 10,000" in the credit of Miss. Malika's account.

Thus, we learn that the general rule that errors affecting two accounts can always be corrected by journal entry is not always valid.

Illustration 1

How would you rectify the following errors in the book of M/s. Rara & Co.?

1. The total of the Purchases Book has been undercast by Rs. 1,000.
2. The Returns Inward Book has been undercast by Rs. 500.
3. A sum of Rs. 250 written off as depreciation on Machinery has not been debited to Depreciation Account.
4. A Payment of Rs. 750 for salaries (to Mr. Mohan) has been posted twice to Salaries Account.
5. The total of Bills Receivable Book Rs. 1,500 has been posted to the credit of Bills Receivable Account.
6. An amount of Rs 1,510 for credit sales to Mr. Harish, although correctly entered in the Sales Book, has been posted as Rs. 1,150.
7. Discount allowed to Mr. Satish Rs. 250 has not been entered in the Discount Column of the Cash Book but it has been posted to his personal account.

Solution:

1. The Purchase Account should receive another debit of Rs 1,000 since it was debited short, previously.
   'To, Undercasting of Purchases Book for the month of –Rs. 1,000'
2. Due to this error the Returns Inward Account has been posted short by Rs. 500, the correct entry will be:
   'To, Undercasting of Returns Inward Book for the month of –Rs. 500'
3. The omission of the debit to the Depreciation Account will be rectified by the entry:

'To, Omission of posting on – Rs. 250'

4. The excess debit will be removed by a credit in the Salaries Account by the entry:
   'By, Double posting on – Rs. 750'
5. Rs. 1,500 should have been debited to the Bills Receivable Account and not credited. To correct the mistake, the Bills Receivable Account should be debited by Rs, 3,000 by the entry.
   'To, Wrong posting of B/R received on- Rs. 3,000'
6. Mr. Harish's personal A/c is debited Rs. 360 short, the rectification entry will be:
   'To, Wrong posting –Rs. 360'
7. Due to this error, the discount account has been debited short by Rs. 250. The required entry is:
   'To, Omission of discount allowed to Mr. Satish on Rs. 250'

So far we have discussed the correction of errors which affected only one Account or more than one account but for which rectifying entries were not complete journal entries in fact that rectifying entry is made directly in the account(s) concerned.

8.3.1.2 Two Sided Errors

Correction of errors which affects more than one account in such a way that complete journal entries are possible for their rectification. Examples are as follows:

(i) **The purchase of Machinery for Rs. 200,000 has been entered in the purchase book**.

The effect of the entry is that the account of the supplier has been credited by Rs. 200,000 which is quite correct. But the debit to the Purchase Account is wrong: the debit should be to the Machinery Account. To rectify the error, the debit in the purchase account has to be transferred to the Machinery Account. Following steps can be taken for rectification of these types of errors.

a. Wrong entry:

Purchase A/c	Dr.	200,000	
To, Creditors			200,000

b. Reverse Entry:

Creditors A/c	Dr.	200,000	
To, Purchase			200,000

c. Correct entry:

Machinery A/c	Dr.	200,000	
To, Creditors			200,000

d. Rectification entry (Consolidated Entry of b & c)

Machinery A/c	Dr.	200,000	
To, Purchase A/c			200,000

(ii) Rs. 10,000 received from Mr. Kamal Kumar has been credited in the account of Mr. Krishna Kumar.

The error is that there is a wrong credited in the account of Mr. Krishna Kumar and omission of credit in the account of Mr. Kamal Kumar. Mr. Krishna Kumar should be debited and Mr. Kamal Kumar be credited. The following three entries make this clear:

Wrong Entry:

Cash Account	Dr.	10,000	
To, Krishna Kumar A/c			10,000

Correct Entry:

Cash Account	Dr.	10,000	
To, Kamal Kumar A/c			10,000

Rectification Entry:

Krishna Kumar A/c	Dr.	10,000	
To, Kamal Kumar A/c			10,000

(iii) The sale of old machinery, Rs. 15,000 has been entered in the sales book.

By this entry the account of the buyer has been correctly debited by Rs. 15,000. But instead of crediting the Machinery Account, Sales Account has been credited. To rectify the error Sales account should be debited and the Machinery Account credited, See the three entries given below:

Wrong Entry:

Buyer's Account	Dr.	15,000	
To, Sales Account			15,000

Correct Entry:

Buyer's Account	Dr.	15,000	
To, Machinery Account			15,000

Rectification Entry:

Sales Account	Dr.	15,000	
To, Machinery Account			15,000

Illustration 2

Pass the necessary journal entries to rectify the following errors:

a. A credit sale of Rs. 1,700 to Sushil was posted Sunil's Accounts.

b. A cash sale of Rs. 20,000 to Mukesh was posted to the credit of Mukesh.

c. A credit sale of old furniture to Bishnu for Rs. 2,700 was credited to Sales A/c.

d. A cheque for Rs. 12,800 received from Srikant was dishonored and has been posted to the debit of Sales Revenue Account.

e. An amount of Rs. 5,720 due from Lila Prasad, written off as bad debts in previous year, was recorded and credited to the personal account of Lila Prasad.
f. A discounted Bill Receivable for Rs. 32,000 returned by the firm's bank had been credited to the Bank Account and debited to Bills Receivable Account. A cheque was received later from the customer for Rs. 32,000 as duly paid.
g. Rs. 4,000 paid for the telephone bill of the telephone at the proprietor's residence was debited to Postage Account.
h. An amount of Rs. 15,000 withdrawn from bank by the proprietor for his personal use has been charged to Trade Expenses Account.
i. An amount of Rs. 3,000 withdrawn from Bank by the proprietor for office use has been debited to Drawings Account.
j. Rs. 16,000 paid as salary to staff and debited to staff's personal account.
k. Rs. 2,000 paid as Rent to Baburam, a landlord, debited to Baburam.

Solution

a.	**Wrong Entry:**			
	Sunil A/c	Dr.	1,700	
	To, Sales A/c			1,700
	Correct Entry			
	Sushil A/c	Dr.	1,700	
	To, Sales A/c			1,700
	Rectifying Entry			
	Sushil A/c	Dr.	1,700	
	To, Sunil A/c			1,700
b.	**Wrong Entry:**			
	Cash A/c	Dr.	20,000	
	To, Mukesh A/c			20,000
	Correct Entry			
	Cash A/c	Dr.	20,000	
	To, Sales A/c			20,000
	Rectifying Entry			
	Mukesh A/c	Dr.	20,000	
	To, Sales A/c			20,000
c.	**Wrong Entry:**			
	Bishnu A/c	Dr.	2,700	
	To, Sales A/c			2,700
	Correct Entry			
	Bishnu A/c	Dr.	2,700	
	To, Furniture A/c			2,700
	Rectifying Entry			
	Sales A/c	Dr.	2,700	
	To, Furniture A/c			2,700

d.	**Wrong Entry:**			
	Sales A/c	Dr.	12,800	
	To, Bank A/c			12,800
	Correct Entry			
	Srikant A/c	Dr.	12,800	
	To, Bank A/c			12,800
	Rectifying Entry			
	Srikant A/c	Dr.	12,800	
	To, Sales A/c			12,800
e	**Wrong Entry:**			
	Cash A/c	Dr.	5,720	
	To, Lila Prasad A/c			5,720
	Correct Entry			
	Cash A/c	Dr.	5,720	
	To, Bad Debt Recovered A/c			5,720
	Rectifying Entry			
	Lila Prasad A/c	Dr.	5,720	
	To, Bad Debt Recovered A/c			5,720
f	**Wrong Entry:**			
	Bills Receivable A/c	Dr.	32,000	
	To, Bank A/c			32,000
	Correct Entry			
	Customer's A/c	Dr.	32,000	
	To, Bank A/c			32,000
	Rectifying Entry			
	Customer's A/c	Dr.	32,000	
	To, Bills Receivable A/c			32,000
g.	**Wrong Entry:**			
	Postage A/c	Dr.	4,000	
	To, Cash A/c			4,000
	Correct Entry			
	Drawing A/c	Dr.	4,000	
	To, Cash A/c			4,000
	Rectifying Entry			
	Drawing A/c	Dr.	4.000	
	To, Postage A/c			4,000
h.	**Wrong Entry:**			
	Trade Expenses A/c	Dr.	15,000	
	To, Bank A/c			15,000
	Correct Entry			
	Drawing A/c	Dr.	15,000	

	To, Bank A/c			15,000
	Rectifying Entry			
	Drawing A/c	Dr.	15,000	
	To, Trade Expenses A/c			15,000
i.	**Wrong Entry:**			
	Drawing A/c	Dr.	3,000	
	To, Bank A/c			3,000
	Correct Entry			
	Cash A/c	Dr.	3,000	
	To, Bank A/c			3,000
	Rectifying Entry			
	Cash A/c	Dr.	3,000	
	To, Drawing A/c			3,000
j.	**Wrong Entry:**			
	Staff's Personal A/c	Dr.	16,000	
	To, Bank A/c			16,000
	Correct Entry			
	Salary A/c	Dr.	16,000	
	To, Bank A/c			16,000
	Rectifying Entry			
	Salary A/c	Dr.	16,000	
	To, Staff's Personal A/c			16,000
k.	**Wrong Entry:**			
	Baburam A/c	Dr.	2,000	
	To, Bank A/c			2,000
	Correct Entry			
	Rent A/c	Dr.	2,000	
	To, Bank A/c			2,000
	Rectifying Entry			
	Rent A/c	Dr.	2,000	
	To, Baburam A/c			2,000

Illustration 3

The following errors were found in the book of M/s. RPP& Sons. Give the necessary entries to correct them.

1. Rs. 5,000 paid for furniture purchased has been charged to ordinary Purchases A/c.
2. Repairs made were debited to Building A/c for Rs. 15,000.
3. An amount of Rs, 1,000 withdrawn by the proprietor for his personal use has been debited to Trade Expenses A/c.
4. Rs. 10,000 paid for rent debited to Landlord's A/c.
5. Salary Rs. 12,500 paid to a staff due to him has been debited to his personal account.

6. Rs. 10,000 received from M/s. Shah & Co. has been wrongly entered as from M/s. Shaw & Co.
7. Rs. 37,000 paid in cash for a Computer was charged to Office Expenses Account.

Solution

Date	Particular		Debit	Credit
1	Furniture A/c	Dr.	5,000	
	To, Purchase A/c			5,000
	(Correction of wrong debited to Purchase account for furniture purchase)			
2	Repairs and Maintenance A/c	Dr.	15,000	
	To, Building A/c			15,000
	(Correction of wrong debited to Building account for repairs of building)			
3	Drawing A/c	Dr.	1,000	
	To, Trade Expenses A/c			1,000
	(Correction of wrong debited to Trade expenses account for cash withdrawn by proprietor for personal use)			
4	Rent A/c	Dr.	10,000	
	To, Landlord A/c			10,000
	(Correction of wrong debited to Landlord account for rent paid)			
5	Salary A/c	Dr.	12,500	
	To, Staff personal A/c			12,500
	(Correction of wrong debited to staff's personal account for salary paid)			
6	Shaw & Co. A/c	Dr.	10,000	
	To, Shah & Co. A/c			10,000
	(Correction of wrong credited to M/s. Shaw & Co. instead of M/s. Shah & Co.)			
7	Office Equipment-Computer A/c	Dr.	37,000	
	To, Office Expenses A/c			37,000
	(Correction of wrong debited to office expenses account for acquisition of Computer)			

Illustration 4

Give journal entries to rectify the following:

1. A purchase of goods from Mr. Ram amounting to Rs. 15,000 has been wrongly entered through the Sales Book.
2. A Credit Sales of goods Rs. 12,000 to Mr. Ramesh has been wrongly passed through the Purchase Book.
3. On 31st December 2012, goods of the value of Rs. 30,000 were returned by Mr. Krish and were taken into stock on the same date but no entry was passed in the books.
4. An amount of Rs. 2,000 due from Mr. Saroj, which had been written off as a Bad Debt in a previous year, was unexpectedly recovered, and had been posted to the personal account of Mr. Saroj.
5. A cheque for Rs. 1,000 received from Mr. Man Bahadur was dishonored and had been posted to the debit of Sales Returns Account.

Solution

Date	Particular		Debit	Credit
1	Sales A/c	Dr.	15,000	
	Purchases A/c	Dr.	15,000	
	To, Ram A/c			30,000
	(Correction of wrong entry in sales book for purchase of good from Ram)			
2	Ramesh A/c	Dr.	24,000	
	To, Purchase A/c			12,000
	To, Sales A/c			12,000
	(Correction of wrong entry in purchase book for credit sale of good to Ramesh)			
3	Sales Return A/c	Dr.	30,000	
	To, Krish A/c			30,000
	(Goods returned by Krish omitted to record has been recorded)			
4	Saroj A/c	Dr.	2,000	
	To, Bad Debts Recovered A/c			2,000
	(Correction of wrong credited to Personal A/c in respect of recovery of previously written off bad debts)			

5	Man Bahadur A/c Dr. To, Sales Return A/c (Correction of wrong debited to sales Return A/c for dishonor of cheque received from Man Bahadur)	1,000	 1,000

8.3.2 Rectification after Preparing Trial Balance but Before the Final Account

Sometimes the trial balance is artificially made to agree in spite of errors by putting the difference in the trial balance in suspense account. The Suspense Account will be debited if the total of the credit column in the trial balance exceeds the total of the debit column; it will be credited in the other case for temporary measure. It should be noted that such agreement of the trial balance would not be real. Effort must be made to locate the errors.

The rule of rectifying errors detected at this stage of rectification (i.e. before trial balance) can now be rectified by way of journal entry with the help of suspense account, for it is these errors which gave rise to the suspense account in trial balance as discussed in previous unit. In case of double-side errors, the same procedure is followed as in rectification before preparing the trial balance. In case of single-side errors, the affected account is to be debited/credited, as the case may be, and the other side A/c (in journal entries) is to be shown in Suspense A/c.

In a nutshell, it can be said that each and every error detected at this stage can only be corrected by a complete journal entry. Those errors for which journal entries were not possible at the earlier stage will now be rectified by a journal entry, the difference or the unknown side is being taken care of by suspense account.

Illustration 5

A book-keeper while preparing trial balance finds that the debit exceeds by Rs. 500. He places the difference to a Suspense Account. Pass the necessary journal entries to rectify the following errors discovered by the auditor and prepare Suspense Account.

(a) A cheque from A for Rs. 150 had been posed to the credit of A as Rs. 100
(b) Goods worth Rs. 100 purchased from Chandra were entered in the Sales book. However, the account of Chandra was correctly credited.
(c) A Credit balance of Rs. 755 of Rent Received Account was shown as Rs. 570.
(d) Goods worth Rs. 130 returned by Jems were entered in the Sales Book and were posted therefrom to the credit Jems' personal Account.
(e) Bills Receivable from Hari Shankar of Rs. 1,600 posted to the Credit of Bills Payable Account and also credited to Hari Shankar.
(f) An amount of Rs. 800 owing by a customer had been omitted from the list of Sundry Debtors.
(g) A credit item of Rs, 349 has been debited to a Personal Account of customer as Rs, 439.
(h) A discount allowed to a customer has been credited to him as Rs. 145 in place of Rs. 154.
(i) Total sales of Rs. 594 had been posted as Rs. 495 in the Sales Account.
(j) Discount received of Rs. 1,420 had been debited to discount allowed account.
(k) Cash received from Maxy Rs. 720 was posted to the debit of Max as Rs. 270.

Solution

a

Date	Particular		Debit	Credit
a	Suspense A/c	Dr.	50	
	To, A's A/c			50
	(Correction of short amount credited to A's A/c)			
b	Sales A/c	Dr.	100	
	Purchase A/c	Dr.	100	
	To, Suspense A/c			200
	(Purchase wrongly treated as sales now corrected)			
c	Suspense A/c	Dr.	185	
	To, Rent Received A/c			185
	(Correction of short amount credited to Rent Received A/c)			
d	Sales A/c	Dr.	130	
	Sales Return A/c		130	
	To, Suspense A/c			260
	(Correction of wrong credited to sales A/c in respect of goods returned by Jems)			
e	Bills Payable A/c	Dr.	1,600	
	Bills Receivable A/c		1,600	
	To, Suspense A/c			3,200
	(Correction of wrong credited to Bills Payable A/c for bills received from Hari Shankar)			
f	Sundry Debtors A/c	Dr.	800	
	To, Suspense A/c			800
	(Omission of record regarding amount due from customer have been provided)			
g	Suspense A/c	Dr.	788	
	To, Customer's A/c			788
	(Rectification of wrong posting in customer's A/c)			
h	Suspense A/c	Dr.	9	
	To, Customer's A/c			9

	(Rectification of under credit in customer's A/c)			
i	Suspense A/c	Dr.	99	
	To, Sales A/c			99
	(Rectification of under credit in Sales A/c)			
j	Suspense A/c	Dr.	2,840	
	To, Discount allowed A/c			1,420
	To, Discount Received A/c			1,420
	(Rectification of discount received amount wrongly posted in discount allowed A/c)			
k	Suspense A/c	Dr.	990	
	To, Max A/c			270
	To, Maxy A/c			720
	(Rectification of wrong amount posting in wrong account)			

Suspense A/c

Particulars	Rs.	Particulars	Rs.
To, A's A/c	50	By, Balance b/d	500
To, Rent Received A/c	185	By, Sales& Purchase A/c	200
To, Customer's A/c	788	By, Sales& Sales Return A/c	260
To, Customer's A/c	9	By, Bills Payable A/c	1,600
To, Sales A/c	99	By, Bills Receivable A/c	1,600
To, Discount Allowed A/c	1,420	By, Sundry Debtors A/c	800
To, Discount Received A/c	1,420	**By, Balance c/d**	**1**
To, Max A/c	270		
To, Maxy A/c	720		
	4,961		**4,961**

Illustration 6

Pass journal entries to rectify the following errors (after preparation of the trial balance but before preparation of the final account).

(a) Goods purchased for Rs. 2,300 from K.K. Traders but wrongly credited Rs. 3,200 to K.K. Traders A/c and debited to Purchase A/c Rs. 230 only.

(b) Goods purchased for Rs. 560 had been posted to the credit of the Suppliers A/c as Rs. 60.

(c) Rs. 400 due from a customer was omitted, to be taken in the schedule of sundry debtors.

(d) Rs. 34,000 paid for purchase of computer, was charged to Office Expenses A/c.

(e) Rs. 5,000 paid to the landlord for rent wrongly debited to Landlord's Personal A/c.

(f) Rs. 3,000 cash withdrawn by the proprietor for personal use debited to Trade Expenses A/c.

(g) Bad debt amounting to Rs. 300 recovered but credited to Personal A/c.

(h) Sale worth Rs. 2,500 to S.S. Bros. wrongly passed through the purchase day book.

(i) Goods worth Rs. 620 returned by a customer were taken in to stock but no entry was made in the book.

(j) A sale of Rs. 650 to I.P. Pokharel was entered in the sales book as Rs. 560.

Solution

Journal Entries

S.No.	Particulars		L.F.	Dr. (Rs.)	Cr. (Rs.)
(a)	Purchase A/c	Dr.		2,070	
	K.K. Trader's A/c	Dr.		900	2,970
	To, Suspense A/c				
	(Being purchase & entry to supplier's account rectified.)				
(b)	Suspense A/c	Dr.		500	
	To, Suppliers A/c				500
	(Being rectification of error of wrong amount posting.)				
(c)	Sundry Debtors A/c	Dr.		400	
	To, Suspense A/c				400
	(Being error of omission rectified.)				
(d)	Office Equipment-computer A/c	Dr.		34,000	
	To, Office Expenses A/c				34,000
	(Being purchase of computer recorded as Office expense now rectified.)				
(e)	Rent A/c	Dr.		5,000	
	To, Landlord's Personal A/c				5,000
	(Being rent paid wrongly debited to landlord's account now rectified.)				
(f)	Drawing A/c	Dr.		3,000	
	To, Trade Expenses A/c				3,000
	(Being withdrawl for personal use debited to trade expense, now rectified.)				
(g)	Customer's Personal A/c	Dr.		300	
	To, Bad Debts Recovered A/c				300
	(Being bad debt recovered credited to personal account of customer, now rectified.)				
(h)	S.S. Bros A/c	Dr.		5,000	
	To, Purchase A/c				2,500
	To, Sales A/c				2,500
	(Being sales entered as purchase rectified.)				
(i)	Return Inward A/c	Dr.		620	

	To, Customer's A/c (Being entry of sales return passed which was omitted.)			620
(j)	I.P. Pokharel A/c Dr. To, Sales A/c (Being wrong amount entry of sales, now rectified.)		90	90

Illustration 7

A firm noticed that its trial balance on December 31. 2012 did not agree and as such, the difference (excess credit) Rs. 570 was carried to the Suspense Account and the books were closed. Ongoing through the records, the following errors were detected;

a. Annual whitewashing of Rs. 6,000 was debited to Building A/c.
b. A sales return of Rs. 450 from Mr. Gautam was entered in the sales book.
c. Return outwards book undercast by Rs. 100.
d. An item of Rs. 170 was posted as Rs. 710 in the Sales A/c.
e. A credit sale of Rs. 900 to Mr. Dinesh Basnet was debited to Mr. Divesh Basnet.
f. A sum of Rs. 250 received from a debtor was debited to his account.
g. Discount allowed of Rs. 350 was credited to Discount Received A/c.
h. A sale of Rs. 600 to Miss. Manisha was credited to her account.
i. Sales day book overcast by Rs. 100.
j. Cash sales of Rs. 300 to Miss. Rachana debited to her A/c in the ledger.
k. A Purchase of Rs. 250 had been posted to the debit of Suppliers Mr. Kamal as 520.

Show journal entries which are necessary to correct the above errors and prepare the suspense account. Work out their effect on the Profit and Loss of the concern.

Solution

Rectification Entries

S.No.	Particulars	L.F.	Dr. (Rs.)	Cr. (Rs.)
(a)	Repairs and Maintenance Exp-Whitewashing A/c Dr. To, Building A/c (Being rectification of error)		600	600
(b)	Sales Return A/c Dr. Sales A/c Dr. To, Mr. Gautam A/c (Being rectification of error)		450 450	900
(c)	Suspense A/c Dr. To, Return Outwards A/c (Being rectification of error)		100	100
(d)	Sales A/c Dr. To, Suspense A/c (Being rectification of error)		540	540
(e)	Dinesh Basnet A/c Dr. To, Divesh Basnet A/c		900	900

	(Being rectification of error)			
(f)	Suspense A/c	Dr.	500	
	To, Debtors A/c			500
	(Being rectification of error)			
(g)	Discount Received A/c	Dr.	350	
	Discount Allowed A/c	Dr.	350	700
	To, Suspense A/c			
	(Being rectification of error)			
(h)	Manisha A/c	Dr.	1,200	
	To, Suspense A/c			1,200
	(Being rectification of error)			
(i)	Sales A/c	Dr.	100	
	To, Suspense A/c			100
	(Being rectification of error)			
(j)	Suspense A/c	Dr.	600	
	To, Sales A/c			300
	To, Rachana A/c			300
	(Being rectification of error)			
(k)	Suspense A/c	Dr.	770	
	Kamal A/c			770
	(Being rectification of error)			

Suspense A/c

S.N.	Particulars	(Rs.)		S.N.	Particulars	(Rs.)
	To, Balance b/d	570		(d)	By, Sales A/c	540
(c)	To, Return Outwards A/c	100		(g)	By, Discount Received A/c	350
(f)	To, Debtors A/c	500			By, Discount Allowed A/c	350
(j)	To, Sales A/c	300		(h)	By, Manish A/c	1,200
	To, Pratap A/c	300		(i)	By, Sales A/c	100
(k)	To, Kamal	770				
		2,540				**2,540**

Effect of Rectification of Errors on Net Profit

S.N.	Items	Effects	
		Increase in profit (Rs.)	**Decrease in profit (Rs.)**
(a)	Decrease	-	600
(b)	Decrease	-	900
(c)	Increase	100	-
(d)	Decrease	-	540
(e)	No effect	-	-
(f)	No effect	-	-
(g)	Decrease	-	700
(h)	No effect	-	-

(i)	Decrease	-	100
(j)	Increase	300	-
(k)	No effect	-	-
		400	2,840
	Net decrease in profit	2,440	
		2,840	**2,840**

8.3.3 Rectification in the Next Accounting Period

Rectification of errors discussed so far assumes that it was carried out before the books were closed for the concerned year. However, sometimes, the rectification is carried out in the next year, carrying forward the balance in the Suspense account. In this case, it should be noted that there should be no violation of the principle that the Statement of Profit or Loss should reflect amounts relating to the year for which the account is being prepared- i.e amounts relating to the previous years, if they are substantial, should be shown separately. Suppose, the Purchase Book was undercast Rs. 10,000 in December 2012 and a suspense account was opened with the difference in the trial balance. If the error is rectified next year and the entry is passed by debiting purchase account (and credit Suspense Account), it shows that the Purchase account for 2013 will be Rs. 10,000 more than the amount relating to 2013 and thus the profit for 2013 will be less than the actual for that year. Thus, correction of errors in this manner will 'falsify' the Statement of Profit or Loss. To avoid this, correction of all amounts concerning nominal accounts i.e. expenses and incomes should be through a special account as “Prior Period Items" or "Profit and Loss Adjustment Account". The balance in this account should be shown under equity, which will not be any disturb to current year net profit or loss.

Illustration 8

The following errors were disclosed in the books of Mr. Madan Guragai on Ashad 31, 2072. The difference in the trial balance has been transferred to a Suspense Account and on correction of errors the Suspense A/c was eliminated:

(a) While carrying forward the total of one page of the sales book to the next, the amount of Rs. 1,850 was written as Rs. 1,580.
(b) Goods bought from a trader amounting to Rs. 152 had been posted to the credit of his account as Rs. 125.
(c) Rs. 380 cash received from Miss. Karuna was debited to Mr. Karma.
(d) Sales to Mr. X of Rs. 450 credited to Miss.Y's A/c as Rs. 540.
(e) The total of discount column in the cash-book on the debit side was Rs. 715 on one page but was carried forward to the next page as Rs. 517.
(f) A machine which stood in the book at Rs. 3,900 was sold for Rs. 1,950 in part exchange of a new machine costing Rs. 8,300 and the net invoice of Rs. 6,350 was passed through the purchase day book.
(g) Bad debts amounting to Rs. 710 recovered by credited to party's account and included in the list of creditors.
(h) A cheque of Rs. 7,200 was paid to a creditor, who allowed 10% cash discount but the payment was wrongly posted to Purchase A/c as Rs. 720 only without any other entry.

(i) An old furniture (of book value Rs. 3,800) was sold for Rs, 2,100 but the proceeds had been wrongly credited to Sales A/c
(j) A credit purchase of Rs. 2,350 had been passed twice through the purchase book.
(k) Rs. 620 paid toward carriage for purchase of machinery was debited to Carriage A/c as Rs. 260.
(l) Goods purchased for credit from M/s. SK. Brothers for Rs. 640 had been entered in the sales day book as Rs. 460, but the Party A/c was credited by Rs. 460.

Pass necessary rectification entries, close the Suspense A/c. Give necessary journal entries if corrections are made after preparation of the Final A/c.

Solution

Rectification Entries

Before final account	After final account
(a) Suspense A/c Dr. 270 To, Sales A/c 270 (For sales book shown short-now corrected)	(a) Suspense A/c Dr. 270 To, P/L Adjustment A/c 270 (For sales book shown short-now corrected)
(b) Suspense A/c Dr. 27 To, Suppliers A/c 27 (For Supplier's A/c shown short-now corrected)	(b) Suspense A/c Dr. 27 To, Suppliers A/c 27 (For Supplier's A/c shown short-now corrected)
(c) Suspense A/c Dr. 760 To Karuna A/c 380 To Karma A/c 380 (For cash received from Karuna but debited to Karma A/c-now corrected.)	(c) Suspense A/c Dr. 760 To Karuna A/c 380 To Karma A/c 380 (For cash received from Karuna but debited to Karma A/c-now corrected.)
(d) X's A/c Dr. 450 Y's A/c Dr. 540 To, Suspense A/c 990 (For goods sold to X but credited to Y-now corrected)	(d) X's A/c Dr. 450 Y's A/c Dr. 540 To, Suspense A/c 990 (For goods sold to X but credited to Y-now corrected)
(e) Discount Allowed A/c Dr. 198 To, suspense A/c 198 (For discount allowed A/c was shown short-now corrected.)	(e) P/L Adjustment A/c Dr. 198 To, suspense A/c 198 (For discount allowed A/c was shown short-now corrected.)
(f) Machinery A/c Dr.8,300 Loss on Sale A/c Dr.1,950 To, Machinery(old) A/c 3,900 To, Purchase A/c 6,350 (For sale of old machinery in part exchange of a new machinery and the net invoice was passed through the purchase day book-now rectified,)	(f) Machinery A/c Dr.8,300 To, Machinery A/c 3,900 To, P/L Adjustment A/c 4,400 (6,350-1,950) (For sale of old machinery in part exchange of a new machinery and the net invoice was passed through the purchase day book-now rectified,)
(g) Creditors A/c Dr. 710 To, Bad Debts Recovery A/c 710	Creditors A/c Dr. 710 To, P/L Adjustment A/c 710

(For bad debts recovered but credited to Party's A/c-now corrected.)	(For bad debts recovered but credited to Party's A/c-now corrected.)
(h) Creditors A/c Dr.8,000 To, Discount Received A/c 800 To, Purchase A/c 720 To, Suspense A/c 6,480 (For cheque issued to a creditor and received 10% discount but recovered in Purchase A/c – now rectified)	(h) Creditors A/c Dr.8,000 To, P/L Adjustment A/c 1,520 To, Suspense A/c 6,480 (For cheque issued to a creditor and received 10% discount but recovered in Purchase A/c –now rectified)
(i) Sales A/c Dr.2,100 Loss on Sale A/c Dr.1,700 To, Furniture A/c 3,800 (For sale of an old furniture and sale proceeds credited to Sales A/c-now corrected)	(i) P/L Adjustment A/c Dr.3,800 To, Furniture A/c 3,800 (For sale of an old furniture and sale proceeds credited to Sales A/c-now corrected)
(j) Creditors A/c Dr. 2,350 To, Purchase A/c 2.350 (For a purchase recorded twice in the books-now rectified)	(j) Creditors A/c Dr. 2,350 To, P/L Adjustment A/c 2.350 (For a purchase recorded twice in the books-now rectified)
(k) Machinery A/c Dr. 620 To, Carriage A/c 260 To, Suspense A/c 360 (For carriage paid on purchase of machinery debited to Carriage A/c-now rectified)	(k) Machinery A/c Dr. 620 To, P/L Adjustment A/c 260 To, Suspense A/c 360 (For carriage paid on purchase of machinery debited to Carriage A/c-now rectified)
(l) Purchase A/c Dr. 640 Sales A/c Dr. 460 To, S.K. Bros. A/c 180 To, Suspense A/c 920 (For goods purchased on credit and passed through the sales day book, but Party's A/c was credited Rs. 460-now corrected)	(l) P/L Adjustment A/c Dr.1,100 To, S.K. Bros. A/c 180 To, Suspense A/c 920 (For goods purchased on credit and passed through the sales day book, but Party's A/c was credited Rs. 460-now corrected)

Dr. **Suspense A/c** **Cr.**

(before preparation of the Final Account)

	Particular	Rs.		Particular	Rs.
	To, Balance b/d	7,891	(d)	By, X's A/c	450
	(difference in trial balance)			By, Y's A/c	540
(a)	To, Sales A/c	270	(e)	By, Discount allowed A/c	198
(b)	To, Suppliers A/c	27	(h)	By, Creditors A/c	6,480
(c)	To, Karuna A/c	380	(k)	By, Machinery A/c	360
	To, Karma A/c	380	(l)	By, Purchase and Sales	920
		8,948			**8,948**

Illustration 9

Mr. Anand closed his books of account on July 15, 2012 in spite of a difference in the trial balance. The difference was Rs. 830, the credits being short; it was carried forward in a Suspense Account. In next accounting year following errors were located.

(a) A sale of Rs, 2,300 to Mr. Laxman was posted to the credit of Mrs. Laxmi.

(b) The total of the Returns Inwards Book for April 2012 Rs. 1,240 was not posted in the ledger.

(c) Freight paid on a machine Rs.5,600 was posted to the Freight Account as Rs, 6,500.

(d) While carrying forward the total in the Purchases Account to the next page, Rs. 65,590 was written instead of Rs. 56,950.

(e) A sale of machine on credit to Mr. Mahat for Rs. 9,000 was not entered in the books at all. The book value of the machine was Rs. 7,500. The firm has the practice of writing off depreciation @ 10 % on the balance at the end of the accounting year.

Pass the journal entries to rectify the errors.

Solution

Journal of Mr. Anand

S.N.	Particulars	L.F.	Dr. (Rs.)	Cr. (Rs.)
(a)	Mr. Laxman A/c Dr. Mrs. Laxmi A/c Dr. To, Suspense A/c (Sales amount wrong posted to Mrs. Laxmi now corrected.)		2,300 2,300	 4,600
(b)	P/L Adjustment A/c Dr. To, Suspense A/c (Rectification of omission to post the total of Returns Inward Book for April)		1,240	 1,240
(c)	Machinery A/c Dr. Suspense A/c Dr. To, P/L Adjustment A/c (Correction of error by which freight paid for a machine Rs. 5,600 was posted to Freight Account at Rs. 6,500 instead of capitalizing it.)		5,600 900	 6,500
	P/L Adjustment A/c Dr. To, Machinery A/c (Providing depreciation on freight paid for machine.		560	 560
(d)	Suspense A/c Dr. To, P/L Adjustment A/c (correction of wrong carry forward of total in the Purchase Account Rs. 65,590 instead of Rs. 56,950)		8,640	 8,640
(e)	Mr. Mahat A/c Dr. To, Machinery A/c To, P/L Adjustment A/c		9,000	 6,750 2,250

	(Correction of omission of a sale of machine on credit to Mr. Mahat for Rs. 9,000 with a book value of Rs. 7,500 on which depreciation 10% has been charged in July, 15, 2012)			

Illustration 10

A merchant's trial balance as on Ashad 31,2072 did not agree. The difference was put to a Suspense A/c. During the next accounting year the following errors were discovered:

(a) The total of the Purchase Book of one page, Rs. 4,539 was carried forward to the next page as Rs. 4,593.

(b) A sale of Rs. 573 was entered in the sales book as Rs. 753 and posted to the credit of the customer.

(c) A return to creditor, Rs. 510 was entered in the Returns Inward Book; however, the creditor's account was correctly posted.

(d) Cash received from C. Dangol Rs. 620 was posted to the debit of G. Dangol.

(e) Goods worth Rs. 840 were dispatched to a customer before the close of the year but no invoice was made out.

(f) Goods worth Rs. 1,000 were sent on sale or return basis to a customer and entered in the sales book. At the close of the year, the customer still had the option to return the goods. The sale price was 25% above cost.

You are required to give journal entries to rectify the errors in a way so as to show the current year's profit or loss correctly.

Solution

S.N.	**Particulars**	**L.F.**	**Dr. (Rs.)**	**Cr. (Rs.)**
(a)	Suspense A/c Dr. To, P/L Adjustment A/c (Correction of over debited in Purchase A/c.)		54	 54
(b)	P/L Adjustment A/c Dr. Customer's A/c Dr. To, Suspense A/c (Rectification of over credited in sale A/c and customer was credited by Rs. 753 instead of being debited by Rs. 573)		180 1,326	 1,506
(c)	Suspense A/c Dr. To, P/L Adjustment A/c (Correction of error by which Returns Inward Account was debited by Rs. 510 instead of Returns Outwards A/c being credited by Rs. 510)		1,020	 1,020
(d)	Suspense A/c Dr. To, C. Dongol A/c To, G. Dongol A/c (Correction of wrong debited to G. Dangol and		1,240	 620 620

	giving credit to C. Dongol from whom cash was received.)			
(e)	Customer's A/c Dr. To, P/L Adjustment A/c (Rectification of the error arising from non-preparation of invoice for goods delivered)		840	 840
(f)	P/L Adjustment A/c Dr. Stock A/c Dr. To, Customer's A/c (The customer's account credited with Rs. 1000 for good not yet purchased by him; cost of the good debited to Stock and Profit debited to P/L Adjustment Account.)		200 800	 1,000
(g)	P/L Adjustment A/c Dr. To, Capital Account (Transfer of the Profit and Loss Adjustment A/c balance to the capital account)		1,534	 1,534

Illustration 11

The under mentioned errors were discovered in the books of Miss. Roseleen after the Statement of Profit or Loss had been prepared for the year ended 31st March 2015 . The difference in Trial Balance was carried to Suspense Account in the Statement of Financial Positon. Miss. Roseleen provided depreciation on Machinery at 10% p.a. and on furniture at 5% p.a. at the closing balance. A Reserve for Bad Debts was provided at 2% on outstanding Debtors. Net profit for the year was transferred to Capital Account.

(a) A cheque received of Rs. 8,000 from a customer was not posted to ledger. The corresponding sales invoice was for Rs. 12,000 which had been wrongly passed though the Sales Day Book as Rs. 2,000 only.

(b) Machinery purchased for Rs. 20,000 on 1st April 2012 was wrongly debited to Furniture Account.

(c) Sales included Rs. 25,000 for goods sold for cash on behalf of Mrs. Charu. Miss. Roseleen was entitled to a commission of 10% on sales plus expenses for which no adjustment was made. Her Trade Expenses included Rs. 1,500 as selling Expenses in connection with the above sale.

(d) Some old furniture (Book value on 1st April, 2012 Rs. 6,000 was disposed of for Rs. 3,000 on 30th September, 2012 but the proceeds had been wrongly credited to Sales Account.

(e) A credit Sales for Rs. 5,000 had been passed twice through the Sales Day Book.

Solution

JOURNAL ENTRIES

S.N.	Particulars	L.F.	Dr. (Rs.)	Cr. (Rs.)
(a)	Suspense A/c Dr. Customer(sundry debtors) A/c Dr. To, P/L Adjustment A/c (A sale of Rs. 12,000 recorded as Rs. 2,000 now adjusted by crediting P/L adjustment A/c for the difference. Rs. 8,000 received from the customer not being posted to his account, he needs a debit for Rs. 2,000 i.e. 12,000-(2,000+8,000).		8,000 2,000	 10,000
(b)	Machinery A/c Dr. P/L Adjustment A/c Dr. To, Furniture A/c (Machinery purchased for Rs. 20,000 wrongly debited to Furniture A/c; Machinery A/c debited by Rs. 18,000 i.e. Rs. 20,000-2,000 (depreciation for one year); Furniture A/c Credited by Rs. 19,000 net debit remaining in that account after depreciation. The short provision for depreciation @ 5 % on 20,000 now debited to P/L adjustment A/c).		18,000 1,000	 19,000
(c)	P/L Adjustment A/c Dr. To, Charu A/c (Correction of (i) consignment sales as normal sales for Rs. 25,000; (ii) not accounting for commission Rs. 2,500 and (iii) treatment of consignment expenses & commission credited to his account by debit to P/L Adjustment A/c.)		21,000	 21,000
(d)	P/L Adjustment A/c Dr. To, Furniture A/c (Sale of furniture (book value Rs.6,000) wrongly credited to Sales A/c; P/L Adjustment A/c now debited by this figure plus loss on sale after depreciation of Rs. 300)		5,700	 5,700
(e)	P/L Adjustment A/c Dr. To, Customer's A/c (Rectification of sales twice entered in sales book)		5,000	 5,000
(f)	Provision for Doubtful Debts A/c Dr. To, P/L Adjustment A/c (Excess Provision of doubtful debts written back-debtor increase by Rs. 2,000 as a result of rectification No. (a) and reduced by Rs. 5,000 by rectification no.(e))		60	 60

(g)	Capital Account Dr. To, P/L Adjustment A/c (Transfer of the Profit and Loss Adjustment A/c balance to the capital account)		22,640	 22,640

8.4 PREPARATION OF ADJUSTED FINAL TRIAL BALANCE

A trial balance is a list of the debit balances and credit balance of all ledger accounts. It is a statement that tests the arithmetical accuracy of the ledger at a specific date. Normally a trial balance is prepared at the end of each month. It may be prepared everyday, everyweek, everymonth o only once a year as nature or sensitivity of transactions. However, it is good to prepare it at short intervals such that errors in the ledger may be identified within a short period of time. The errors should be corrected as soon as they are detected.

The Final Trial Balance

It is assumed that, vouchers for all regular business transactions are passed and posted to the ledger accounts and the initial trial balance is tallied, and that errors detected have also been adjusted.

Basically, the closing journal entries concerning the liabilities to expenses, inventory stock, depreciation, provisions etc. need to be passed which have already been discussed. Once these entries are adjusted with the concerned account heads, the ledgers will be finalized to prepare the final trial balance. Take the example,

Trial Balance before adjustment as on 31 December is as follows:

S.No.	A/C Heads	Debit (Rs.)	Credit (Rs.)
1	Share Capital	-	300,000
2	Purchases	1,500,000	-
3	Sales	-	2,166,000
4	Vehicles	1,72,000	
5	Land	150,000	
6	Building	441,000	
7	Furniture & Fixtures	79,200	
8	Plant & Machinery	420,000	
9	Staff advance	9,000	-
10	Salary	132,000	-
11	Advertisement	30,000	-
12	Insurance	18,000	-
13	Stationery	18,000	-

14	Loan from Bank a/c	-	1,200,000
15	Interest on Loan	108,000	-
16	Investment in 8% Govt. Securities	300,000	-
17	Interest Income	-	12,000
18	Cash Balance	42,000	-
19	Bank Balance	30,000	-
20	Accounts Payable	-	150,000
21	**Accounts Receivable**	245,100	-
22	Opening Stock	110,000	-
23	Provision for Bad & Doubtful Debts	-	7,500
24	Traveling	20,700	
25	Godown Rent	18,000	-
26	Commission Income		10,500
27	Telephone, Telex & Postage	3,000	-
		3,846,000	**3,846,000**

At the year ending, the following information is provided and requires preparing adjustment entries;

a) A vehicle whose written down value is Rs. 55,600 (original cost: Rs.278,000) was sold for Rs. 65,000. The amount received has been credited to Accounts Payable and no required entries have been passed.

b) Depreciation on following assets has to be provided on original cost at rate mentioned in respective assets.

Assets	Original Cost	Depreciation rate
Building	5,22,000	5%
Furniture & Fixtures	1,44,000	15%
Plant & Machinery	6,00,000	10%
Vehicles after sale of old vehicle	1,53,500	20%

c) Salary for the month of December, Rs. 11,000 is paid on 1st January and has been accounted for on that date. While distributing the salary, staff advance of Rs. 3,000 was recovered.

d) The firm has a practice of providing provision for bad and doubtful debts at 2% of the outstanding Receivable balance.

e) Rs. 4,500 receivable from Mr. Abhishek went bad due to his bankruptcy.

f) Closing Stock at the end of Fiscal year is valued at Rs. 2,68,500. However, it is found that a new purchase of stock for Rs. 30,000 included in above stock has not yet been accounted in the books. Transport charges Rs. 500 also payable. It is the practice to debit transport charges in 'Purchases Account'.

g) Insurance policy on assets was taken on June 30 and the amount paid represents the annual premium.

h) The last quarter interest on loan has not yet been paid (Rate of Interest 12% per annum).

i) The Government Securities was purchased on 1st March. Interest received pertains to first six months only.

j) Rent of Godown for one year @ 1,500 p.m. was paid on 1st February.

k) Sales worth Rs. 1,30,000 to Customer has not been accounted.

Solution

Journal Entries

Date	Particular		Debit	Credit
a)	Accounts Payable A/c	Dr.	65,000	
	To, Motor Vehicle A/c			55,600
	To, Profit on Sales of Assets			9,400
	(For rectification entry made to vehicle sold)			
b)	Depreciation A/c	Dr.	138,400	
	To, Building A/c			26,100
	To, Furniture & Fixtures A/c			21,600
	To, Plant & Machinery A/c			60,000
	To, Vehicles A/c			30,700
	(Depreciation charge on assets for the year)			
c)	Salary A/c	Dr.	11,000	
	To, Staff Advance A/c			3,000
	To, Outstanding Expenses Salary			8,000
	(Being Dec. salary provided)			
d)	Provision for Bad & Doubtful	Dr.	88	
	To, Profit & Loss A/c			88
	(Being excess provision has been written back).			
	Note: Out of 245,100 account receivable balance, Rs. 4,500 bad debt is deducted & added sales of Rs. 130,000 (adj. K). Therefore, in the net balance of Rs. 370,600 provision of 2% comes to Rs. 7,412. Since there already exists a provision of Rs. 7,500 the excess of Rs. 88 has been written bank.			

f) 1)	Closing Stock	Dr.	268,500	
	To, Profit & Loss A/c			268,500
	(Closing stock at year end accounted for) *Note: The unaccounted purchase is already included in above stock. Hence no need to increase value of stocks.*			
2)	Purchase A/c	Dr.	30,500	
	To, Accounts Payable (Supplier)			30,000
	To, Accounts Payable (Transporter)			500
	(Purchases of stock pending adjustment accounted for). *Note: This may be entered through purchase book.*			
g)	Prepaid (Insurance) A/c	Dr.	9,000	
	To, Insurance expenses			9,000
	(Premium pertaining to next year adjusted six months).			
h)	Interest expenses A/c	Dr.	36,000	
	To, Outstanding expenses (Interest Payable)			36,000
	(The last quarter's interest on bank loan provided @ 12%).			
i)	Interest receivable A/c	Dr.	8,000	
	To, Interest income			8,000
	(Interest on Government Securities accrued from 1^{st}Sept. to 31^{st} Dec. i.e. 4 months @ 8%).			
j)	Prepaid (rent) A/c	Dr.	1,500	
	To, Rent expense A/c			1,500
	(Godown rent paid for Jan. next year reversed).			
k)	Account Receivable A/c	Dr.	130,000	
	To, Sales			130,000
	(Bill No. .... adjusted)			

Ledgers

Bad Debts Account

Date	Particulars	Debit	Credit	Cr./Dr.	Balance
31.12	To, Accounts receivable from Customer written off due to his bankruptcy	4,500		Dr.	4,500

Accounts Payable Account

Date	Particulars	Debit	Credit	Cr./Dr.	Balance
31.12	By, Balance		150,000	Cr.	150,000
	To, Reversal of 30.11 entry concerning receipt of sale proceed of vehicle	65,000		Cr.	85,000
	By, Purchase		30,500	Cr.	115,500

Accounts Receivable Account

Date	Particulars	Debit	Credit	Cr./Dr	Balance
31.12	To, Balance	245,100		Dr.	245,100
	By, Bad debts written off		4,500	Dr.	240,600
	To, Sales (Bill No. ....)	130,000		Dr.	370,600

Vehicle Account

Date	Particulars	Debit	Credit	Cr./Dr.	Balance
31.12	To, Balance	172,000		Dr.	172,000
	By, Sale of Vehicle		55,600	Dr.	116,400
	By, Depreciation for the year		30,700	Dr.	85,700

Profit on Sale of Asset Account

Date	Particulars	Debit	Credit	Cr./Dr.	Balance
31.12	By, Sale of Vehicle (65,000-55,600)		9,400	Cr.	9,400

Building Account

Date	Particulars	Debit	Credit	Cr./Dr.	Balance
31.12	To, Balance	441,000		Dr.	441,000
	By, Depreciation for the year		26,100		414,900

Depreciation Account

Date	Particulars	Debit	Credit	Cr./Dr.	Balance
31.12	To, Depreciation provided for the year				
	On Building	26,100			
	On Furniture & Fixture	21,600			
	On Plant & Machinery	60,000			
	On Motor Vehicle	30,700		Dr.	138,400

Plant and Machinery Account

Date	Particulars	Debit	Credit	Cr./Dr.	Balance
31.12	To, Balance	420,000		Dr.	420,000
	By, Depreciation for the year		60,000	Dr.	360,000

Furniture and Fixture Account

Date	Particulars	Debit	Credit	Cr./Dr.	Balance
31.12	To, Balance	79,200		Dr.	79,200
	By, Depreciation for the year		21,600	Dr.	57,600

Provision for Bad and Doubtful Account

Date	Particulars	Debit	Credit	Cr./Dr.	Balance
31.12	To, Balance		7,500	Cr.	7,500
	By, Profit & Loss (written back)	88		Cr.	7,412

Salary Account

Date	Particulars	Debit	Credit	Cr./Dr.	Balance
31.12	To, Balance	132,000		Dr.	132,000
	By, Salary for the Dec. month payable	11,000		Dr.	143,000

Outstanding Expenses Account

Date	Particulars	Debit	Credit	Cr./Dr.	Balance
31.12	By, December salary payable		8,000	Cr.	8,000
	By, Interest on loan for last quarter		36,000	,,	44,000

Profit and Loss (Written Back Item)

Date	Particulars	Debit	Credit	Cr./Dr.	Balance
31.12	By, Excess provision written back		88	Cr.	88
	By, Closing Inventory		268,500	,,	268,588

Closing Stock (Asset) Account

Date	Particulars	Debit	Credit	Cr./Dr.	Balance
31.12	To, Inventory balance at year ending	268,500		Dr.	268,500

Prepaid Expenses Account

Date	Particulars	Debit	Credit	Cr./Dr.	Balance
31.12	To, Insurance expenses	9,000		Dr.	9,000
	To Rent expenses	1,500		Dr.	10,500

Purchases Account

Date	Particulars	Debit	Credit	Cr./Dr.	Balance
31.12	To, Balance	1,500,000		Dr.	1,500,000
	To, Sundry Creditors				
	(Supplier + Transporter)	30,500		Dr.	1,530,500

Insurance Expenses Account

Date	Particulars	Debit	Credit	Cr./Dr.	Balance
31.12	To, Balance	18,000		Dr.	18,000
	By, Transfer to prepaid a/c		9,000	Dr.	9,000

Sales Account

Date	Particulars	Debit	Credit	Cr./Dr.	Balance
31.12	By, Balance		2,166,000	Cr.	2,166,000
	By, Bill No. (A & Co.)		130,000	-	2,296,000

Interest Expenses Account

Date	Particulars	Debit	Credit	Cr./Dr	Balance
31.12	To, Balance	108,000		Cr.	108,000
	By, Outstanding interest for last quarter	36,000		Cr.	144,000

Interest Income Account

Date	Particulars	Debit	Credit	Cr./Dr.	Balance
31.12	To, Balance		12,000	Cr.	12,000
	By, Interest on bond to be received for 4 month		8,000	Cr.	20,000

Interest Receivable Account

Date	Particulars	Debit	Credit	Cr./Dr.	Balance
31.12	To, Interest Income on bonds for 4 months	8,000		Dr.	8,000

Staff Advance Account

Date	Particulars	Debit	Credit	Cr./Dr.	Balance
31.12	To, Balance	9,000		Dr.	9,000
	By, Salary of Dec.		3,000	Dr.	6,000

Godown Rent Expenses Account

Date	Particulars	Debit	Credit	Cr./Dr.	Balance
31.12	To, Balance	18,000		Dr.	18,000
	By, Transfer to prepaid expenses		1500	Dr.	16,500

Adjusted Final Trial Balance as on 31 December

S.No.	A/C Heads	Debit	Credit
		(Rs.)	(Rs.)
1	Share Capital	-	300,000
2	Purchases*	1,530,500	-
3	Sales*	-	2,296,000
4	Vehicles*	85,700	
5	Land*	150,000	
6	Building*	414,900	
7	Furniture & Fixtures*	57,600	
8	Plant & Machinery*	360,000	
9	Staff advance*	6,000	-
10	Salary*	143,000	-
11	Advertisement	30,000	-
12	Insurance*	9,000	-
13	Stationery	18,000	-
14	Loan from Bank a/c	-	1,200,000
15	Interest on Loan*	144,000	-
16	Investment in 8% Govt. Securities	300,000	-
17	Interest Income*	-	20,000
18	Cash balance	42,000	-

19	Bank balance	30,000	-
20	Accounts Payable*	-	115,500
21	Accounts Receivable*	370,600	-
22	Opening Stock	110,000	-
23	Provision for Bad & Doubtful Debts*	-	7,412
24	Traveling	20,700	
25	Godown Rent*	16,500	-
26	Commission Income		10,500
27	Telephone, Telex & Postage	3,000	-
28	Bad debts**	4,500	
29	Profit on sale of assets**		9,400
30	Depreciation**	138,400	
31	Outstanding Expenses**		44,000
32	Profit and Loss A/c Written back**		268,588
33	Closing Stock (Assets)**	268,500	
34	Prepaid Expenses**	10,500	
35	Interest Receivable**	8,000	
		4,271,400	**4,271,400**

Note:

*** Accounts balance has been affected due to posting of adjustment entries.**
**** New accounts have been opened to accommodate adjustments.**

8.5 COMPUTERIZED ACCOUNTING SYSTEM

Traditionally accounting was done manually by business owner. The process proved time consuming, cumbersome and prone to human error. There were also problem with storage and retrieval of infomation. Computerized accounting systems have revolutionized the way businesses are conducted. They have enabled companies to present a more accurate picture of their organization's financial performance and to make comparisons and across places and periods of that performance.

How are computers used in accounting?

Most firms will make some use of a computer within accounting at some point. Some firms will have all their accounting performed by computers. What we need to understand is how the computer can be used.

Any accounting system does the following:

1. It records and stores data.
2. It performs arithmetic operations on data.
3. It sorts and summarizes data.
4. It prepares reports.

The principal differences between manual and computerized accounting systems lie in the means of performance of arithmetic operations and in the storage of data. Illustration given below depicts the most significant similarities and differences between the two types of system. Regardless of the degree of computerization in the record keeping process, professional accounting judgment is required in analyzing transactions and creating source documents to capture the important information about routine transactions. In a computerized system, however, the computer does tasks that human do in a manual system: journalizing entries, posting in general and subsidiary ledgers, taking a trial balance, and preparing the reports. Accountants still must analyze the trial balance and initiate the proper adjusting entries.

Difference between computerized system and manual system

a. Audit Trial:

In a manual system, the ability to trace every entry in the ledger to its components in journals and eventually to the source document establishes the integrity of the audit trial. In computerized system, creating and acceptable audit trial becomes more difficult because the data storage and arithmetic manipulation are hidden from view. The integrity of accounting data within computerized databases is an important concern of internal accounting control. Spectacular computer frauds in recent years have made management more aware of the internal control complexities that accompany the computerized system of record keeping.

b. Report Generation:

In the manual system, the cost of preparing reports other than the basic financial statement is high, most reports are of board, general purpose nature, and identical reports are distributed to many different managers in the organization. On the other hand, the cost of preparing specialized management reports in computerized system is usually quite low. This often leads to a large number of different reports oriented towards specific managers and their responsibilities. Such customized reports are advantageous if they are carefully designed to meet their recipients' needs. However, managers in some organization suffer from "information overload" as a result of having too many detailed in the reports. In such instances, the managers may cease to use any of the reports, making the reports of no value despite the low cost of preparing them.

Example: Comparison of Manual and Computerized Systems

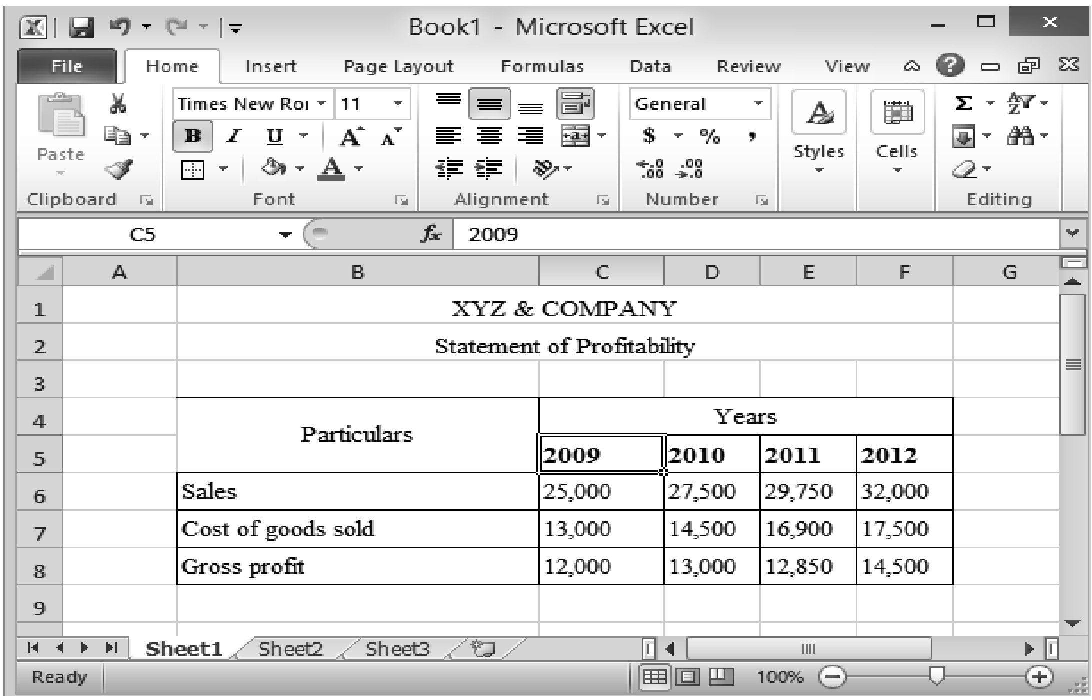
	Step 1	**Step 2**		**Step 3**	**Step 4**
Computerized	Transaction analysis	Recording data	Data storage for steps 2 & 3	Data Processing	Reports
	(H) Source data (not necessarily a tangible documents)	(H) Entering data in to data base (C) Capturing data with a machine (e.g. optical scanner)	Punched cards Disk Tape Other memory	(C) Update account balances (C) Trial Balance (H)(C) Adjusting entries (C) Final trial balance (C) Reports	(C) Financial Statements (C) Numerous specialized management reports

Manual	(H) Source Documents	(H) Journalizing	Journals Subsidiary Ledgers	(H) Summarize journals (H) Post summaries to ledger(s) (H) Trial balances (H) Adjusting entries (H) Final trial balance (H) Reports	(H) Financial Statements (H) Numerous specialized management reports

(H)=Human operation (C)=Computer program operator

8.5.1 Spread Sheet/Excel Sheet

A computer-generated spreadsheet is commonly used by firms when presenting their accounts. A simple spreadsheet will appear as a grid to which both numbers and text can be inserted. Each 'cell' of the spreadsheet can be used to insert data. A typical spreadsheet will appear as follows:



	A	B	C	D	E	F	G
1		XYZ & COMPANY					
2		Statement of Profitability					
3							
4		Particulars	Years				
5			2009	2010	2011	2012	
6		Sales	25,000	27,500	29,750	32,000	
7		Cost of goods sold	13,000	14,500	16,900	17,500	
8		Gross profit	12,000	13,000	12,850	14,500	
9							

One of the attractions of using a spreadsheet is that the calculations can be done by the computer. Some data, such as sales and cost of goods sold would need to be manually typed in, but then the gross profit can be automatically calculated by inserting a formulae into the relevant 'cell' which states how the profit is to be calculated, Once inserted ,the formulae can apply to the whole row (or whole column) which makes the process both easier and more less likely to be inaccurate. Obviously the example above is a fairly limited illustration of how spreadsheets can be used but for many small firms. The use of a spreadsheet is the main way in which computers are integrated into the work of the accountant.

8.5.2 Accounting Software

There is accounting software packages then can be purchased by a firm that will perform many, if not all of the tasks that would normally be manually entered by the person responsible for the firm's accounts. These packages will be able to produce many of the accounting records that were previously produced by hand. Transactions may be entered into the computer package and many will produce the double entry records based on this one entry. Although the exact capabilities of each package will vary, it is possible that most, if not all of these packages will be able to produce invoices. They calculate VAT returns, discounts and all the other areas of the accounting information system. Logically, these packages will also produce the final accounts for the business when required.

For larger firms this software can actually be tailor-made for the firm's own specific requirements. This sort of tailor made package is known as a 'bespoke' system. These packages are normally produced by specialist computer software firm who have experience in producing accounting packages. Technically, these packages are available for any firm, but given the expense of a bespoke system and the general low cost of a 'off the shelf' system (one that can be used by any firm) most firms will simply purchase a general package.

8.5.3 Advantages of Using Computers within Accounting

The main benefits of using computers (to any level within accounting) can be summarized as follows:

Increased accuracy

Computers are less likely to make errors.. Things will still go wrong, but this is likely to be the fault of the person entering the data into the computer, rather than the computer itself making an error.

Time saving

The use of a computer should be able to speed up the whole process of keeping accounting records. This is especially likely to be the case when the firm wishes to produce the final financial statements at the end of a period. The computer will be able to extract a trial balance (if necessary at all) and produce the trading and Statement of Profit or Loss as well as the balance sheet almost instantaneously, based on the data already inputted.

Performance analysis

Once the data has been inputted, it is possible to change the existing data to produce variations on the firm's overall performance. Even a simple spreadsheet can be changed to consider

different scenarios. For example, a firm may wish to see the effects of an increase in sales of the overall profit level. A range of forecasted accounts can be generated to see how well the firm could expect to produce in the future (this is known as sensitivity analysis).
The data can be changed into accounting ratios automatically, which allow managers to assess the overall performance. For example, the profits can be related to sales, to capital or to assets to see how effectively the firm is operating.

Job satisfaction
The use of computers in accounting will save the time for the accountant to concentrate on more wide ranging tasks. This means that there is likely to be increased job satisfaction within the firm. Studies suggest that if workers are more satisfied or more motivated in the workplace, they are likely to be more productive in their output.

8.5.4 Disadvantages of Using Computers within Accounting

The use of computers does not provide a perfect solution. There are drawbacks associated with the introduction of computers.

Cost
Computers have fallen in price over the last ten years. Also, computers are far more powerful than earlier models. However, the cost of the computer and of any associated software packages can still proved to be a huge capital expenditure for the small firm. The purchase will not affect profits, but will affect the firm's cash flow position. The cost of training staff will also have to be factored into the equation when deciding if and what sort of accounting package to purchase.

Reliability
Computers are generally very reliable but problems do occur. If the computer hardware (the physical computer and other devices used in the system) or the software develops a fault, then it is likely that the whole system will not able to be used until the fault can be addressed. This could be very problematic if the fault takes time to found and corrected.

Training time
It may take time for operators to be trained in using any accounting package on the computer. This requires personnel to be diverted from other areas that they may have been working on. However, this problem is becoming less important as newer software packages have become more 'user friendly' (easier to use to even a novice).

Summary

In this unit, we have seen four types of errors namely, Errors of Principle, Errors of Omission, Errors of Commission and Compensating Errors. Of these, errors of commission have one-side effect and therefore, trial balance will not agree for these errors. However, for errors of principle, errors of omission and compensating errors, there will be no effect on trial balance. Still it is required to rectify such errors for giving a true and fair view of the business to the user of accounts. A suspense account is opened to reconcile the trial balance and afterwards by locating the errors such difference is resolved through such suspense account. In case of other

errors for which trial balance is not affected necessary rectification entries are passed by debiting and crediting the appropriate accounts. When error of one accounting period is corrected in the next accounting period, then effects of such prior period items shall be shown separately in financial statements.

Further we have studied that when final account are to be prepared, the ledger balances need to update the effect of transactions that are either unrecorded or recorded improperly, like outstanding expenses, depreciation, closing stock, provision etc. Adjusting entries as well as rectification of errors are necessary to bring the ledger balances to their proper level. After all the necessary adjusting entries have been journalized and posted, Adjusted Final Trial Balance is prepared again to facilitate the preparation of final account. The final adjusted trial balance provides a complete listing of the accounts balances to be used in preparing the final account. We have also studied that nearly all firms make some use of computers in accounting which suggests that the benefits outweigh the costs. Most firms have found computers a very valuable addition to their abilities in processing the vast amounts of financial data. However one can never underestimate the benefits of having a skilled human operator who understands the accounting system and can reason and use intuition in a way that computer cannot.

In a manual accounting systems, special journals, subsidiary ledgers and other devices facilitate the process of recording accounting data. A computer-based system performs the same functions more rapidly, more accurately and at lower cost.

Self-Examination Questions

I. Multiple Choice Questions (MCQs)

1. Goods worth Rs. 250 given as charity should be credited to

   (a) Charity Account (b) Sales Account
   (c) Purchase Account (d) Cash Account

2. The preparation of trial balance is for:

   (a) Locating errors of commission (b) Locating error of principles
   (c) Locating clerical errors (d) All of the above

3. Rs. 330 received from Sujan whose account was written off as a bad debt in previous year should be credited to

   (a) Sujan's Account (b) Bad debt account
   (c) Bad debt recovered account (d) Cash Account

4. Goods purchased from Amit for Rs. 10,000 passed through the sales book. The error will result in

   (a) Increase in gross profit (b) Decrease in gross profit
   (c) No effect in gross profit (d) Either (a) or (b)

5. Sales of office furniture should be credited to

(a) Sales Account (b) Furniture account
(c) Purchase Account (d) Cash Account

6. Which of the following errors will be revealed by the Trial Balance

(a) Compensating Errors (b) Errors of principle
(c) Wrong balancing of an account (d) Wrong totaling of an account

7. Rs. 400 paid as wages for erecting a machine should be debited to

(a) Repair Account (b) Machine Account
(c) Capital Account (d) Furniture Account

8. If the amount is posted in the wrong account or it is written on the wrong side of the account, it is called

(a) Error of omission (b) Error of commission
(c) Error of principle (d) Compensating Error

9. A cheque for Rs. 500 received from Yuvraj & Co was dishonored and debited to Discount Account. Due to rectification of this error, net profit will

(a) Decrease by Rs. 1,000
(b) Increase by Rs. 500
(c) Increase by Rs. 1,000
(d) No change

10. A second hand machinery is purchased for Rs. 10,000 the amount of Rs. 1,500 is spent on transportation and Rs. 1,200 is paid for installation. The amount debited to machinery account will be:

(a) Rs. 10,000
(b) Rs. 10,500
(c) Rs. 11,500
(d) Rs. 12,700

11. If suspense account appear in debit side then that should be shown in

(a) Debit side of PL account (b) Assets side of Statement of Financial Positon
(c) Debit side of capital Account (d) None of the above

12. Profit & Loss Adjustment Account is used

(a) to rectify all the errors in the year of occurrence of errors
(b) to rectify all the errors involving real accounts in the subsequent year
(c) to rectify all the errors involving nominal accounts in the subsequent year
(d) None of the above

II. Short Descriptive Questions (SDQs)

1. Explain the errors which are disclosed by trial balance?
2. Differentiate between clerical error and error of principle.
3. **Does computerized accounting system not require human effort to recording, processing, reporting and analyzing accounting transactions?**
4. **What are the major difference between computerized accounting system and manual accounting system?**
5. **Explain the advantages and disadvantages of computerized accounting system.**
6. **Write Short Notes**
   a. Types of Errors
   b. Error of Omission and Commission
   c. Computarised Environment
   d. Accounting Software

III. Practical Questions (PQs)

1. The following errors are discovered in the books of Ram Krishna. Make necessary entries to rectify them.
   a) Purchase journal was undercast by Rs. 2150
   b) Rs. 5,000 received from S. Rimal was debited to his account.
   c) Discount allowed to Sharma of Rs. 450 for credit sales on his payment of Rs. 8,550 has not been entered in the discount column of the Cash Book. The credit to Sharma's account stands at Rs. 9,000.
   d) An amount of Rs. 1,750 credit sale to Raman correctly entered in the sales book, has been debited to account as 175.
   e) A payment of Rs. 1,250 salaries has been posted twice to Salaries Account.
   f) Rs. 750 received from Rajesh was entered on the debit side of the Cash Book. No posting was done in Rajesh's A/c.

2. Naresh closes his account on 31st December in 2012, his books showed a difference which he transferred to the debit of his capital account. The mentioned errors had been committed in 2012.
   a. A machine book value Rs. 8,200 was sold on credit to Mahant for Rs. 7,500. The amount was posted to the credit to Mahajan.
   b. A cheque for Rs. 21,000 was received from Keshav and was correctly dealt with. It was however, returned dishonoured and was the posted to the debit of trade expenses account.
   c. The closing stock sheet for 2012 was found to be totalled Rs, 10,000 in excess.
   d. The income-tax paid on behalf of the proprietor, Rs. 2,370 was debited to General Expenses Account as Rs. 2,150.

   Give journal entries to carry out the corrections required. How the difference in the books on December 31, 2012?

3. Mr. A.K. Shrestha has been carrying on wholesale trade from September 1, 2012. His Trial Balance as on December 31,2012 is as follows:

Accounts heads	Debit (Rs.)	Credit (Rs.)
Salary	3,200	
Rent	29,000	
Sundry Debtors	43,000	
Loan from Mrs. Kavita Shrestha		60,000
Cash	4,000	
Sundry Creditors		27,000
Interest paid in part on Loan	1,200	
Capital		32,500
Sales		75,800
Purchases	92,500	
Furniture and Fixtures	20,000	
Insurance premium	2,400	
	1,95,300	195,300

Mr. Shrestha furnishes the following additional information:

1. Salary due to his shop assistants on December 31, is Rs. 800.
2. Rent includes a deposit of Rs. 15,000, refundable by the landlord when the premises are vacated.
3. Sundry Debtors represent the amounts invoiced but not yet collected, except for a sum of Rs. 2,200 shown as due from Mr. Him in respect of goods sent to him on sale or approval basis. Mr. Him has to exercise his option by January 5, 2013 cost of the goods is Rs.1,800.
4. Loan from Mrs. Kavaita Shrestha taken on October 1, 2012 carried simple interest at the rate of 12% per year. The first installment of Rs. 15,000 including interest falls due for payment on February 1, 2015 .
5. Inventory of main goods in the shop on December 31, 2012 is Rs. 35,000 (cost)
6. All items of shop furniture were bought on October 1, 2012. They are expected to be useful for 10 years at the end of which they are to be scrapped.
7. Insurance premium for the period September 1, 2012 to August 31, 2013 has been paid.

Required: (1) Post the entries to ledger accounts, and,
(2) Prepare adjusted Trial Balance as on December 31, 2012.

4. Pass rectification entries for the following transactions:

a. A contractor's bill for Rs. 14,600 for construction of a small shed was debited to repair account.

b. Repairs to plant amounting to Rs. 1,900 had been charged to Plant and Machinery Account.

c. Wages paid to the firm's workmen for making certain additions to machinery amounting to Rs. 1,340 were debited to Wages account.

d. A cheque for Rs. 7,500 received from S. Sharma was credited to the account of R. Raut.

e. Goods to the value of Rs. 700 returned by Laxman were included in closing stock, but no entry was made in the books.
f. Goods costing Rs. 2,000 were purchased for various members of the staff and the cost was included in 'Purchases'. A similar amount was deducted from the salaries of the staff members concerned and the net payments to them debited to Salaries Account.
g. A bill of exchange (received from Hari) for Rs. 13,000 had been returned by the Bank with whom it had been discounted, as dishonoured and had been credited to Bank account and debited to Bills receivable Account.
h. Goods sold to Mr. Deuba Rs. 475 have been wrongly entered in the sales Journal as Rs. 745.

5. A bookkeeper while preparing his trial balance finds that the debit exceeds to credit. Being required to prepare the final account he places the difference to a suspense Account. In the next year the following mistakes were discovered:
   a. Maintenance expenses Rs. 1,800 has been omitted to be posted into ledger.
   b. A sale of Rs. 4,000 has been passed through the purchase daybook. The entry in customer's account has been correctly recorded.
   b. Goods worth Rs. 2,500 taken away by the proprietor for his personal use have been debited to repairs account.
   c. A bill receivable for Rs. 1,300 received from Miss. Krisha has been dishonored on maturity but no entry passed.
   d. Salary Rs. 650 paid to Mr. Bhanu has been debited to his personal account.
   e. A purchase of Rs. 750 from Raghubir has been debited to his account but purchases account has been correctly debited.
   f. A sum of Rs. 2,250 written off as depreciation on furniture has not been debited to depreciation account.

   Draft the Journal Entries for rectifying the above mistakes and prepare Suspense Account.

6. Correct the following errors found in the books of Mr. Dhital. The Trial Balance was out by Rs. 493 excess credit. The difference thus has been posted to a Suspense Account.
   - An amount of Rs. 200 was received from D. Das on 31st December 2003 but has been entered in the cash book on 3rd January 2015 .
   - The total of returns inward book for December has been cast Rs. 100 short.
   - The purchase of an office table costing Rs. 300 has been passed through the purchases Day book
   - Rs. 375 paid for wages to workmen for making show-cases had been charged to Wages Account.
   - A purchase of Rs. 50 had been posted to the creditors account as Rs. 500
   - A cheque for Rs. 200 received from P. Joshi had been dishonored and was passed to the debit of 'Allowances Account.'
   - Rs. 1,000 paid for purchases of Cycle for Mr. Dhital had been charged to 'Miscellaneous Expenses Account'.

- Goods amounting to Rs. 100 had been returned by customer and were taken into stock, but no entry in respect thereof, was made into the books.
- A sale of Rs. 200 to Shrestha& Co. was wrongly credited to their account.

ANSWER

Multiple Choice Questions (MCQs)

1	c	6	d	11	b
2	c	7	b	12	c
3	c	8	b		
4	a	9	b		
5	b	10	d		

CHAPTER- 3

Capital & Revenue Concept and Depreciation

UNIT 1:

Capital and Revenue Concept

Learning Objectives

1. *Try to learn the criteria for identifying revenue expenditure, capital expenditure and deferred revenue expenditure.*
2. *Learn the distinction between capital and revenue receipts.*
3. *Try to understand the linkage of such distinction with the preparation of financial statements.*
4. *Try to learn about contingent liabilities and contigent assets.*

1. INTRODUCTION

The basic objective of the final statements i.e. Statement of Profit or Loss and Statement Of Financial Position is to exhibit truly and fairly the profitability and financial position of the business. The financial position of the business concern is bound to be affected by the result of its operations. Business transactions can be capital transactions or revenue transactions. Thus a proper distinction must be accounted for between capital and revenue transactions. Capital nature transaction means the business transactions, benefit of which can be obtained in more than one accounting period and revenue nature means benefit of which is only for a particular accounting period. This concept applies to both expenditures and receipts. The distinction of transaction into revenue and capital is done for the purpose of placing them in Statement Of Profit or Loss and Statement Of Financial Position. For example: revenue expenditures are shown in Statement Of Profit or Loss as their benefits are for one accounting period i.e. in which they are incurred while capital expenditure are shown on the asset side of the Statement of Financial Position as they will generate benefits for more than one accounting period.

1.2 CONSIDERATION IN DETERMINING CAPITAL AND REVENUE TRANSACTIONS

Total The basic considerations in distinction between capital and revenue expenditures are;

a. **Nature of business:** For a trader dealing in furniture, purchase of furniture for trading purpose is revenue expenditure but for any other trader, the purchase of furniture should be treated as capital expenditure and shown in the Statement Of Financial Position as an asset. Therefore, the nature of business is a very important criterion in separating expenditure between capital and revenue.

b. **Nature of expenditure:** If the frequency of an expense is quite often in an accounting year then it is said to be an revenue expenditure like; salary, rent etc. while non-recurring expenditure is infrequent in nature and do not incur often in an accounting year like; purchase of vehicle, computers etc.

c. **Purpose of expenditure:** Expense for repairs of machine may be incurred in course of normal maintenance of the asset. Such expenses are revenue in nature. On the other hand, expenditure incurred for major repair of the asset so as to increase its productive capacity is capital in nature.

d. **Effect in revenue earning capacity:** The expenses which help to generate revenue in the current period are revenue in nature and should be matched against the revenue earned in the current period. On the other hand, if expenditure helps to generate revenue over more than one accounting period, it is generally called capital expenditure.

e. **Materiality of the amount involved:** Nepal Accounting Standard on Presentation of Financial Statements (NAS-1) defines the term Material. It states that omission or misstatements of item are material if they could, individually or collectively; influence the economic decisions of users taken on the basis of financial statements. Materiality depends on the size and nature of the omission or misstatement judged in the surrounding circumstances. The size or nature of the item or a combination of both could be the determining factor. So the relative proportion of the amount involved is another important consideration in distinction between revenue and capital transaction. Even if expenditure does not increase the productive capacity of an asset, it may be capitalized because the amount is material or expenditure may increase the asset value or yet to be expensed because the amount is material in value.

1.3 CAPITAL EXPENDITURES

Capital expenditure is that expenditure which is incurred for acquiring assets, improving its condition/capacity and for substantial replacement of existing fixed assets. Generally, all the expenditure incurred for acquiring land, buildings, machines, vehicles etc. represent the capital expenditure. It is so because it contributes to the revenue earning capacity of a business over more than one accounting period either by increasing the output or by reducing the cost. In other words, capital expenditure provides benefit to the business for more than one accounting period. The expenditure is generally non-recurring and the amount spent is normally large. However, it should be noted that every big expenditure is not capital expenditure. Capital expenditures are shown in the assets side of the Statement Of Financial Position under the significant head. Similarly cost of any additions to the assets are also considered as capital expenditure so long as it results in increasing their usefulness to the business.

- Capital expenditure is that expenditure the benefits of which are not fully consumed in a year but spread over several years.
- It is the expenditure which results in the purchase or acquisition of asset or property.
- It is the expenditure incurred in connection with the purchase of asset.
- It is the expenditure incurred for extending or improving an existing asset to increase its productivity or to increase the earning capacity of business or to decrease working expenditure.

1.4 REVENUE EXPENDITURE

Revenue expenditure is that expenditure which is incurred for maintaining productivity or earning capacity of the business. In other words, revenue expenditure is incurred to generate revenue for a particular accounting period. Revenue expenditure is generally charged to Statement Of Profit or Loss to find out the actual profit or loss of the business for the period. The amount spent is generally small and the benefit is for a short period which is not more than a year. The examples of revenue expenditure include salaries, wages, rent, insurance, interest etc.

- Revenue expenditure is the expenditure which benefits in the current accounting year. It is not carried forward to the next year or years.
- It is the expenditure which is incurred in the normal course of business to run the business and to maintain the fixed assets of business.
- It is the expenditure which is incurred on purchase of goods meant for resale or to purchase materials which will be used to convert them into final product.

1.5 CAPITAL RECEIPTS

Capital receipts mean such receipts which are of a capital nature. In other words, amount of receipts which remains in business for more than one accounting period and which arise due to sale of assets having life of more than one year is called capital receipts. The examples of capital receipts include money obtained from the sale of fixed assets and investments, capital contribution by the proprietor, loan taken from the bank etc. Capital receipts are shown on liability side in the Statement Of Financial Position.

1.6 REVENUE RECEIPTS

Revenue receipts mean such receipts which are of a revenue nature. It means that receipts which are only for a particular accounting period are called revenue receipts. These are receipts obtained in the normal course of business. It is a receipt against supply of goods or services. These arise due to regular business operation. The examples of revenue receipts include sale of goods, commission received, rental income, discount received etc. These are credited to Statement Of Profit or Loss.

Illustration 1

Classify the following expenditures and receipts as capital or revenue:

(i) Rs. 10,000 spent as travelling expenses of the directors on trips abroad for purchase of capital assets.
(ii) Amount received form debtors during the year.
(iii) Amount spent on demolition of building to construct a bigger building on the same site.
(iv) Insurance claim received on amount of a machinery damaged by fire.

Solution:

(i) Capital Expenditure
(ii) Revenue Receipt
(iii) Capital Expenditure
(iv) Capital Receipt

Illustration 2

State with reason, how you would classify the following items of expenditure.

i) Overhauling expenses of Rs. 25,000 for the engine of a motor car to get better fuel efficiency.
ii) Inauguration expenses of Rs. 25 lakhs incurred on the opening of a new manufacturing units in an existing business.
iii) Compensation of Rs. 2.5 crores paid to workers, who opted for voluntary retirement.

Solution:

i) Overhauling expenses are incurred for the engine of motor car to derive better fuel efficiency. These expenses will reduce the running cost in future and thus the benefit is in form of endurable long term advantage. So this expenditure should be capitalized.

ii) Inauguration expenses incurred on the opening of a new unit may help to explore more customers. This expenditure is in the nature of revenue expenditure as the expenditure may not generate any enduring benefit to the business over more than one accounting period.

iii) The amount paid to workers on voluntary retirement is in the nature of revenue expenditure

1.7 CONTINGENT LIABILITIES/CONTINGENT EXPENSES

Nepal Accounting Standard on Provisions, contingent Liabilities and Contingent Assets (NAS 37) issued by The Institute of Chartered Accountant of Nepal defines liability as present obligation of the business arising from past events, the settlement of which is expected to result in an outflow from the entity of resources embodying economic benefits.

Further, Nepal Accounting Standard on Provisions, contingent Liabilities and Contingent Assets (NAS 37) issued by The Institute of Chartered Accountant of Nepal defines contingent liability means

a. A possible obligation that arises from past event and whose existence will be confirmed by the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the entity or

b. A present obligation that arises from past event but is not recognized because

a. It is not probable that an outflow of resources embodying economic benefits will be required to settle the obligation, or

b. The amount of the obligation cannot be measured with sufficient reliability.

Generally, contingent liability means those future liabilities which will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events not fully within the control of the entity. Contingent liability should not be recognized in the books of the entity but should be disclosed in '*Notes to Accounts of the Financial Statements'*. Claims against entity not acknowledged as debts, guarantee given in respect of third parties, liability in respect of bills discounted etc. are example of contingent liabilities. If contingent liability turns into actual liability, then such should be recorded in the books.

1.8 CONTINGENT ASSETS/CONTINGENT INCOMES

Nepal Accounting Standard on Provisions, contingent Liabilities and Contingent Assets (NAS 37) issued by The Institute of Chartered Accountant of Nepal as a possible asset that arises from past event and whose existence will be confirmed only by the occurrence or non occurrence of one or more uncertain future events not wholly within the control of the entity.

Generally, contingent assets mean that possible assets which will arise from past events and whose existence will be confirmed only after occurrence or non-occurrence of one or more uncertain future events not fully within the control of the entity. Contingent assets need not be disclosed in the Financial Statements but there is a practice of disclosing contingent assets in the '*Report of Board of Directors'*. Claim lodged by the entity but not confirmed yet is an example of contingent asset.

Illustration 3

State with reason, how you would classify the following items of expenditure.

1. An old machinery is purchased for Rs. 1,00,000 and Rs. 25,000 has been spent to bring it in working condition.
   Answer: Both the above expenses are capital expenditures as Rs. 1,00,000 has been spent to acquire the asset and Rs. 25,000 has been spent to make the machinery productive. The machinery will now be used for many years and its cost is Rs. 1,25,000.
2. A building is purchased for Rs. 10,00,000 and Rs. 1,00,000 has been spent as expenses like brokerage, stamp duty, registration charges and on other legal expenses.
   Answer-- Both the above expenditures are capital expenditures as Rs. 10,00,000 has been spent for the purchase of asset and Rs. 1,00,000 for all the incidental expenses for buying the asset. The cost of the building is now Rs. 11,00,000.
3. Repairs to building
   Answer-- It is revenue expenditure because it is incurred for maintaining the building. Both the reason for repairs and the amount are not important.
4. Amount spent for the replacement of defective and worn out parts of an old plant
   Answer-- It is revenue expenditure as it is incurred to keep the plant in normal working condition. No new asset comes into existence.
5. Heavy expenditure incurred on advertisements.
   Answer-- advertisement is revenue expenditure.

Illustration 4

State with reason, whether the following items are of capital or revenue expenditure.

1. A machinery costing Rs. 5,00,000 is imported on which freight and insurance of Rs. 7,000, custom duty of Rs. 13,000, clearing charges of Rs. 5,000 and installation charges of Rs. 10,000 were incurred.
   Answer-- Rs. 5,00,000 spent on the purchase of asset and Rs. 35,000 spent on other incidental expenses should be considered as capital expenditure until the machinery comes in working condition. The cost of machinery will be Rs. 5,35,000.
2. New equipment for existing machinery were bought for Rs. 30,000 to increase the production by 25%
   Answer-- The above expenditure is capital expenditure as it increases the production capacity and thereby increases the earning capacity of the business. It is a non- recurring expense and should be added to the value of asset.
3. Taxes paid
   Answer-- It is revenue expenditure as it is a regular expense of the business. It is a recurring expense. The benefit is only for one year.
4. Expenditure for repainting the factory shed
   Answer-- As repainting is a normal expenditure made for maintenance of the factory, it is revenue expenditure. It is a recurring expense and no new asset comes into existence.
5. Traveling expenses of directors for a trip abroad for purchasing imported machinery
   Answer-- As the traveling expenses is incidental expenditure to purchase machinery, it should be treated as capital expenditure and should be added to the cost of machinery. In this case, if

directors purchase the machinery, it would be deferred revenue expenditure and would be written off over a reasonable period of say 3 to 5 years

Illustration 5

State whether the following are capital or revenue expenditure

i. Carriage of Rs 7,500 spent on machinery purchased and installed
ii. Advertising cost of Rs 20,000 spend on the launching of a company new product
iii. Rs 200, paid for servicing the company vehicle, including Rs 50 paid for changing the oil
iv. Construction of basement costing Rs 195,000 at the factory Premises
v. Extension of roadway track in the factory area
vi. Wages paid to machine operators
vii. Installation cost of new production machine
viii. Wages paid to own employees for building the foreman's office

Solution

i. Carriage of Rs 7500 paid for machinery purchased and installed should be treated as Capital expenditure
ii. Advertising expense for launching a new product of the company should be treated as revenue expenditure
iii. Rs 250 paid for servicing and oil change should be treated as Revenue expenditure
iv. Construction cost of basement should be treated as capital expenditure
v. Expenses incurred for extension of roadway in the factory area should be treated as a capital expenditure because it will benefit the business for more than one accounting period
vi. Wages paid for machine operator should be treated as revenue expenditure because it will benefit only in the current period
vii. Installation cost of new production machine should be treated as capital expenditure because it will benefit the business for more than one accounting period
viii. Wages paid for building foreman's office should be treated as capital expenditure because it will benefit the business for more than one accounting period.

Illustration 6

State whether the following are capital or revenue expenditure

i. Redecoration expenditure of Rs 6,000
ii. Installation of new wine bar for Rs 10,000 in restaurant
iii. Building of an extension of the club dressing room for Rs 15,000
iv. The purchase of wine and spirit Rs 2,000
v. The Purchase of VCR and TV for the use in the club lounge for Rs 75,000

Solution

i. The redecoration expense of Rs 6,000 shall be treated as Revenue expenditure

ii. The installation of new wine bar is Capital expenditure because it is the acquisition of assets

iii. Rs 15,000 spent for the extension of club dressing room is capital expenditure because it create an asset of an permanent nature

iv. The purchase of wine and spirit of Rs 2000 is revenue expenditure

v. The purchase of VCR and TV for Rs 75,000 is capital expenditure because it is acquisition of assets

Illustration 7

State whether the following are capital or revenue expenditure

i. Rs 2,000 customs duty is paid on import of machinery for modernization of factory production during the current year and Rs 6,000 is paid on import duty for purchase of raw materials

ii. Rs 18,000 interest had accrued during the year on term loan obtained and utilized for the construction of factory building and purchase of machineries, however, the production has not commenced till the last date of the accounting year

Solution:

i. Custom duty paid on import of machinery should be treated as capital expenditure. However, import duty paid for raw materials should be treated as revenue expenditure

ii. Interests paid during preconstruction period should be treated as capital expenditure

Summary

In this unit we have discussed concept of capital and revenue items regarding expenditure and receipts. Deferred revenue expenditures are those revenue expenditures which are deferred due to its capital nature. Contingent liability and contingent assets are important concepts.

Self-Examination Questions

I. Multiple Choice Questions (MCQs)

1. Entrance fee of Rs. 2,000 received by Famous Social Club is

(a) Capital Receipt (b) Revenue Receipt
(c) Capital Expenditure (d) Revenue Expenditure

2. Subsidy of Rs. 400,000 received from the government for working capital by a manufacturing concern is

(a) Capital Receipt (b) Revenue Receipt
(c) Capital Expenditure (d) Revenue Expenditure

3. Interest on investment received from Citizen Investment Trust is
(a) Capital Receipt (b) Revenue Receipt
(c) Capital Expenditure (d) Revenue Expenditure

4. Amount received from Big Bank Ltd. as a medium term loan for augmenting working capital is
(a) Capital Receipt (b) Revenue Receipt
(c) Capital Expenditure (d) Revenue Expenditure

5. Insurance claim received on account of machinery damaged completely by fire is
(a) Capital Receipt (b) Revenue Receipt
(c) Capital Expenditure (d) Revenue Expenditure

6. Amount of Rs. 6,000 spent as lawyers' fee to defend a suit claiming that the firm's factory site belonged to the plaintiff's land is
(a) Capital Expenditure (b) Revenue Expenditure
(c) Deferred Revenue Expenditure (d) None of the above

7. Whitewashing expenses are
(a) Capital Expenditure (b) Revenue Expenditure
(c) Deferred Revenue Expenditure (d) None of the above

8. Paper purchased for use as stationery is
(a) Capital Expenditure (b) Revenue Expenditure
(c) Deferred Revenue Expenditure (d) None of the above

9. In the financial statement, contingent liability is
(a) Recognized (b) Not Recognized
(c) Adjusted (d) None of the above

10. In the case of __________, either outflow of resources to settle the obligation is not probable or the amount expected to be paid to settle the liability cannot be measured with sufficient reliability.
(a) Liability (b) Provision
(c) Contingent Liabilities (d) None of the above

II. Short Descriptive Questions (SDQs)

1. Differentiate between Capital and Revenue Expenditure.
2. Differentiate between Capital and Revenue Receipts.
3. Write short note on
(a) Contingent Assets
(b) Deferred Revenue Expenditure
(c) Contingent Liabilities

ANSWER

Multiple Choice Questions (MCQs)

1	B	6	B
2	B	7	B
3	B	8	B
4	B	9	B
5	A	10	C

CHAPTER- 3

Capital & Revenue Concept and Depreciation

UNIT 2:

Accounting Treatment of Fixed Asset and Depreciation

Learning Objectives

1. *Distinguish an enterprise's expenses from expenditures that should be capitalized.*
2. *Measuring acquisition cost of tangible assets such as land, building and equipment.*
3. *Compute depreciation of various assets using different methods of depreciation.*
4. *Compute gains and losses on the disposal of fixed assets and consider its impact.*

2. INTRODUCTION

Assets are the resources controlled by an entity as a result of past event and from which future economic benefits are expected to flow to the entity. Most of the entities hold major assets such as land, buildings, equipment, natural resources, and patents. These fixed assets are utilized during the operation of business for number of successive accounting periods for the utilization in the process of production and distribution of goods or services. Because these assets are necessary in a company's day-to-day operations, companies do not sell them in the ordinary course of business. However, replacement of these assets is an essential part of the successful operation of a business

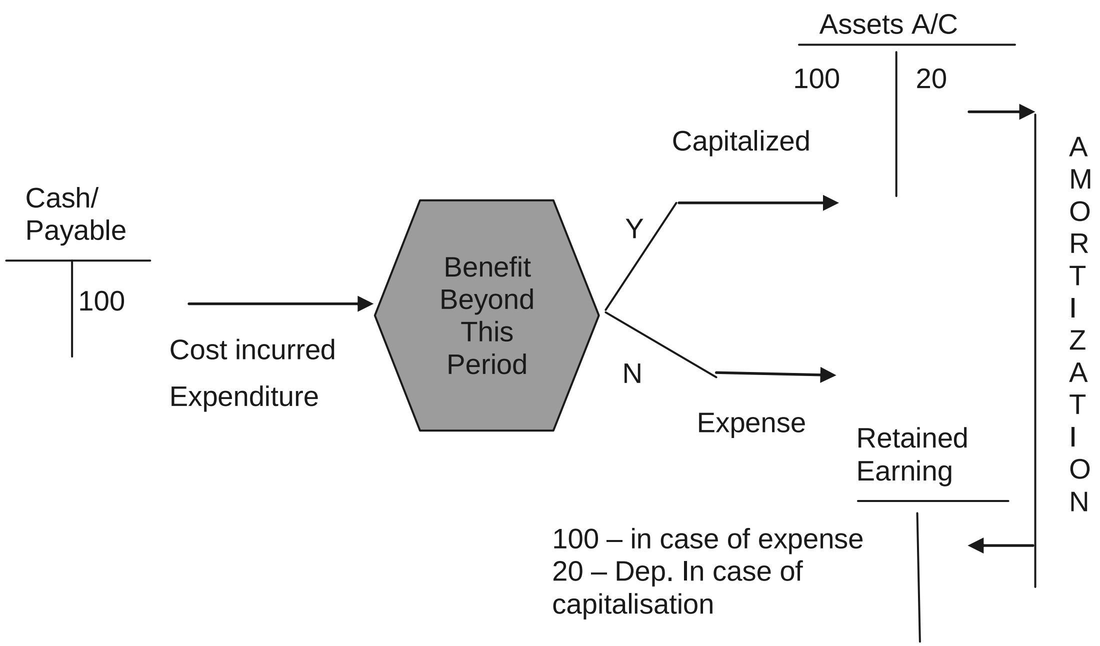
Long-term assets are divided into tangible and intangible categories. Tangible assets are physical item that you can see and touch. Examples are land, building, natural resources, and equipment. In contrast, intangible assets are not physical in nature. They generally consist of contractual or legal rights or economic benefits, such as patent, trademarks, and copyrights.

2.1 NATURE OF FIXED ASSETS

Fixed assets are relatively long-term assets which are not consumed entirely in the operations of business within the period of one year. The common characteristics of these assets are that they have long term benefits; that is, they provide benefits to the entity for several future years. Similarly, these assets are not held for sale rather they are used for the revenue producing activities of the business.

When an enterprise incurs expenditure, the benefits from the goods or services acquired are either in the current period or expected to be obtained in future period. If the benefits are obtained in the current period, the costs of the goods or services are expenses. If benefits are expected in future periods, the costs are assets in the current period, and the expenditures are said to be capitalized. Although inventory and pre-paid expenses also are assets because they benefit future periods, the term capital assets is usually taken to mean fixed assets- assets that provide services for several years. A capital asset can usefully be thought of as a bundle of services. When a company buys a truck that is intended to last for 200,000 miles, the company is in effect buying transportation services that will benefit it over several future years. The cost of these services, that is, the cost of the truck, should be matched with the revenues that are obtained from its use in these future periods. The general name for this matching process is amortization or depreciation. The portion of the asset's cost that is charged to a given period is an expense of that period. A fixed asset is therefore, initially recorded as an asset and is converted to an expense in one or more future periods.

Example



Above illustration depicts how expenditures either are expensed in the current period (period cost) or capitalized in an asset account and amortized (expensed) in later periods. Know that all costs eventually become expenses; but capital assets' cost do so over a period of several years, whereas period costs become expenses as they are incurred.

2.2 TYPES OF FIXED ASSETS

The most frequently used accounting heads for fixed assets are;

Assets	Method of converting to expenses
Tangible Assets:	
Land	Not amortized
Building	Depreciation
Plant and equipment	Depreciation
Furniture and Fixtures	Depreciation
Office Equipment	Depreciation
Vehicles	Depreciation
Natural Resources	Depletion

Intangible Assets	
Goodwill (GW)	Written-off
Intangible Assets –other than GW-limited life	Amortization
Intangible Assets –other than GW-indefinite life	Written-off
Leasehold improvement	Amortization
Deferred charges	Amortization
R&D cost	capitalized

Above lists depicts the principal types of fixed assets and the terms used to describe the process of amortization (Depreciation) the cost of each type. The principal distinction is between tangible assets and intangible assets. A tangible asset is an asset that has physical substances, such as a building or machine. An intangible asset, such as patent rights or copyrights, has no physical substance. Long-term(fixed) assets are usually listed on the Statement Of Financial Position under heading "Property, plant and equipment".

General Concept in Fixed Assets Accounting

Distinction between Assets and Expense:

The distinction between expenditures that are capitalized and expenditures that are expensed as period costs is not entirely clear-cut. Some borderline cases are described in the following paragraphs.

Low cost items: In accordance with the materiality concept, items that have a low unit cost, such as hand tools, are charged immediately as expenses even though they may have a long life. Each company sets its own criteria for items that are to be capitalized. Generally, the line is drawn in terms of the cost of an item, which may be anywhere from Rs. 1,000 to Rs. 25,000. Items costing less are expenses.

Nevertheless, the capitalization cost of a new facility may include the cost of the initial outfit of small items that do not individually meet the criteria for capitalization. Examples are the initial outfit of small tools in a factory, books in a library, and tableware and kitchen utensils in a restaurant. When these items are replaced, the cost of the replacement items is charged as an expense, not capitalized. However, the Nepal Accounting Standard –NAS 16, does not allow this arrangement. As per NAS 16, the cost of an item of property, plant and equipment shall be recognized as an asset, if and only if (a) it is probable that future economic benefits associated with the item will flow to the entity; and (b) the cost of the item can be measured reliably. Spare parts and servicing equipment are usually carried as inventory and recognised in Profit or loss as consumed. The major spare parts and stand-by equipment qualify as property, plant and equipment; they are accounted for as property, plant and equipment.

Betterment: Repairs and maintenance is work done to keep an asset in good working condition or to bring back to good operating condition if it has broken down. Repairs and maintenance costs are ordinarily period costs; they are not added to the capitalized cost of the asset. Betterment is added to the cost of the assets.

Distinction between repairs and betterment

Maintenance keeps the asset in good condition but in no better condition than when it was purchased; betterment makes the asset better than it was when it was purchased or extends its useful life beyond the original estimate of useful life. In practice, the line between the two is difficult to draw. A new accessory designed to make a machine operate more efficiently or perform new functions is betterment; an overhaul during which worn-out parts are replaced with new ones is maintenance. In the interest of conservatism, some work that strictly speaking should be considered as betterment is charged as an expenses of the current period.

Replacement

Replacement may be either assets or expenses, depending on how the asset unit is defined. The replacement of an entire asset results in the writing off of old asset and the recording of the new asset. The replacement of a component part of an asset is maintenance expense. For example, assume that one company treats a complete airplane as a single asset unit and another company treats the airframe as one unit and the engines as another. The replacement of an engine results in a maintenance charge in the first company and in a new asset in the second. In general, the broader the definition of the asset unit, the greater will be the amount of costs charged as maintenance and, hence, expenses in the year the replacement parts are installed.

Items included in cost

The governing principle is that the cost of property, plant and equipment includes all expenditures that are necessary to make the asset ready for its intended use. In many cases, the amount can be determined easily. For example, the cost of a truck purchased for cash is simply the amount of cash paid. In other cases, the problem is more complicated. The cost of parcel of land includes the purchase price, broker's commission, legal fees, and the cost of grading or of tearing down existing structures so as to make the land ready for its intended use. The cost of machinery includes the purchase price, VAT or sales tax, transportation costs to where the machinery is to be used, and installation costs.

Consider the following example for acquisition of equipment:

Invoice price (Gross)	10,00,000
Less: 2% cash discount for payment made within stipulated time	(20,000)
Invoice price net	980,000
VAT @ 13% on 980,000	127,400
Transportation cost	30,000
Installation cost	80,000
Repair cost prior to use	70,000
Total acquisition cost	**12,87,400**

Self-Constructed Assets

When a company constructs a building or item of equipment for its own use, the amount of capitalized cost includes all the costs incurred in construction. As in the case of product costs, these costs include the materials and labor directly associated with the project, as well as a fair share of the company's indirect cost incurred during the construction period.

The NAS requires that these capitalized costs include interest. The amount of interest is the amount related to borrowings made to finance the project (construction loans) if these are identifiable. If not, the company must estimate the interest cost that could have been avoided if the asset in question had not been constructed. The total amount of interest capitalized cannot exceed the company's total interest cost for the period. The interest capitalization period ends when the asset is substantially complete and ready for its intended use.

If the company contracts with an outside party to build the asset and makes deposits or progress payments to the contractor, then interest costs associated with these funds are included in the capitalized cost.

As is the case with other items of cost, capitalizing rather than expensing interest cost has the effect of increasing the income of the current period and decreasing income during the years of the asset's useful life. This decreases occur because each year's depreciation expense for the asset is larger than it would have been had the interest cost not been capitalized.

Non-Cash cost

In general, capital assets are acquired for cash or other obligation whose cash equivalent is easily determined. When some other consideration, such as common stock, is given, there may be problems in determining the amount to be capitalized.

The general principles are as follows:

First, the fair market value of the consideration given for the asset should be determined;

Second, if it is not feasible to determine this value, then the fair market value of the new capital asset itself is used.

Acquisition recorded at other than cost

There are few exceptions to the basic rules that assets acquisitions are recorded in the accounts at cost. If the entity acquires an asset by donation/grant or pays substantially less than the market value of the asset, the asset is recoded at its fair value. This happens, for example, when a community donates land or a building in order to induce a company to locate there. Increase in market value does not affect the accounting records for capital assets. E.g. appreciation of value of building year by year.

Basket Purchases

An entity acquires in one transaction several capital assets that are to appear in more than one Statement Of Financial Position category. This is called basket purchase, such as land and building due to depreciable and non-depreciable nature of assets. Similarly, if the capital assets in the basket have different useful lives separation is required due to applicable of different depreciation rates.

Accretion and Appreciation

Agricultural product-timberland, cattle, tobacco, wine etc. the increase in value that arises through the natural process of growth or aging is called accretion. Accretion does not represent realized revenue thus not recognized in accounts. Appreciation in value of asset is recognized only when revenue is realized.

Leased Assets

In a lease agreement, the owner of property, the lesser, conveys to another party, the right to use property, plant, or equipment for a stated period of time. A Lease is classified as an operating lease if it does not transfer substantially all the risks and rewards incidental to ownership. The lease payments on such operating lease are treated as expenses of the accounting period to which they apply.

Finance leases: A Lease is classified as finance lease if it transfers substantially all the risks and rewards incidental to ownership. It covers a period that is substantially equal to the estimated life of the asset, or they contain other provisions that give the lessee almost as many rights to the use of the asset as if the lessee owned it. Assets on Financial Lease are treated as if they had been purchased. The lease obligation is a liability, which is treated in the same manner as long-term debt.

Intangible Assets

Intangible asset-such as goodwill, organization costs/Preliminary Expenses (i.e. costs incurred to get a company started), trademarks and patents–are usually converted to expenses over a number of accounting periods. The systematic allocation of the costs of these assets to the periods in which they provide benefits is called amortization.

a. Goodwill

When one company buys another company, the purchasing company may pay more for the acquired company than the fair market value of its net identifiable assets (tangible assets plus identifiable intangibles, net of any liabilities assumed by the purchaser). The amount by which the purchase price exceeds the fair value of the net identifiable assets is recorded as an asset of the acquiring company. Goodwill arises only as part of a purchase transaction. Sometimes the buying company is willing to pay more than the fair value of the identifiable assets because the acquired company has a strong management team, a favorable reputation in the marketplace, superior production methods, of other unidentifiable intangibles.

Amortization: In most cases, there is no way of estimating the useful life of goodwill and hence no reliable way of deciding what fraction of the cost should be amortized as an expense in a given year. A company may select whatever period it believes to be reasonable, but in no event can the amortization period for long period say 40/50 years.

b. Patent, copyrights and franchise rights-

Patent, copyrights, franchise rights and similar intangible assets are initially recorded at their cost. If they are purchased, the cost is the amount paid. If a patented invention is developed within the company, however, the costs involved are ordinarily not capitalized. These are considered as research and development cost. The cost of any of these intangible assets is amortized over the useful life of the asset. If the useful life is limited by law or agreement, the amortization period cannot be longer. It may be shorter if the company believes that because of technological advances or other reasons, the practical life will be shorter than the legal life.

2.3 DEPRECIATION

Most fixed assets give up their benefits to the entity in a continuous stream. Thus, the cost of these assets is continuously being converted to an expense (written off) in the same manner as the current assets- fuel oil and prepaid insurance-that was discussed above. The item that shows the portion of such fixed assets costs that has become expenses during an accounting period is called depreciation expense. In accrual system of accounting, depreciation on fixed assets is calculated on some suitable basis and charged against periodic revenue in the process of determination of profit. Allocation of expenses which were incurred on account of purchasing fixed assets, although subjective, is essential for determination of business income because when replacement will be due, money set aside by way of depreciation can be used.

2.3.1 Definition

Depreciation has been defined as 'the diminution in the utility or value of an asset, due to natural wear and tear, exhaustion of the subject-matter, effluxion of time accident, obsolescence or similar causes'. The word "accident", "obsolescence" and the phrase "effluxion of time" included in the definition, signify that when an asset held by a business cannot be employed for even one of the purposes for which it was acquired due to some damage suffered, the assets having become out of date or could not be used, such a loss caused to the business will be termed as depreciation. Depreciation caused by any one of the last mentioned factors often is described as external depreciation, to distinguish it from the natural wear and tear of assets which is known as internal depreciation. Commonly, the word "depreciation" is also employed to represent a fall in the market value of an asset due to a fall in the price level in the country. Since the last-mentioned type of diminution in value is the outcome of a different set of causes, it is necessary to differentiate it from the others. But a distinction can be possible only if we decide not to use the term in two different senses and accept the suggestion, that some accountants have made in the past to describe the diminution resulting from the use of assets as 'wear and tear' or expired capital outlay.

The loss in the value of assets employed for carrying on a business being an essential element of business expenditure, it is necessary to calculate the amount of such loss and to made a provision, to obtain the amount of profit or loss made by the business. Normally, the cost of an asset used for purposes of business has to be written off over its economic (not physical) life which must be estimated. A point to remember is that usually, at the end of the economic life, an asset has some value as scrap or otherwise. The amount to be written off in each year should be such as will reduce the book value of the asset, at the end of its economic life to the firm, to its estimated scrap value.

The objectives of providing depreciation are: **Correct income measurement:** Depreciation should be charged for proper estimation of periodic profit or loss. **True position statement**: Value of the fixed assets should be adjusted for depreciation charged in order to depict the actual position. **Funds for replacement:** Generation of adequate funds in the hands of the business for replacement of the asset at the end of its useful life. Further it is a non-cash expenses and depreciation by itself does not create funds it merely draws attention to the fact that out of gross revenue receipts, a certain amount should be retained for replacement of assets used for replacement of assets used of carrying on operation.

2.3.2 Factors of Depreciation

Depreciation is an expense which is unavoidable in nature. Every entity should plan after acquiring assets to expense it off during its useful life. There are some factors which are very important to calculate amount of depreciation.

- **Cost of Asset**

  Normally cost of assets means its purchase price or amount paid to acquire that asset. But as other expenses like freight, transportation, import duty, installation charge etc. which are directly associated with the fixed assets should be added to calculate the cost of asset. It means that all the expenses incurred up to the assets *put to use* should be capitalized to concern assets and expenses incurred after the assets put to use should be recorded as expenses in Statement Of Profit or Loss.

- **Expected useful life**

  After acquisition of fixed asset, the management of the company should determine the expected useful life of that fixed asset. It means that the active life of the asset should be determined to expect benefit by using that fixed asset.

- **Estimated residual/Scrap/salvage value**

  Scrap or salvage value means that worth of the fixed asset which will be expected at the end of useful life. It means that the minimum amount which can be recovered by selling fixed asset after its expected useful life. In the question, if scrap value is not given then it should be taken as a nil value.

2.3.3 Accounting Entries

1. For purchase of Fixed Assets

   Fixed Asset Account Dr.
   To Cash/Bank/ Supplier's Account

2. For providing Deprecation at year end or at the time of disposal

   Depreciation/Depletion/Amortization Account Dr.
   To Fixed Asset Account

3. For transferring Deprecation to Statement Of Profit or Loss at the end of the year
   Manufacturing/Trading/Profit & Loss Account Dr.
   To Depreciation/Depletion/Amortization Account

4. For sale of Fixed Assets at loss
   Cash/Bank/Party's Account Dr.
   Loss on sale of Fixed Asset Account Dr
   To Fixed Asset Account

5. For sale of Fixed Assets at profit
   Cash/Bank/Party's Account Dr.
   To Fixed Asset Account
   To Profit on sale of Fixed Asset Account

2.3.4 Methods of Providing Depreciation:

Generally, following factors are taken into consideration for calculation of depreciation.

1. Cost of asset including expenses for installation, commissioning and trail run, etc.
2. Estimated useful life of the asset
3. Estimated scrap value (if any) at the end of useful life of the asset.

Apart from above, other factor like estimated working hours, production capacity, repairs and renewal, etc. shall also take into consideration on demanding situation.

If any Asset is used beyond its expected life, then, it is clear that there will be no amount left to be depreciated. In that case the value of asset should not be put nil. This will mean that no further depreciation is to be provided and the existence of assets will be carried out at negligible value.

The various methods of depreciation are discussed in the paragraphs hereunder. Even though the various methods for the calculation of depreciation have been specified, Nepal Accounting standard on Property, Plant and Equipment (NAS-16) states three method of depreciation. They are :

a. Straight Line Method
b. Written Down Value Method
c. Unit Of Production Method

2.3.4.1 Straight-Line Method

According to this method, an equal amount is written off every year during the working life of an asset so as to reduce the cost of the asset to the nil or its residual value at the end of its useful life. This method is simple to apply and gives accurate results especially in cases of leases, patents and copy rights, and also in case of plant and machinery. This method is also known as fixed installment method.

$$\text{Straight Line Depreciation} = \frac{\text{Cost of Asset} - \text{Scrap Value}}{\text{Useful Life}}$$

$$\text{Straight Line Depreciation Rate} = \frac{\text{Straight line depreciation}}{\text{Cost of asset}} \times 100$$

The underlying assumption of this method is that the particular asset generates equal utility during its life time. But this cannot be true under all circumstances. The expenditure incurred on repairs and maintenance will be low in earlier years, whereas the same will be high as the asset becomes old. Apart from this the asset may also have varying capacities over the years, indicating logic for unequal depreciation provision. However, many assets have insignificant repairs and maintenance expenditures for which straight line method can be applied.

Illustration 1

Mr. Shrestha acquired machinery on 1st January 2017 at a cost of Rs. 90,000 and spent Rs. 18,000 on its installation. The scrap value after 7 years will be Rs. 24,000. Calculate the amount of depreciation per year under Straight Line Method (SLM) and rate of depreciation. Prepare Machinery A/C and Depreciation A/C for the year ended 31st December for FY 2017 and 2018 .

Solution:

Cost of Machinery = 90,000+18,000=108,000

Scrap Value = 24,000

No. of Years = 7

$$\text{Now, Annual amount of Depreciation} = \frac{(108{,}000-24{,}000)}{7}$$

$$= 12{,}000$$

Rate of Depreciation = {12,000/108,000}X 100% = 11.11%

Machinery Account

Date	Particular	Rs.	Date	Particular	Rs.
1.1.2017	To Bank	108,000	31.12.2017 31.12.2017	By Depreciation By Balance c/d	12,000 96,000
		108,000			108,000
1.1.2018	To Balance b/d	96,000	31.12.2018	By Depreciation By Balance c/d	12,000 84,000
	Total	96,000		Total	96,000

Depreciation Account

Date	Particular	Rs.	Date	Particular	Rs.
31.12.2017	To Machinery A/c	12,000	31.12.2017	By Profit & Loss A/c	12,000
31.12.2018	To Machinery A/c	12,000	31.12.2018	By Profit & Loss A/c	12,000

Illustration 2

On 1st January 2017 , ABC Ltd purchased a second hand machine for Rs 80,000 and spend Rs 20,000 on its carriage , repair and installation. The residual value at the end of its expected useful life of 4 years is estimated at Rs 40,000. On 30th Sept 2018 this machine is sold for Rs 50,000. Depreciation is to be provided according to Straight line method

Required: Prepare Machinery Account for the first three years assuming that the account are closed on 31st March each year.

Solution:

Machinery Account

Date	Particular	Rs.	Date	Particular	Rs.
01.01.2017	To, bank A/c To Bank A/c Expense	80,000 20,000	31.03.2017	By Depreciation A/c (Rs 100,000*15/100 * 3/12) By Balance c/d	3,750 96,250
		100,000			**100,000**
01.04.2017	To Balance B/d	96,250	31.03.2018	By Depreciation A/c (Rs 100,000*15/100 * 12/12) By Balance c/d	15,000 81,250
		96,250			**96,250**
01.04.2018	To Balance B/d	81,250	31.09.2018	By Depreciation A/c (Rs 100,000*15/100 * 6/12) By Bank A/c - Sales By Profit and loss A/c	7,500 50,000 23,750
		81,250			**81,250**

Working Note

Calculation of Profit / Loss on sale of Machine

Particular	Rs.	Rs.
Total cost of Assets	(Rs 80,000 + Rs 20,000)	100,000
Less: Depreciation from date of Purchase to date of Sales	(Rs 100,000 * 15/100 * 21/12)	26,250
Book Value as on date of sale		**73,750**
Less: Sales Proceeds		

		50,000
Loss on Sale of Assets		**23,750**

Illustration 3

On January 1, 2016 , X Ltd purchased a second hand machine for Rs 52,000 and spent Rs 2,000 as shipping and forwarding charges, Rs 5,000 as import duty, Rs 500 as carriage inwards, Rs 1,500 as repair charges , Rs 500 as installation charges , Rs 400 as brokerage of the middleman and Rs 100 for an iron pad. It was estimated that the machine will have a scrap value of Rs 2,000 at the end of its useful life which is 20 years. On 30 Sept 2016 repairs and renewal amounted ot Rs 20,000. On July 1, 2018 this machine was sold for Rs 30,600

Required : Prepare the Machinery Account for the first three years

Machinery Account

Date	**Particular**	**Rs.**	**Date**	**Particular**	**Rs.**
01.01.2016	To, bank A/c To Bank A/c Expense	52,000 10,000	31.12.2016	By Depreciation A/c By Balance c/d	3,000 59,000
		62,000			**62,000**
01.01.2017	To Balance B/d	59,000	31.12.2017	By Depreciation A/c By Balance c/d	3,000 56,000
		59,000			**59,000**
01.01.2018	To Balance B/d	56,000	31.09.2018	By Depreciation A/c By Bank A/c - Sales By Profit and loss A/c	1,500 30,600 23,900
		56,000			**56,000**

Working Note

i. Calculation of Profit / Loss on sale of Machine

Particular	**Rs.**	**Rs.**
Total cost of Assets	(Rs 52,000 + Rs 10,000)	62,000
Less: Depreciation from date of Purchase to date of Sales	(Rs 3000 + Rs 3000 + Rs 1500)	7,500
Book Value as on date of sale		**54,500**
Less: Sales Proceeds		30,600
Loss on Sale of Assets		**23,900**

ii. The amount spent on repairs and renewals on 30.09.2016 is of revenue nature and not the capital nature and hence not debited to machinery Account

iii. Calculation of cost of Machinery

Total Cost of Machinery = Purchase Price + Expenses to be Capitalized

= RS 52000+RS 2000+RS 5000+RS 500+RS 1500+RS 500+RS 400+RS 100

Rs 62,000

iv. Amount of depreciation p.a

= (Total cost of machine- Estimated Scrap Value) / Expected Useful life

= (Rs 62000-Rs 2000) / 20

= Rs 3000

v. Rate of depreciation

=Amount of Depreciation / Total cost of machine * 100

=Rs 3000 / Rs 62000 * 100

= 4.84 %

Illustration 4

X Ltd has imported a machine on July 1, 2016 for Rs 1,28,000 paid customs duty and freight Rs 64,000 and incurred erection charges Rs 48,000. Another local machinery costing Rs 80,000 was purchased on January 1, 2017. On July 1, 2018 a portion of the imported machinery (Value one third) got out of order and was sold for Rs 27,840. Another machinery was purchased to replace the same for Rs 40,000. Depreciation to be calculated at 20 % pa.

Required: Show the machinery Account for 2016, 2017, 2018

Solution:

Machinery Account

Date	Particular	Rs.	Date	Particular	Rs.
01.07.2016	To Bank A/c - Machine 1 To, Bank A/c Expense To Bank A/c Expense	128,000 64,000 48,000	31.12.2016	By Depreciation A/c (Rs 240,000 * 20/100 * 6/12) By Balance c/d	24,000 216,000
		240,000			**240,000**
01.01.2017	To Balance B/d -	216,000	31.12.2017	By Depreciation A/c	

01.01.2017	Machine 1 To Bank A/c - Machine 2	80,000		- Machine 1 - Machine 2 By Balance c/d - Machine 1 - Machine 2	48,000 16,000 168,000 64,000
		296,000			**296,000**
01.01.2018 01.07.2018	To Balance B/d - Machine 1 - Machine 2 To Bank A/c - Machine 3	- 168,000 64,000 40,000	01.07.2018	By Depreciation A/c (1/3 * Rs 240,000 * 20/100 * 6/12) By Bank A/c - Sales By Profit and loss A/c By Depreciation - Machine 1 - Machine 2 - Machine 3 By Balance c/d - Machine 1 - Machine 2 - Machine 3	8,000 27,840 20,160 32,000 16,000 4,000 80,000 48,000 36,000
		272,000			**272,000**

Calculation of Profit / Loss on sale of Machine

Particular	**Rs.**	**Rs.**
Total cost of Assets	Rs 240000 * 1/3	80,000
Less: Depreciation from date of Purchase to date of Sales	(Rs 24000 + Rs 48000 + 24000) * 1/3	32,000
Book Value as on date of sale		**48,000**
Less: Sales Proceeds		27,840
Loss on Sale of Assets		**20,160**

2.3.4.2 Written Down Value (WDV) Method

Another method is called "Reducing Balance" or "Written Down Value" (WDV) method. Written down value method is one where the depreciation is provided on the remaining balance of the asset after providing depreciation on an asset costing Rs. 10,000 will be 2,000, The value of assets has come down to 8,000. Next year 20% depreciation will be Rs. 1,600 only (instead of 2,000 in straight line method: third year depreciation amount will be Rs. 1,280 (8,000 – 1,600 = 400X20%) only and so on. If a firm is following Written Down Value Method, it is clear that it takes long period to write off the cost of assets. Hence, in comparison to Straight Line Method, Written Down Value Method carries higher rate of depreciation. So, under this method, a fixed percentage of the diminishing value of the assets is written off each year so as to reduce the asset to its break-up value at the end of its useful life, repairs and small renewals being charged to revenue. This method is commonly used for plant, fixtures, etc.

Under this method, the annual charge for depreciation decreases from year to year, so that the earlier years suffer to the benefit of the later years. Also under this method the value of asset can never be completely extinguished, which happens in the case under method, mentioned earlier after all the installments have been written off. The other advantage of this method is that the total charge to revenue is uniform when the depreciation is high, repairs are negligible; and as the repairs increase, the depreciation gets lesser and lesser. On the other hand, under the Straight Line Method, the charge for depreciation is constant, while repairs tend to increase with the life of the asset. Disadvantage of this method are difficult to calculate the rate of depreciation and it takes a very long time to write an asset down to its break-up value, unless a very high rate is used. Similarly, there is possibility of using very low rate of depreciation and full depreciation may not be provided during the life of the asset.

The rate of depreciation under this method may be determined by the following formula:

$$[1-n\sqrt{(\text{Residual Value/Cost of Assets})}]\times 100$$

Where, n = useful life.

Illustration 5

The cost of machinery is Rs. 216,000 and salvage value at the end of useful life is Rs. 27,000. The estimated useful life of asset is three years. It is decided to depreciate the asset under WDV method. Find out the rate of Deprecation and prepare Machinery Account for first two year.

$$\text{Rate of Dep.} = 1 - \sqrt[3]{(27{,}000/2{,}16{,}000)}$$
$$= 50\%$$

Machinery Account

Date	**Particular**	**Rs.**	**Date**	**Particular**	**Rs.**
1st Year	To Bank	216,000	1st Year End	By Depreciation By Balance c/d	108,000 108,000
		216,000			216,000
2nd Year	To Balance b/d	108,000	2nd Year End	By Depreciation By Balance c/d	54,000 54,000
	Total	108,000		Total	108,000

Illustration 6

On 1st January 2017 XYZ Ltd purchased a second hand machine for Rs 80,000 and spent Rs 20,000 on its carriage, repairs and installation. On 30th Sept 2018 this machine is sold for rs 50,000. Depreciation is to be provided @ 20% p.a according to written down value method

Require: Prepare Machinery account for the first three years assuming that the accounts are closed on 31st March each year.

Solution

Machinery Account

Date	Particular	Rs.	Date	Particular	Rs.
01.01.2017	To, bank A/c To Bank A/c – Expense	80,000 20,000	31.03.2017	By Depreciation A/c (Rs 100,000*20/100 * 3/12) By Balance c/d	5,000 95,000
		100,000			**100,000**
01.04.2017	To Balance B/d	95,000	31.03.2018	By Depreciation A/c (Rs 95,000*20/100 * 12/12) By Balance c/d	19,000 76,000
		95,000			**95,000**
01.04.2018	To Balance B/d	76,000	31.09.2018	By Depreciation A/c (Rs 76,000*20/100 * 6/12) By Bank A/c - Sales By Profit and loss A/c	7,600 50,000 18,400
		76,000			**76,000**

Working Note

Calculation of Profit / Loss on sale of Machine

Particular	Rs.	Rs.
Total cost of Assets	(Rs80,000+Rs20,000)	100,000
Less: Depreciation for 2016-2017	(Rs100,000*20/100*3/12)	5,000
Book value as on 01.04.2017		95,000
Less: Depreciation for 2017-2018	(Rs95,000*20/100*12/12)	19,000
Book Value as on 01.04.2018		76,000

Less : Depreciation up to date of Sales for six month	(Rs76000*20/100*6/12)	7,600
Book Value as on date of sale		**68,400**
Less: Sales Proceeds		50,000
Loss on Sale of Assets		**18,400**

Illustration 7

On 1st January 2016, X Ltd purchased machinery for Rs 58,000 and spent Rs 2,000 on its erection. On 1st July, 2016 an additional machinery costing Rs 20,000 was purchased. On 1st July 2018 the machine purchased on 01.01.2016 was sold for Rs 28,600 and on the same date, a new machine was purchased at a cost of Rs 40,000.

Required: Show the machinery Account for the first three calendar year according to written down value method taking the rate of depreciation at 10% pa assuming that the accounts are closed on 31st December each year.

Solution

Machinery Account

Date	Particular	Rs.	Date	Particular	Rs.
01.01.2016	To Bank A/c - Machine 1	**58,000**	31.12.2016	By Depreciation A/c	
	To, Bank A/c - Erection Charges	**2,000**		- Machine 1	**6,000**
01.07.2016	To Bank A/c - Machine 2	20,000		- Machine 2	1,000
				By balance C/d	
				- Machine 1	54,000
				- Machine 2	19,000
		80,000			**80,000**
01.01.2017	To Balance B/d - Machine 1	54,000	31.12.2017	By Depreciation A/c	
01.01.2017	To Bank A/c - Machine 2	19,000		- Machine 1	5,400
				- Machine 2	1,900
				By Balance c/d	
				- Machine 1	48,600
				- Machine 2	17,100
		73,000			**73,000**
01.01.2018	To Balance B/d		01.07.2018	By Depreciation A/c (Rs 48600 * 10/100 * 6/12)	2,430

	- Machine 1	48,600		By Bank A/c - Sales	28,600
	- Machine 2	17,100		By Profit and loss A/c	17,570
01.01.2018	To Bank A/c - Machine 3	40,000	31.12.2018	By Depreciation	
				- Machine 2	1,710
				- Machine 3	2,000
				By Balance c/d	
				- Machine 2	15,390
				- Machine 3	38,000
		105,700			**105,700**

Calculation of Profit / Loss on sale of Machine

Particular	**Rs.**
Total cost of Assets	60,000
Less: Depreciation for 2016	6,000
Book value as on 01.01.2017	54,000
Less: Depreciation for 2017-2018	5,400
Book Value as on 01.04.2018	48,600
Less : depreciation up to date of Sales for six month	2,430
Book Value as on date of sale	**46,170**
Less: Sales Proceeds	28,600
Loss on Sale of Assets	**17,570**

2.3.4.3 Unit Of Production Method

In some cases, time is not the limiting factor on the useful life of an asset. When physical wear and tear determines the useful life of the asset, accountants may base depreciation on units of service or units of production instead of units of time (years). Depreciation based on units of service is unit depreciation, in our example cost of machine being Rs. 300,000 with an estimated scrap value of Rs. 20,000 and has a useful life of 200,000 units, so depreciation computed on a production unit basis is:

$$\text{Dep. expense per unit of service} = \frac{\text{(Acquisition cost-scrap value)}}{\text{Estimated units of services}}$$

$$\frac{\text{(Rs.300,000-Rs.20,000)}}{\text{200,000 units}}$$

$$= \text{Rs } 1.40 \text{ per unit}$$

Illustration 8

A machine is purchased for Rs. 200,000. Its estimated useful life is 10 years with a residual value of Rs. 20,000. The machine is expected to produce 150,000 units during its life time. Expected distribution pattern of production is as follows:

Year	
1-3	20,000 units per year
4-6	15,000 units per year
8-10	10,000 units per year

Determine Annual Depreciation for each year using unit production Method.

Solution:

Statement of annual depreciation under unit production Method.

Year	Annual Depreciation
1-3	$\frac{20,000}{150,000}$ X (Rs.200,000-Rs.20,000)=Rs 24,000
4-6	$\frac{15,000}{150,000}$ X (Rs.200,000-Rs.20,000)=Rs 18,000
7-10	$\frac{10,000}{150,000}$ X (Rs.200,000-Rs.20,000) =Rs 12,000

2.3.4.4 Sum of Years Digits Method

This is a very simple method where the amount of depreciation is higher in earlier years and gradually becomes lower in same proportion in later years. This method looks like a written down value method.

Amount of depreciation = (Cost of Assets-Scrap value) X (1 + no. of years remaining)/ Sum of years digits

Illustration 9

M/s Raj & Co. purchased a machine for Rs. 100,000. Estimated useful life and scrap value were 5 years and Rs. 10,000 respectively. The machine was put to use on 1.1.2017. Show the Machinery Account in their books for 2017 and 2018 by using sum of years digits method.

Solution

Amount of depreciation for 2017 (1^{st} Year) = $\frac{(100,000-10,000) \text{ x } (1+4)}{(1+2+3+4+5)}$

= Rs. 30,000

Amount of depreciation for 2018 (2nd Year) = $\frac{(100{,}000-10{,}000) \times (1+3)}{(1+2+3+4+5)}$

= Rs. 24,000

Machinery Account

Date	Particular	Rs.	Date	Particular	Rs.
1.1.2017	To Bank	100,000	31.12.2017	By Depreciation By Balance c/d	30,000 70,000
	Total	100,000		Total	100,000
1.1.2018	To Balance b/d	70,000	31.12.2018	By Depreciation By Balance c/d	24,000 46,000
	Total	70,000		Total	70,000

2.3.4.5 Machine Hour Rate Method

This is the method of providing depreciation on annual machine hours in use compare with the anticipated machine hours over the life of the machine. This method is appropriate for those entities where record of the actual running hours of each machine can be maintained. The machine hour rate of the depreciation, is calculated after estimating the total number of hours that machine would work during its whole life, however, it may be varied from time to time, on consideration of the changes in the economic and technological conditions which might take place to ensure that the amount provided for depreciation corresponding to that considered appropriate in the changed circumstances. It would be observed that the method is only a slight variation of the straight-line method under which depreciation is calculated for each hour the machine works. For example, a machine costs Rs 50,000 with an estimated residual value of Rs 10,000. The expected effective hours during its life are 20,000. The depreciation charge per machine hour would be:

$$\text{Machine Hour Rate} = \frac{\text{Cost of the Machine - Scrap value}}{\text{Effective Working Hours}}$$

Therefore, depreciation rate per machine hour is $= \frac{\text{Rs } 50{,}000 - \text{Rs } 10{,}000}{20{,}000}$

= Rs 2.

Under this method, each period is charged with depreciation to the extent of the use of machine. But this method misses a vital point i.e. depreciation also takes place even when a machine is not in use.

Illustration 10

A machine was purchased for Rs 300,000 having estimated total working hours of 24,000 hours, the scrap value is expected to be Rs. 20,000 and anticipated pattern of distribution of effective hours is as follows:

Year	Hours
1-3	3,000 hours per year
4-6 2,600 hours per year	
7-10	1,800 hours per year

Determine Annual Depreciation for each year under Machine Hours Rate Method.

Solution:

Statement of annual depreciation under Machine Hour Rate Method.

Year Annual Depreciation

1-3 ~~3,000~~ X (Rs.300,000-Rs.20,000)=Rs 35,000

24,000

4-6 ~~2,600~~ X (Rs.300,000-Rs.20,000)=Rs 30,333

24,000

7-10 ~~1,800~~ X (Rs.300,000-Rs.20,000)=Rs 21,000

24,000

2.3.4.6 Depletion Method

This method is an accounting for natural resources rather than accounting for depreciation. Wasting assets such as mines, quarries, and the like are examples of such natural resources. Distinguishing features of these types of assets is that they cannot be depreciated but can gradually be depleted. This is because these assets can be physically consumed and converted into inventory. For example, a coal mine can be considered as an underground inventory of coal. But such inventory cannot be considered as one of the current assets.

The depreciation rate is calculated by dividing the cost of the asset by the estimated quantity of product likely to be available. Annual depreciation will be the quantity extracted multiplied by the rate per unit.

Illustration 11

M/s JK & Company took lease of a quarry on 1.1.2013 for Rs. 10,000,000. As per technical estimate the total quantity of mineral deposit is 200,000 tones. Depreciation was charged on the basis of depletion method. Expected pattern is given in the following table.

Year	Quantity of minerals extracted in tons
2013	2000
2014	10000
2015	15000
2016	15000

2017	15000
2018	15000

Show the Quarry Account and Depletion Account for each year from 2013 to 2018.

Solution:

Quarry Account

Dr. **Cr.**

Date	Particular	Rs.	Date	Particular	Rs.
01-Jan-13	To, Bank Account	10,000,000	31-Dec-13	By, Depletion A/c [2,000/200,000 X Rs. 1,00,00,000]	100,000
				By, Balance c/d	9,900,000
		10,000,000			10,000,000
01-Jan-14	To, Balance b/f	9,900,000	31-Dec-14	By, Depletion A/c	500,000
				By, Balance c/d	9,400,000
		9,900,000			9,900,000
01-Jan-15	To, Balance b/f	9,400,000	31-Dec-15	By, Depletion A/c	750,000
				By, Balance c/d	8,650,000
		9,400,000			9,400,000
01-Jan-16	To, Balance b/f	8,650,000	31-Dec-16	By, Depletion A/c	750,000
				By, Balance c/d	7,900,000
		8,650,000			8,650,000
01-Jan-17	To, Balance b/f	7,900,000	31-Dec-17	By, Depletion A/c	750,000
				By, Balance c/d	7,150,000
		7,900,000			7,900,000
01-Jan-18	To, Balance b/f	7,150,000	31-Dec-18	By, Depletion A/c	750,000
				By, Balance c/d	6,400,000
		7,150,000			7,150,000

Depletion A/c

Date	Particular	Rs.	Date	Particular	Rs.
31-Dec-13	To, Quarry Lease A/c	100,000	31-Dec-13	By, P&L A/c	100,000
		100,000			100,000
31-Dec-14	To, Quarry Lease A/c	500,000	31-Dec-14	By, P&L A/c	500,000
		500,000			500,000
31-Dec-15	To, Quarry Lease A/c	750,000	31-Dec-15	By, P&L A/c	750,000
		750,000			750,000

31-Dec-16	To, Quarry Lease A/c	750,000	31-Dec-16	By, P&L A/c	750,000
		750,000			750,000
31-Dec-17	To, Quarry Lease A/c	750,000	31-Dec-17	By, P&L A/c	750,000
		750,000			750,000
31-Dec-18	To, Quarry Lease A/c	750,000	31-Dec-18	By, P&L A/c	750,000
		750,000			750,000

2.3.4.7 Double Declining Method

Double declining method is one of the accelerating methods of depreciation which depreciates the asset at higher rate in the earlier years and at lower rate in the later years. It means that amount of depreciation becomes higher at the earlier period and becomes gradually lower in the subsequent periods. Under this method, a fixed double declining rate is calculated and charged up on the diminishing value of the asset to calculate amount of deprecation which is written off in each accounting period during the expected useful life of the asset. The scrap value of the assets should be ignored while calculating depreciation rate. But the written down value of the asset should not be lower than scrap value.

Double Declining Rate = 2/n × 100 %
Where, n = useful life of the asset
Annual Amount of Depreciation = Written down Value X Double Declining Rate

Illustration 12

A machine is purchased by PS Pvt. Ltd. for Rs. 50,000 on 1.1. 2072. The scrap value is estimated at Rs. 5,000 at the end of 5 years useful life of the asset. The machine is depreciated by double declining balance method. Books of accounts are closed at Chaitra End every year. You are asked to prepare machinery account for 5 years.

Solution:

Double Declining Rate (DDR) = 2/5x100% = 40% p.a.

Machinery Account

Date	Particular	Rs.	Date	Particular	Rs.
1.1.2072	To Bank	50,000	31.12.2072	By Depreciation By Balance c/d	20,000 30,000
	Total	50,000		Total	50,000
1.1.2073	To Balance b/d	30,000	31.12.2073	By Depreciation By Balance c/d	12,000 18,000
	Total	30,000		Total	30,000
1.1.2074	To Balance b/d	18,000	31.12.2074	By Depreciation By Balance c/d	7,200 10,800
	Total	18,000		Total	18,000
1.1.2075	To Balance b/d	10,800	31.12.2075	By Depreciation By Balance c/d	4,320 6,480

	Total	10,800		Total	10,800
1.1.2076	To Balance b/d	6,480	31.12.2076	By Depreciation By Balance c/d (cash a/c)	1,480 5,000
	Total	6,480		Total	6,480

2.3.4.8 Annuity Method

In this method, not only is the original cost of the asset but also the periodic interest that would have been earned if the amount was invested elsewhere, rather than on this asset is taken into consideration for calculation of depreciation. A reference to the annuity table gives the amount to be written off as depreciation together with specified rate of interest for Rs. 1 value of asset over 'n' number of economic years of useful life of an asset. In other word, this method also takes into account the element of interest on capital outlay and seeks to write off the value of the asset as well as the interest lost over the life of the asset. It assumes that the amount laid out in acquiring asset, if invested elsewhere, would have earned interest which must be reckoned as part of the cost of asset. On that basis, the amount of depreciation to be annually provided in the accounts is ascertained from the Annuity Tables, to write off each year interest on the capital outlay as well as part of the capital sum at a rate that the whole of the capital sum and interest accruing thereon would be written off over the life of the asset. Though the amount written off annually is constant, the interest in the earlier years being greater, only small amount of the capital outlay is written off. This portion is reversed with the passage of time. This method is eminently suitable for writing off the amounts paid for long leases which involve a considerable capital outlay. It is not practicable to adopt this method for writing off depreciation on plant and machinery on account of frequent changes in the value of such an asset which would necessitate the recalculation of the amount of the amount of depreciation to be written off annually.

Annual amount of depreciation = {(Cost of Asset – Scrap Value) X Annuity Factor + (same in all years) Scrap value X Annual Interest Rate}

Opportunity income (Interest Amount) = Written Down Value X Interest Rate

The relevant journal entries are:

a. **For charging interest on asset account**
   Asset Account Dr.
   To, Interest account
b. **For charging depreciation on asset**
   Depreciation Account Dr.
   To, Asset Account
c. **For transferring Depreciation to Profit and Loss Account**
   Profit and Loss Account Dr.
   To, Depreciation Account
d. **For transferring interest to Profit and Loss Account**
   Interest Account Dr.
   To, Profit and Loss Account

Illustration 13

An asset is purchased on 1st January, 2015 for 4 years at a cost of Rs. 20,000. It is proposed to depreciate the lease by the annuity method charging 5 percent interest. A reference to the annuity table shows that to depreciate Rs. 1 by annuity method over 4 years charging 5 % interest, one must write off a sum of Rs. 0.282012. [To write off Rs. 20,000 one has to write off every year Rs. 5,640.24 i.e. 0.282012 X 20,000]

Show the Asset Account for four year and also the relevant entries in the profit and loss account.

Solution:

Asset Account

Dr. Cr.

Date	Particular	Rs.	Date	Particular	Rs.
1-Jan 15	To, Bank Account	20,000.00	31 Dec 15	By, Depreciation	5,640.24
	To, Interest A/c	1,000.00		By, Balance c/d	15,359.76
	(5% of 20,000)				
		21,000.00			21,000.00
1-Jan 16	To, Balance b/d	15,359.76	31-Dec 16	By, Depreciation	5,640.24
	To, Interest A/c	767.99		By, Balance c/d	10,487.51
	(5% of 15,359.76)				
		16,127.75			16,127.75
1-Jan 17	To, Balance b/d	10,487.51	31-Dec 17	By, Depreciation	5,640.24
	To, Interest A/c	524.38		By, Balance c/d	5,371.65
	(5% of 10,487.51)				
		11,011.89			11,011.89
1-Jan 18	To, Balance b/d	5,371.65	31-Dec 18	By, Depreciation	5,640.24
	To, Interest A/c	268.59		By, Balance c/d	-
	(5% of 5,615.26)				
		5,640.24			5,640.24

Profit and Loss Account (abstract)

31-Dec 15	To, Depreciation	5,640.24	31-Dec 15	By, Interest A/c	1,000.00
31-Dec 16	To, Depreciation	5,640.24	31-Dec 16	By, Interest A/c	767.99
31-Dec 17	To, Depreciation	5,640.24	31-Dec 17	By, Interest A/c	524.38
31-Dec 18	To, Depreciation	5,640.24	31-Dec 18	By, Interest A/c	268.59

2.3.4.9 Depreciation Fund/Provision for Depreciation Method

Provision for depreciation method is an alternative method of recording depreciation calculated by other methods (method no. 1 to 8 above). It means that depreciation fund method should appear with the other method of deprecation calculation. According to this method, depreciation amount is not charged to concern assets directly but credited to special account called provision for depreciation account/depreciation fund account or accumulated depreciation account so that the value of fixed assets remain at original cost and depreciation thereon accumulates in provision for depreciation account. The main objective of this method is to show original value of fixed assets in financial statement. This method is also called 'gross method'. This is the alternative method of presentation of fixed asset in financial statement.

Under this method, at the time of disposal of assets, cost of the assets and its accumulated depreciation should be transferred to assets disposal account. A proceeds received from disposal of the assets is also charged to same account and gain or loss there on calculated accordingly.

Journal Entries to record transactions

a. For purchase of fixed asset
Fixed Asset Account Dr.
To Cash/Bank Account

b. For recording depreciation (at year end or at disposal)
Depreciation Account Dr.
To Provision for Depreciation Account

c. For Transferring depreciation to P/L Account
Profit & Loss Account Dr.
To Depreciation Account

d. At the time of disposal of the Fixed Asset

i. For transferring original cost of the asset to be disposed off to asset disposal account
Asset Disposal Account Dr.
To Fixed Asset Account

ii. For transferring accumulated depreciation amount of the asset to be disposed off to asset disposal account
Provision for Depreciation Account Dr.
To Asset Disposal Account

iii. For receiving sales amount (proceed of the disposal)
Cash/Bank Account Dr.
To Asset Disposal Account

iv. For profit on disposal
Asset Disposal Account Dr.
To Profit on Disposal Account

v. For loss on disposal
Loss on Disposal Account
To Asset Disposal Account Dr.

Illustration 14

ABC Ltd. purchased on 1.7.2016 some machinery for Rs. 200,000. On 1.1.2018 a part of machinery purchased on 1.7.2016 for Rs. 60,000 was sold for Rs. 42,000 and new machinery at a cost of Rs. 125,000 was purchased and installed on the same date. The company has adopted the method of providing 10% p.a. depreciation as per Straight Line Method (SLM). Show machinery account, provision for depreciation account and machinery disposal account upto 2018.

Solution:

Working Note

Particular	**I**	**II**	**III**
1.7.2016 Purchased	140,000	60,000	-
31.12.2016 Depreciation	(7,000)	(3,000)	-
31.12.2016/1.1.2017	133,000	57,000	-
31.12.2017 Depreciation	(14,000)	(6,000)	-
31.12.2017/1.1.2018	119,000	51,000	-
1.1.2018 Sold (cash)	-	(42,000)	-
1.1.2018 Loss on Sale	-	(9,000)	-
1.1.2018 Purchased	-	-	125,000
31.12.2018 Depreciation	(14,000)	-	(12,500)
31.12.2014	105,000	-	112,500

Machineries Account

Date	**Particular**	**Rs.**	**Date**	**Particular**	**Rs.**
1.1.2016	To Bank	200,000	31.12.2016	By Balance c/d	200,000
1.1.2017	To Balance b/d	200,000	31.12.2017	By Balance c/d	200,000
1.1.2018 1.1.2018	To Balance b/d To Bank	200,000 125,000	1.1.2018 31.12.2018	By Machinery Disposal a/c By Balance c/d	60,000 265,000
	Total	325,000		Total	325,000

Provision for Depreciation Account

Date	**Particular**	**Rs.**	**Date**	**Particular**	**Rs.**
31.12.2016	To Balance c/d	10,000	31.12.2016	By Depreciation a/c	10,000
31.12.2017	To Balance c/d	30,000	1.1.2017 31.12.2017	By Balance b/d By Depreciation a/c	10,000 20,000
	Total	30,000		Total	30,000
1.1.2018 31.12.2018	By Machinery Disposal a/c To Balance c/d	9,000 47,500	1.1.2018 31.12.2018	By Balance b/d By Depreciation a/c	30,000 26,500
	Total	56,500		Total	56,500

Machinery Disposal Account

Date	Particular	Rs.	Date	Particular	Rs.
1.1.2018	To Machinery a/c	60,000	1.1.2018	By Provision for Dep. a/c By Bank a/c By Loss on Sale a/c	9,000 42,000 9,000
	Total	60,000		Total	60,000

2.3.4.10 Sinking Fund Method

In this method, the original cost and the probable interest that would have been earned must be provided for by depreciation, similar to the annuity method. The amount earmarked by way of depreciation each year will be invested in external securities. The previous year's investment will be sold and the amount utilized for replacement of the asset. This method is useful for replacing funds invested in wasteful assets and lease assets. The interest earned from securities would be re-invested and the amount thereof would be credited to the Sinking Fund Account. The amount of the annual provision for depreciation in such a case is calculated after taking into account interest, that the annually invested shall be earning over the period these will remain invested. When the asset is due for replacement, the securities are sold and the new asset is purchased with the proceeds of their sale. The book value of the old asset, at the time, is transferred to the Sinking Fund Account. Any amount realizes on sale of the old asset, as well as the profit or loss on sale of securities is transferred to the Sinking Fund Account and it is closed off by transfer of the balance to the Profit and Loss Account or General Reserve.

The amount set aside annually by way of depreciation is ascertained from Sinking Fund tables. They readily show the amount which must be invested each year to accumulate to Rs. 1 at a given rate of interest within the stated period.

Relevant entries are:

1. For transfer of depreciation to Sinking Fund

Depreciation A/c Dr.
To, Sinking Fund A/c

2. **For charging depreciation to profit and loss account**

Profit and Loss A/c Dr.
To, Depreciation A/c

3. **For investment of amount of depreciation**

Sinking Fund Investment A/c Dr.
To, Bank A/c

4. **In subsequent years, for interest earned on sinking fund investment and on investment of the interest and depreciation.**

Bank A/c Dr.
To, interest on sinking fund investment A/c

Interest on sinking fund investment A/c Dr.
To, Sinking Fund A/c

(in addition to these entries, entries (1) and (2) will also be passed in subsequent years for transfer of depreciation to sinking fund and for charging it to profit and loss account)

Sinking Fund Investment A/c Dr.
To, Bank A/c
(Yearly depreciation and interest earned.)

5. **<u>For sale of sinking fund investment at the end of useful life of the asset.</u>**

Bank A/c Dr.
To, Sinking Fund Investment A/c

<u>If sale is at a profit</u>
Sinking Fund Investment A/c Dr.
To, Sinking Fund A/c

<u>If sale is at a loss</u>
Sinking Fund A/c Dr.
To, Sinking Fund Investment A/c

6. **<u>For transfer of the amount to the extent of book value of the asset from asset account to sinking fund account.</u>**

Sinking Fund A/c Dr.
To, Asset A/c

Any surplus in Sinking Fund Account may be transferred to General Reserve Account and if any deficit, that may be transferred to Profit and Loss Account.

Sinking Fund A/c Dr.
To, General Reserve A/c

Or

Profit and Loss A/c Dr.
To, Sinking Fund A/c

The aforementioned method may also be operated a little different. The amount set aside on account of depreciation, instead of being invested annually in the purpose of securities may be paid out as premium on a policy maturing at the end of the life of the asset, for an amount equal to the sum that will be required for its replacement. In that case the amounts of the premium when paid will be debited to the Policy Account instead of the investment account.

Illustration 15

On 1st January 2014 Wells Company Ltd. purchased a machine for Rs. 110,000 and spent Rs. 6,000 on its installation. The expected life of the machine is 4 years at the end of which the estimated scrap value will be Rs. 16,000. Desiring to replace the machine on the expiry of its life, the company establishes a sinking fund. Investments are expected to realize 5% interest. On 31st December, 2017, the machine was sold off as scrap for Rs. 18,000 and the investments were realized at 5% less than the book value. On 1st January 2018, a new machine is installed at a cost of Rs. 125,000. Sinking fund tables show that Rs. 0.2320 invested each year will produce Rs. 1

at the end of 4 years at 5%. Show the necessary ledger accounts in the books of Wells Company Ltd. for all the years.

Solution

Amount required =Rs. 110,000+6,000-16,000 = Rs. 100,000;
Therefore, annual contribution = Rs. 100,000 X 0.232= Rs. 23,200.

Machinery A/c

Dr. Cr.

Date	Particular	Rs.	Date	Particular	Rs.
1-Jan-14	To, Bank A/c	110,000	31-Dec-14	By, Balance c/d	116,000
	To, Bank A/c	6,000			
		116,000			116,000
1-Jan-15	To, Balance b/d	116,000	31-Dec-15	By, Balance c/d	116,000
		116,000			116,000
1-Jan-16	To, Balance b/d	116,000	31-Dec-16	By, Balance c/d	116,000
		116,000			116,000
1-Jan-17	To, Balance b/d	116,000	31-Dec-17	By, Bank a/c -sold as scrap	18,000
				By, Sinking Fund A/c	96,343
				By, Profit and Loss A/c	1,657
		116,000			116,000
1-Jan-18	To, Bank A/c (new)	125,000			

Sinking Fund A/c

Dr. Cr.

Date	Particular	Rs.	Date	Particular	Rs.
31-Dec-14	To, Balance c/d	23,200	31-Dec-14	By, Depreciation A/c	23,200
		23,200			23,200
31-Dec-15	To, Balance c/d	47,560	31-Dec-15	By, Balance b/d	23,200
				By, Interest on investment A/c	1,160
				By, Depreciation A/c	23,200
		47,560			47,560
31-Dec-16	To, Balance c/d	73,138	31-Dec-16	By, Balance b/d	47,560
				By, Interest on investment A/c	2,378

				By, Depreciation A/c	23,200
		73,138			73,138
31-Dec-17	To, Sinking Fund Investment A/c	3,657	31-Dec-17	By, Balance b/d	73,138
	To, Machinery A/c	96343		By, Interest on investment A/c	3,657
				By, Depreciation A/c*	23,205
		100,000			100,000

*An adjustment has been made in the depreciation charged in 2017.

Sinking Fund Investment A/c

Date	Particular	Rs.	Date	Particular	Rs.
31-Dec-14	To, Bank A/c	23,200	31-Dec-14	By, Balance c/f	23,200
		23,200			23,200
31-Dec-15	To, Balance b/f	23,200	31-Dec-15	By, Balance c/f	47,560
	To, Bank A/c (23,200+1,160)	24,360			
		47,560			47,560
31-Dec-16	To, Balance b/f	47,560	31-Dec-16	By, Balance c/f	73,138
	To, Bank A/c (23,200+2,378)	25,578			
		73,138			73,138
31-Dec-17	To, Balance b/f	73,138	31-Dec-17	By, Bank A/c-sale	69,481
				By, Sinking Fund A/c (Loss on sale)	3,657
		73,138			73,138

2.4 CHANGES IN METHOD OF DEPRECIATION

Depreciation method used to charge cost of Plant, Property and equipment shall reflect the pattern in which the asset's future economic benefits are expected to be consumed by the entity. Management must reviewed the depreciation method applied to the assets at least at each financial year end and if there is any significant changes in the expected pattern of consumption of the future economic benefit, the method of charging depreciation shall be changed to reflect the pattern

Nepal Accounting Standard on Property, Plant and Equipment (NAS 16) requires that change of depreciation method should be accounted for as a change in accounting estimates. The effect of change in method of depreciation shall be recognized prospectively by including it in profit or loss in

a) The period of the change, if the change affects that period only or
b) The period of change and future periods, if the change affects both the period

Further, the change in depreciation method shall be recognized by adjusting the carrying amount of the Property, Plant and Equipment in the statement of financial position in the period of changes

Illustration 16

MNO Ltd. purchased machinery on Baisakh 1, 2074 for Rs. 60,000. The company was following WDV method with 15% p.a. for depreciation. The company decided to change its depreciation policy from WDV to straight-line method with effect from Baisakh 1, 2076. The rate of depreciation for straight-line method is 20% p.a. Prepare machinery account for 2074 to 2076.

Solution:

Machinery Account

Date	**Particular**	**Rs.**	**Date**	**Particular**	**Rs.**
1.1.2074	To Bank	60,000	31.12.2074	By Depreciation By Balance c/d	9,000 51,000
	Total	60,000		Total	60,000
1.1.2075	To Balance b/d	51,000	31.12.2075	By Depreciation By Balance c/d	7,650 43,350
	Total	51,000		Total	51,000
1.1.2076	To Balance b/d	43,350	31.12.2076 31.12.2076	By Depreciation (20% of 43,350) By Balance c/d	8,670 34,680
	Total	43,350		Total	43,350

2.5 REVALUATION OF PROPERTY, PLAN AND EQUIPMENT

Revaluation means measuring actual worth of the assets as per present circumstances. This is a regular process in business. If the management of the entity thinks that the carrying value of Property, Plant and Equipment don't reflect true and fair picture of the assets, then carrying value of the Property, Plant and Equipment may be revalued i.e. the value may be increased or decreased. This kind of activity is duly permitted by Nepal Accounting Standard (NAS) but according to the provisions of NAS, the entity should revalue the entire class of the Property, Plant and Equipment at a time.

a. Upward Revaluation

If an asset's carrying amount is increased as a result of a revaluation then it is called upward revaluation. Increment in value of asset means increment in net worth of the entity. So, the increase should be credited directly to revaluation reserve account.

Fixed Asset Account Dr.

To Revaluation Reserve Account

b. Downward Revaluation

If an asset's carrying amount is decreased as a result of a revaluation then it is called downward revaluation or devaluation of the asset. In this case the firm will suffer loss as its asset will carry less value. So decrease should be debited directly to Statement Of Profit or Loss (profit & loss account). However, the amount should adjust to the extent of balance of revaluation reserve. In other words, only the amount in excess of revaluation reserve account should be charged to Profit & Loss account.

Revaluation Reserve Account Dr.

Profit & Loss Account Dr.

To Fixed Asset Account

Illustration 17

ABC Ltd. acquired some vehicles on 1.1.2074 for Rs. 2,000,000. Straight line method is adopted with rate 20% p.a. On 1.1.2076, the management decided to revalue carrying value of vehicles by 30% up. You are requested to prepare Vehicle Account for 2074 to 2076.

Solution:

Vehicles Account

Date	Particular	Rs.	Date	Particular	Rs.
1.1. 2074	To Bank	2,000,000	31.12.2074	By Depreciation By Balance c/d	400,000 1,600,000
	Total	2,000,000		Total	2,000,000
1.1.2075	To Balance b/d	1,600,000	31.12.2075	By Depreciation By Balance c/d	400,000 1,200,000
	Total	1,600,000		Total	1,600,000
1.1.2076 1.1.2076	To Balance b/d To Revaluation Reserve a/c	1,200,000 360,000	31.12.2076 31.12.2076	By Depreciation By Balance c/d	312,000 1,248,000
	Total	1,560,000		Total	1,560,000

Working Note:

Carrying value on 1.1.2076 = 1,200,000
Revaluation upward by 30%
Revaluation Amount = 1,200,000 x 30% = 360,000

Vehicles Account	Dr.	360,000	
Revaluation Reserve Account			360,000

Illustration 18

ABC Ltd. acquired some Vehicles on 1.1.2074 for Rs. 1,500,000. WDV method is adopted with rate 25% p.a. On 1.1.2075, the management decided to revalue carrying value of vehicles by 20% down. Balance of revaluation reserve as on that date was Rs. 65,000. You are requested to prepare Vehicles Account for 2074 to 2076.

Solution:

Vehicles Account

Date	**Particular**	**Rs.**	**Date**	**Particular**	**Rs.**
1.1.2074	To Bank	1,500,000	31.12.2074	By Depreciation By Balance c/d	375,000 1,125,000
	Total	1,500,000		Total	1,500,000
1.1.2075	To Balance b/d	1,125,000	31.12.2075	By Depreciation By Balance c/d	281,250 843,750
	Total	1,125,000		Total	1,125,000
1.1.2076	To Balance b/d	843,750	1.1.2076 1.1.2076 31.12.2076 31.12.2076	To Revaluation Reserve a/c By Profit & Loss a/c By Depreciation By Balance c/d	65,000 103,750 168,750 506,250
	Total	843,750		Total	843,750

Working Note:

Carrying value on 1.1.2076 = 843,750

Revaluation downward by 20%

Revaluation Amount = 843,750 x 20% = 168,750

Required Journal Entry:

Revaluation Reserve Account	Dr.	65,000	
Profit & Loss Account	Dr.	103,750	
To Vehicles Account			168,750

2.6 SALE OR DISPOSAL OF ASSETS

The Assets that are held by the firm have to be sold or disposed off at one point of time. In this case, the residual value of the assets is credited to the assets account making it nil and the difference amount is taken to the Profit & Loss account as gain or loss on disposal. For example, if an asset costing Rs. 100,000 has been provided annual depreciation at Rs. 20,000 for three years, is disposed off for Rs. 50,000. The entry would be;

Cash/B\ank A/c	Dr.	50,000 (Amount received)	
To, Assets A/c			40,000 (Residual value)
To, Profit from sale of Assets A/c			10,000 (Gain on Sale)

However, if the sale value is Rs. 20,000 (i.e. less than the residual value then the entry would be;

Cash/Bank A/c	Dr.	20,000 (Money received)	
Loss on sale of assets A/c	Dr.	20,000 (Loss on Sale)	
To, Assets			40,000(Residual value)

The concept is that, whenever an asset is sold, the amount appearing in the Asset account should be written off. Since the asset value has not to be maintained in the book once there is no existence of the same. In case of disposal for 'no charge' the residual value should be written off. i.e.

Depreciation Expenses A/c Dr. (Residual amount)
To, Assets

Illustration 19

a. J.B. Company acquired a machine on 1st July, 2015 at a cost of Rs. 140,000 and spent Rs. 10,000 on its installation. The company writes off depreciation at 10% of the original cost every year. The books are closed on 31st December every year. On March 31st 2018 the machine is sold for Rs. 95,000. Show the Machinery A/c and Depreciation A/c.

b. Work out on the basis of the reducing balance method taking rate of depreciation is 25%.

Solution:

a. Straight Line Method:

Machinery A/c

Dr. **Cr.**

Date	**Particulars**	**Rs.**	**Date**	**Particulars**	**Rs.**
01-07-15	To, Bank-including installation Exp.	150,000	31-12-15	By, Depreciation A/c (10% on 150,000 for 6 months)	7,500
				By, Balance c/d	142,500
		150,000			150,000
01-01-16	To, Balance b/d	142,500	31-12-16	By, Depreciation A/c (10% on 150,000)	15,000
				By, Balance c/d	127,500
		142,500			142,500
01-01-17	To, Balance b/d	127,500	31-12-17	By, Depreciation A/c (10% on 150,000)	15,000
				By, Balance c/d	112,500
		127,500			127,500
01-01-18	To, Balance b/d	112,500	31-03-18	By, Bank A/c Sale of machinery	95,000
				By, Depreciation A/c (10% on 150,000 for 3 months)	3,750
				By, PL A/c Loss on sale	13,750
		112,500			**112,500**

Depreciation A/c

Dr. **Cr.**

Date	Particulars	Rs.	Date	Particulars	Rs.
31-12-15	To, Machinery A/c	7,500	31-12-15	By, Profit & Loss A/c	7,500
31-12-16	To, Machinery A/c	15,000	31-12-16	By, Profit & Loss A/c	15,000
31-12-17	To, Machinery A/c	15,000	31-12-17	By, Profit & Loss A/c	15,000
31-03-18	To, Machinery A/c	3,750	31-12-18	By, Profit & Loss A/c	3,750

b. Reducing Balance Method:

Machinery A/c

Dr. **Cr.**

Date	Particulars	Rs.	Date	Particulars	Rs.
01-07-15	To, Bank-including installation Exp.	150,000	31-12-15	By, Depreciation A/c (25% on 150,000 for 6 months)	18,750
				By, Balance c/d	131,250
		150,000			150,000
01-01-16	To, Balance b/d	131,250	31-12-16	By, Depreciation A/c (25% on 131,250)	32,812
				By, Balance c/f	98,438
		131,250			131,250
01-01-17	To, Balance b/d	98,438	31-12-17	By, Depreciation A/c (25% on 98,438)	24,610
				By, Balance c/d	73,828
		98,438			98,438
01-01-18	To, Balance b/d	73,828	31-03-18	By, Bank A/c Sale of machinery	95,000
31-03-18	To, Profit and Loss A/c (gain on sale)	25,786		By, Depreciation A/c (25% on 73,828 for 3 months)	4,614
		99,614			99,614

Depreciation A/c

Dr. **Cr.**

Date	Particulars	Rs.	Date	Particulars	Rs.
31-12-15	To, Machinery A/c	18,750	31-12-15	By, Profit & Loss A/c	18,750
31-12-16	To, Machinery A/c	32,812	31-12-16	By, Profit & Loss A/c	32,812
31-12-17	To, Machinery A/c	24,610	31-12-17	By, Profit & Loss A/c	24,610
31-03-18	To, Machinery A/c	4,614	31-12-18	By, Profit & Loss A/c	4,614

Illustration 20

A Transport company bought 4 motor vehicles costing Rs. 1,200,000 each 0n 1st May, 2015. The company expected to fetch a scrap value of 25% of the cost price of the vehicle after ten years. The company had followed SLM upto 31st December 2017. With effect from 1st January 2018, company decided to introduce the WDV @ 20% instead of SLM after company had sold one of the vehicle at Rs.700,000 on 31st Dec 2017.

Prepare Vehicle Account and Depreciation A/c for the year 2015, 2016, 2017 and 2018; the accounting year being January to December, without giving any retrospective effect.

Solution:

Vehicle Account

Dr. Cr.

Date	**Particulars**	**Rs.**	**Date**	**Particulars**	**Rs.**
01-05-15	To, Bank- acquisition	4,800,000	31-12-15	By, Depreciation A/c (for 8 months)	240,000
				By, Balance c/d	4,560,000
		4,800,000			4,800,000
01-01-16	To, Balance b/d	4,560,000	31-12-16	By, Depreciation A/c	360,000
				By, Balance c/d	4,200,000
		4,560,000			4,560,000
01-01-17	To, Balance b/d	4,200,000	31-12-17	By, Depreciation A/c	360,000
				By, Bank - vehicle sold	700,000
				By, P/L Account (loss on sale)	260,000
				By, Balance c/d	2,880,000
		4,200,000			4,200,000
01-01-18	To, Balance b/d	2,880,000	31-12-18	By, Depreciation A/c – (20% on 2,880,000)	576,000
				By, Balance c/d	2,304,000
		2,880,000			2,880,000
01-01-19	To, Balance b/d	2,304,000			

Depreciation A/c

Dr. Cr.

Date	**Particulars**	**Rs.**	**Date**	**Particulars**	**Rs.**
31-12-15	To, Vehicle A/c	240,000	31-12-15	By, Profit & Loss A/c	240,000
31-12-16	To, Vehicle A/c	360,000	31-12-16	By, Profit & Loss A/c	360,000
31-12-17	To, Vehicle A/c	360,000	31-12-17	By, Profit & Loss A/c	360,000
31-12-18	To, Vehicle A/c	576,000	31-12-18	By, Profit & Loss A/c	576,000

Illustration 21

A company purchased machinery for Rs. 200,000 on 1st January, 2015 and followed the diminishing balance method of depreciating the value @ 15%. At the end of 2018, it was decided to follow the fixed installment method of depreciating the machine at Rs. 30,000 per year from the very beginning and the necessary amount of unabsorbed depreciation of 2015 to 2017 to be adjusted in 2018. Show the machinery account for the period 2015 to 2018.

Solution:

Machinery A/c

Dr. Cr.

Date	Particulars	Rs.	Date	Particulars	Rs.
01-01-15	To, Bank	200,000	31-12-15	By, Depreciation A/c	30,000
				By, Balance c/d	170,000
		200,000			200,000
01-01-16	To, Balance b/d	170,000	31-12-16	By, Depreciation A/c	25,500
				By, Balance c/d	144,500
		170,000			170,000
01-01-17	To, Balance b/d	144,500	31-12-17	By, Depreciation A/c	21,680
				By, Balance c/d	122,820
		144,500			144,500
01-01-18	To, Balance b/d	122,820	31-12-18	By, Profit and Loss adjustment A (as per note 1)	12,820
				By, Depreciation A/c	30,000
				By, Balance c/d	80,000
		122,820			122,820
01-01-19	To, Balance b/d	80,000			

Working Note 1

Total depreciation from 1.1.2015 to 31.12.2017 under old method (30,000+25,500+21,680)	77,180
Total depreciation would be from 1.1.2015 to 31.12.2017 under new method (30,000×3)	90,000
Additional depreciation to be adjusted on 31.12.2018	**12,820**

Journal entry of additional depreciation adjustment:

P/L Adjustment A/c Dr.	12,820	
To, Machinery A/c		12,820

Illustration 22

A firm purchased on 1st January, 2015 certain machinery for Rs. 582,000 and spent Rs. 18,000 on its erection. On July 1, 2015 additional machinery for Rs. 200,000 was acquired. On 1st July

2017 the machinery purchased on 1st January, 2015 having become obsolete was auctioned for Rs. 286,000 and on the same date fresh machinery was purchased at a cost of Rs. 400,000.

Depreciation was provided for annually on 31st December at the rate of 10 percent on written down value. In 2018, however, the firm changed this method of providing depreciation and adopted the method of providing 5 per cent annum depreciation on the original cost of the machinery with retrospective effect.

Solution:

Machinery A/c

Dr. Cr.

Date	Particulars	Rs.	Date	Particulars	Rs.
01-01-15	To, Bank	582,000	31-12-15	By, Depreciation A/c	
				On 1st Machine	60,000
				On 2nd Machine	10,000
	To, Bank	18,000		By, Balance c/d	
				1st Machine	540,000
				2nd Machine	190,000
01-07-11	To, Bank	200,000			
		800,000			**800,000**
01-01-16	To, Balance b/d		31-12-16	By, Depreciation A/c	
	1st Machine	540,000		On 1st Machine	54,000
	2nd Machine	190,000		On 2nd Machine	19,000
				By, Balance c/d	
				1st Machine	486,000
				2nd Machine	171,000
		730,000			**730,000**
01-01-17	To, Balance b/d		01-07-17	By, Depreciation A/c-	
	1st Machine	486,000		(On sold machine)	24,300
	2nd Machine	171,000		By, Bank-Sale proceeds	286,000
01-07-17	To, Bank	400,000		By, Profit and Loss A/c	175,700
			31-12-17	By, Depreciation A/c	
				On 2nd Machine	17,100
				On 3rd Machine	20,000
				By, Balance c/d	
				2nd Machine	153,900
				3rd Machine	380,000
		1,057,000			**1,057,000**
01-01-18	To, Balance b/d		31-12-18	By, Depreciation A/c	30,000
	2nd machine	153,900			
	3rd Machine	380,000			

31-12-18	To, Profit & Loss A/c (Excess Depreciation written back)	31,100		By, Balance c/d 2nd Machine 3rd Machine	 165,000 370,000
		565,000			**565,000**
01-01-19	To, Balance b/d 2nd Machine 3rd Machine	 165,000 370,000			

Working Note 1:

	Machine 1 Rs.	Machine 2 Rs.	Machine 3 Rs.
Cost	600,000	200,000	400,000
Depreciation for 15 @ 10% WDV	60,000	10,000	-
WDV	540,000	190,000	-
Depreciation for 16 @ 10%WDV	54,000	19,000	-
WDV	486,000	171,000	-
Depreciation for 17 @ 10% WDV	24,300	17,100	20,000
WDV	461,700	153,900	380,000
Less: Sale Price	286,000		
Loss on Sale	**175,700**		

Working Note 2: calculation of depreciation adjustment in 31st Dec 2018 due to change in method

Particulars	Machine 2			Machine 3		
	Under WDV	Under original cost	Excess Dep. Charged	Under WDV	Under original cost	Excess Dep. Charged
Depreciation upto 31st Dec 2017 (10,000+19,000+17,100) (5000+10,000+10,000)	46,100	25,000	21,100	20,000	10,000	10,000

Total Depreciation to be adjusted due to change in method of Depreciation = 21,100 + 10,000 = 31,100.

Working Note 3: Balance of Machine at 31st Dec. 2018

	Machine 2	Machine 3
Cost	200,000	400,000
Total Depreciation under Original cost method upto 31st Dec. 2018	35,000	30,000
Balance on 31st Dec. 2018	**165,000**	**370,000**

Illustration 23

M/s. Mills and Wright commenced business on 1st January, 2014, when they purchased plant and machinery for Rs. 700,000. They adopted a policy of (i) charging depreciation at 15% per annum on diminishing balance basis and (ii) charging full year's depreciation on additions.

Over the years, their purchases of plant have been:

Date	Amount Rs.
1.8.2015	150,000
30.9.2018	200,000

On 1-1-2018 it was decided to change the method and rate of depreciation to 10% on Straight Line basis with retrospective effect from 1-1-2014, the adjustment being made in the accounts for the year ending 31st December 2018. Calculate the difference in depreciation to be adjusted in the Plant and Machinery being made in accounts for the year ending 31st December 2018.

Solution:

Depreciation on Written Down Value Basis

Year	Particular	Purchased on Jan.1. 2014		Purchased on August.1. 2015
		Rs.	Rs.	Rs.
2014	Cost Depreciation Written Down Value (WDV)	700,000 105,000 595,000		
2015	 Depreciation WDV	 89,250 505,750		150,000 22,500 127,500
2016	Depreciation WDV	75,863 429,887		19,125 108,375
2017	Depreciation WDV	64,483 365,404		16,256 92,119
	Depreciation Charged Total Depreciation Charged (A)	334,596	392,477	57,881
	Depreciation on Straight Line Annual depreciation (10% basis of original cost) No. of years for which depreciation is to be charged Total depreciation Total (B)	70,000 4 yrs 280,000	325,000	15,000 3 yrs. 45,000
	Difference: Excess of depreciation charged to be adjusted in 2014 (A)-(B)		67,477	

Plant and Machinery A/c

Dr. Cr.

Date	Particulars	Rs.	Date	Particulars	Rs.
01-01-18	To, Balance b/d To, Profit and Loss A/c (adjustment for depreciation)	4,57,523 67,477	31-12-18	By, Depreciation A/c (10 % original cost)	105,000
31-09-18	To, Bank	200,000		By, Balance c/d	620,000
		725,000			**725,000**
01-01-19	To, Balance b/d	620,000			

Illustration 24

A company's plant and machinery account at 31st December 2013 and the corresponding depreciation provision account, broken down by year of purchase are as follows:

Yea\r of Purchase	Plant and Machinery at cost	Depreciation provision
1997	20,000	20,000
2003	30,000	30,000
2004	100,000	95,000
2005	70,000	59,500
2012	50,000	7,500
2013	30,000	1,500

Depreciation is at the rate of 10% per annum on cost. It is the Company's policy to assume that all purchases, sales or disposal of plant occurred on 30th June in the relevant year for the purpose of calculating depreciation, irrespective of the precise date on which these events occurred.

During 2014 the following transactions took place:

1. Purchase of plant and machinery amounted to Rs. 150,000
2. Plant that had been bought in 2003 for Rs. 17,000 was scrapped.
3. Plant that had been bought in 2004 for Rs. 9,000 was sold for Rs. 500.
4. Plant that had been bought in 2005 for Rs. 24,000 was sold for Rs. 1,500.

You are required to:

(a) Calculate the provision for depreciation of plant and machinery for the year ended 31st December, 2014. In calculating this provision you should bear in mind that it is the company's policy to show any profit or loss on the sale or disposal of plant as a completely separate item in the Profit and Loss Account.

(b) Prepare following ledger accounts during 2014:
   i. Plant and Machinery at cost
   ii. Depreciation Provision;
   iii. Sales or disposal of plant and machinery

(c) Show at 31st December 2014 the break down by years of purchase of those balances on the
   i. Plant and Machinery (at cost) account;

Solution:

(a) Calculation of provision for depreciation of plant and machinery for the year ended 31st December 2014.

Year	Plant and Machinery at cost		Rs.
1997	20,000		
2003	30,000		
2004	100,000		5,000
2005		½ year at 10% on Rs. 24,000	1,200
	70,000	1 year at 10% on Rs. 46,000	4,600
2012	50,000	10% on Rs. 50,000	5,000
2013	30,000	10% on Rs. 30,000	3,000
2014	150,000	½ years at 10% on Rs. 150,000	7,500
Total Depreciation			**26,300**

(b) (i) **Plant and Machinery Account (for 2014) at cost**

Particular	Rs.	Particular	Rs.
To, Balance b/d	300,000	By, Disposals Accounts:	
		Scraped	17,000
		Sold	9,000
		Sold	24,000
To, Bank (Purchased) A/c	150,000	By Balance c/d	400,000
Total	**450,000**	**Total**	**450,000**

Depreciation Provision Account for 2014

Particular	Rs.	Particular	Rs.
To, Disposal Accounts		By, Balance b/d	213,500
Scraped- 2003 assets	17,000	By, Depreciation A/c	26,300
Sold – 2004 assets	9,000		
Sold - 2005 assets	21,600		
To, Balance c/d	192,200		
Total	**2,39,800**	**Total**	**2,39,800**

(iii) Sales or disposal of plant and machinery account (for 2014)

Particular	Rs.	Particular	Rs.
To, Plant and Machinery:		By, Provision for Depreciation	47,600
Scraped	17,000	By, Cash-Sales Proceeds	2,000
Sold	33,000	By, Loss on Sale	400
Total	**50,000**	**Total**	**50,000**

(c)

Plant and Machinery at 31st December 2014 - Breakdown by year of purchase

Year of Purchase	Plant and Machinery at cost	Depreciation provision
1997	20,000	20,000
2003	13,000	13,000
2004	91,000	91,000
2005	46,000	43,700
2012	50,000	12,500
2013	30,000	4,500
2014	1,50,000	7,500
	4,00,000	**1,92,200**

2.7 PROVISION FOR REPAIRS AND RENEWALS

Expenditure incurred for repairs, renewals and maintenance on plant and machinery may vary over the years during the working life. Thus, for equalizing the charge of repairs and renewal, sometimes a provision for repairs and renewals account is opened. Total of such expenses that may be incurred over the working life is estimated beforehand. Average of this expenditure is debited to Profit and Loss Account and credited to Provision for Repairs and Renewals Account irrespective of actual expenses incurred.

Illustration 25

The following particulars are available from the books of a public company having a large fleet of vehicles.

Balance in Provision for Repairs and Renewals Account as on 1st January 2017	Rs. 150,000
Actual repairs charged incurred during the year ended 31St Dec 2017	Rs. 75,000
Actual repairs charged incurred during the year ended 31St Dec 2018	Rs. 32,000

The company makes an annual provision of Rs. 40,000 on repairs and renewals. Draw up the Provision and Repairs and Renewals Account for the year 2017 and 2018.

Solution:

Provision for Repairs and Renewals Account

Dr. **Cr.**

Date	Particular	Rs.	Date	Particular	Rs.
31-Dec-17	To, Repairs A/c	75,000	01-Jan-17	By, Balance b/d	150,000
	To, Balance c/d	115,000		By, Profit and Loss A/c	40,000
		190,000			**190,000**

31-Dec-18	To, Repairs A/c To, Balance c/d	32,000 123,000	01-Jan-18	By, Balance b/d By, Profit and Loss A/c	115,000 40,000
		155,000			**155,000**

Illustration 26

A provision for Depreciation and Repairs and Renewals was made every year at 15% of the original cost of a machine purchased at Rs. 50,000. The provision for Depreciation and Repairs and Renewals Account that was opened for the purpose was, therefore, debited with the actual costs of repairs and renewals which were as stated below:

1st year -Rs. 1,500, 2nd Year -Rs. 1,600, 3rd year –Rs. 2,100, 4th year -Rs. 3,000 and 5th year – Rs. 4,200.

At the end of the 5th year, the machine was sold out at Rs. 20,000 after utilizing a few of its parts value at Rs. 4,000, in installing in its place a new machine purchased at Rs. 75,000. The resulting loss in the disposal of the old machine was debited to revenue. Write up "Provision for Depreciation and Repairs and Renewals Account" for the 5 years and the Old and New Machine Account at the end.

Solution:

Provision for Depreciation and Repairs and Renewals

Dr. **Cr.**

Date	Particular	Rs.	Date	Particular	Rs.
1st year	To, Repairs A/c To, Balance c/d	1,500 6,000	1st year	By, Profit and Loss A/c	7,500
		7,500			**7,500**
2nd year	To, Repairs A/c To, Balance c/d	1,600 11,900	2nd year	By, Balance b/d By, Profit and Loss A/c	6,000 7,500
		13,500			**13,500**
3rd year	To, Repairs A/c To, Balance c/d	2,100 17,300	3rd year	By, Balance b/d By, Profit and Loss A/c	11,900 7,500
		19,400			**19,400**
4th year	To, Repairs A/c To, Balance c/d	3,000 21,800	4th year	By, Balance b/d By, Profit and Loss A/c	17,300 7,500
		24,800			**24,800**
5th year	To, Repairs A/c To, Old Machinery A/c	4,200 25,100	5th year	By, Balance b/d By, Profit and Loss A/c	21,800 7,500
		29,300			**29,300**

Old Machinery A/c

Dr. **Cr.**

Date	Particular	Rs.	Date	Particular	Rs.
5th year	To, Balance b/d	50,000	5th year	By, New machinery A/c	4,000
				By, Bank A/c	20,000
				By, Provision for Depreciation and Repairs and Renewals A/c	25,100
				By, Profit and Loss A/c-loss	900
		50,000			**50,000**

New Machinery A/c

Dr. Cr.

Date	Particular	Rs.	Date	Particular	Rs.
5th year	To, Old Machinery A/c	4,000	5th year	By, Balance c/d	79,000
	To, Bank A/c	75,000			
		79,000			**79,000**
6th year	To, Balance b/d	79,000			

2.8 TREATMENT OF FIXED ASSETS AND DEPRECIATION FOR INCOME TAX PURPOSE

The value shown as depreciation for accounting purposes to report to shareholders need not be the same as the depreciation reckoned for tax purpose. The taxable income is generally different from what is shown in books of account. There are many reasons for this; one of them being deprecation. Under the Company's Act-2063, there is no specific minimum rate of depreciation to be charged for company's assets. It specifies the diminishing balance method as well as the Straight-line method only. The company can choose any method and should adopt them consistently. In other hand, Income Tax Act-2058 allows depreciation as an allowable expenditure and list down the rate of depreciation under the diminishing balance method for each class of assets. They are generally different from, and in many cases, more than what is charged in books of accounts. The Income Tax Act has introduced a totally new concept for claiming deduction in respect of depreciation for the purpose of computing income from business and specified the rate for each pool of assets.

Where the asset forms a part of the Pool of Assets it loses its identity and forms a part of the Pool. The Act provides a specific procedure for claiming depreciation as mentioned in Schedule 2 of the Act. Hence a company shall be required to maintain two separate schedules of fixed assets for accounting purpose and tax purpose. As per Income Tax Act the companies are required to classify corporate assets in following pools.

Pooling for Depreciation/Amortization

Pool	Assets to be Included	Rate of Depreciation
A	Buildings, Structures, and similar works of a permanent nature	5%
B	Computers, data handling equipment, fixtures, office	25%

	furniture, and office equipment	
C	Automobiles, buses, and minibuses	20%
D	Construction and earth-moving equipment and any depreciable asset not included in other class including unabsorbed expenditure on pollution control and research and development cost. (Plant & machinery is to be included in this Pool)	15%
E	Intangible assets other than depreciable assets included in class D	To be amortized in accordance with the useful life of such individual assets.

Depreciation is calculated by applying the rates of the respective Pool to the written down value (WDV) of the Pool of Assets at the end of the year. Where in a particular income year, the WDV of a particular Pool after depreciation is less than Rs. 2,000 the balance of such amount should be treated as depreciation for the year. In other words, the WDV of a Pool after depreciation cannot be less than Rs. 2,000.

With respect to assets included in Pool E (i.e. intangible assets) depreciation is to be calculated on each asset separately on the basis of the useful life of the asset.

Disposal of Assets under a Pool of Assets Method

Where the amount received from disposal is more than the amount of the opening WDV and additions, no depreciation shall be allowed since the WDV at the end of the year will be nil. The excess amount thus realized should be credited to Profit and Loss Account.

Where the Pool ceases to exist as a result of disposal of all the assets in the Pool, and where the amount received from such disposal of assets is more/less than the aggregate amount of opening WDV and addition made thereon, then the surplus/deficit as the case may be shall be credited/charged to Profit and Loss Account.

Notes on Depreciation Calculation

a) Where the asset is added during the first two quarters of an income year i.e. upto Poush (Mid-January), then the whole of the cost of acquisition of the asset will be included as cost of addition.

b) Where the asset is added in the third quarter i.e. within a period of Magh to Chaitra (mid-January to mid-April), then the amount to be included in the cost of addition is restricted to two-third of the cost of acquisition.

c) Where the asset is added in the fourth quarter i.e. within a period of Baisakh to Ashad (mid-April to mid-July), then the amount to be included in the cost of addition is restricted to one-third of the cost of acquisition.

d) The balance amount of the cost of acquisition i.e. one-third of the cost of acquisition in case (b) and two-third in case of (c) above shall be included in the respective Pool as cost of addition in the subsequent year provided the Pool exists.

2.9 PHYSICAL VERIFICATION OF FIXED ASSTES

The entity should maintain the proper record of fixed assets in order to proper utilize and control of the fixed assets. What constitutes 'Proper records' regarding fixed assets would depend on the particular circumstances of a case. The records should, however, contain, inter alia, the following particulars: sufficient description of the asset to make identification possible, classification (the head of account under which the asset is shown), location, quantity, original cost, year of purchase, adjustments in cost due to revaluation or due to foreign exchange fluctuations if any, date of revaluation if any, rate of depreciation, depreciation/impairment for the current year, accumulated depreciation/impairment, particulars regarding impairment, and particulars regarding sale, discarding, etc. The records should contain the above particulars in respect all items of fixed assets, whether tangible or intangible.

The location of fixed assets should be so shown that it makes their physical verification possible. In the case of items constantly move, e.g. construction equipment which has to be moved to sites, the relevant record of movement or custody of the asset may need to be maintained.

It is the responsibility of management to carry out the physical verification of fixed assets in regular interval. Physical verification work can be assigned to their own staff or appoint outsider. While conducting physical verification, management should issue written instruction to its staff regarding procedure to be adopted, preparation of working paper, categorization of physically existing assets such good conditions assets, need to repair, to be discarded etc. and time period allowed to complete the verification work.

Physical verification by the management has to be conducted at the 'reasonable intervals', however, the term of physical verification which has to be construed by considering factors like the number, nature, value and geographical spread of the fixed assets. An annual verification may be considered as reasonable, in situations where it is impracticable to do so, physical verification must be done at least once in three years.

Regarding the material discrepancies noticed on verification that should be properly dealt with in the books of account in order to update the assets register/records. The management should decide whether discrepancy is material or not in the light of the nature, location and cost of the asset, total cost of all the fixed assets and other relevant factors,

Summary

Long-lived assets are used in the business to derive benefit for more than one period. Though cost of these assets is incurred at the time of acquisition, however, cost of the assets shall be allocated throughout the useful life to find out the net income/loss of the business during the specified period i.e. accounting period. Since fixed assets are used to generate periodic revenue, a suitable portion of the amount spent to acquire the fixed assets needs to be charged as cost. That appropriate portion of fixed assets which is believed to be used or expired for generation of periodic revenue is termed as depreciation. There are various methods of *charging depreciation, namely Straight Line Method, Reducing Balance Method, Sum of Digit Method, Double Declining Method, Annuity Method, Machine Hour Method and so on. Of these, Straight Line Method and Reducing Balance Method are used popularly for charging depreciation.*

The entity should maintain the proper record of fixed assets in order to proper utilization and control of fixed assets. The management should carry out the physical verification of fixed assets at reasonable interval which will help to find out condition of all fixed assets and their utilization.

Self-Examination Questions

I. Multiple Choice Questions (MCQs)

1. Original cost of a Machine — Rs. 130,000
   Salvage value — Rs. 4,000
   Useful life — Rs. 6 years

   Depreciation for the 1st year under sum of year's digit method will be:
   (a) Rs. 6,000 (b) Rs. 12,000
   (c) Rs. 18,000 (d) Rs. 36,000

2. Under annuity method the amount of depreciation is:
   (a) Increasing every year (b) Decreasing every year
   (c) Revalued every year (d) Remains fixed for all the year

3. As asset was purchase for Rs. 12,500 and was depreciated under Reducing Balance Method at the rate of 20% p,a . What is the value of the asset at the end of third year?
   (a) Rs. 8,000 (b) Rs. 7,500
   (c) Rs 6,400 (d) Rs. 5,000

4. The main objective of providing depreciation is to:
   (a) Reduce tax burden
   (b) Provide funds for replacement of fixed asset
   (c) Show true financial position in the Statement Of Financial Position
   (d) Comply with legal requirement

5. Original cost of an asset Rs. 252,000, Salvage value Rs. 12,000 Depreciation for 2nd year @ 10% p.a. under W.D.V. method will be :
   (a) Rs. 21,600 (b) Rs. 22,680
   (c) Rs. 30,000 (d) Rs. 28,000

6. Useful life of an asset can be described as:
   (a) The period over which a depreciable asset is expected to be used by the enterprise

(b) The number of production or similar units expected to be obtained from the use of the asset by the enterprise
(c) 10 year
(d) Both (a) and (b)

7. Amortization refers to writing off:
(a) Depleting assets (b) Wasting assets
(c) Intangible assets (d) Fictitious assets

8. The W.D.V. of an asset after three years of depreciation on the reducing balance method @ 10% p.a. is Rs. 36,450. What was its original value?
(a) Rs. 40,000 (b) Rs. 50,000
(c) Rs. 45,000 (d) Rs. 70,250

9. The cost of a machine having a span of life of 5 year is Rs. 100,000 with a scrap value of Rs. 10,000. The amount of depreciation under sum of years digit method for the second year will be:
(a) Rs. 16,000 (b) Rs. 18,000
(c) Rs. 12,000 (d) Rs. 24,000

10. Which method of depreciation takes into account the element of interest on Capital outlay:
(a) Depletion Method (b) Annuity Method
(c) SLM Method (d) WDV Method

11. Cost of an asset Rs. 75,000. Useful life is 4 year. Find out the depreciation for the 1st year under sum of years digit method:
(c) Rs. 30,000 (b) Rs. 7,500
(c) Rs. 22,500 (d) Rs. 15,000

12. Original cost = 126,000; scrap value = nil; useful life = 6 years. Depreciation for the fourth year under sum of years digits method will be
(a) Rs. 6,000 (b) Rs. 12,000
(c) Rs. 18,000 (d) Rs. 24,000

13. The portion of the acquisition cost of the asset, yet to be allocated is known as
(a) Written down value (b) Accumulated value
(c) Realizable Value (d) Salvage Value

14. For charging depreciation, on which of the following assets, the depletion method is adopted?
(a) Plant & Machinery (b) Goodwill
(c) Land & Building (d) Wasting Assets like mines

15. In case of downward revaluation of an asset which is for the first time revalued, the account to be debited is
    (a) Fixed Asset (b) Revaluation Reserve
    (c) Profit & Loss Account (d) General Reserve

16. Which of the following is not true with regard to the Property , Plant and Equipments?
    (a) They are acquired for using them in the conduct of business operations
    (b) They are not meant for resale to earn profit
    (c) They can easily be converted into cash
    (d) Depreciation at specified rates is to be charged on most of the fixed assets.

II. Short Descriptive Questions (SDQs)

1. Define depreciation. What are the factors of depreciation?
2. Differentiate between Straight Line Method and Written Down Value Method.
3. 'Sinking fund method and depreciation fund method are similar.' Explain.
4. Distinguish between amortization, depreciation and depletion.
5. Write Short note on Double Declining Method.
    (a) Double Declining Method
    (b) Revaluation of Property, Plant and Equipment
    (c) Depreciation as per Income Tax Act 2058
    (d) Provision for Repair & Renewal

III. Practical Questions (PQs)

1. Mrs. Dangol acquired machinery on 1st January 2017 at a cost of Rs. 90,000 and spent Rs. 18,000 on its installation. The scrap value after 7 years will be Rs. 24,000. Calculate the amount of depreciation per year under Straight Line Method (SLM) and rate of depreciation. Prepare Machinery A/C and Depreciation A/C for the year ended 31st December for FY 2017 and 2018.
2. UFO Company follows a straight-line depreciation policy for its fixed assets. It purchased a machine on 1st January, 2016 at cost of Rs. 60,000. At that time the life of the machine was estimated to be of five years. On September 30, 2018, the company sold the machine for Rs. 25,000 and purchased a new machine for Rs. 70,000 with 7 years of life. The Financial year of the company ends at December 31st every year. Prepare Machinery account for 2016 to 2018.
3. A Company purchased machinery for Rs. 50,000 on 1st January, 2016. The expected working life of the machine was five years. The salvage value of the machine is expected to be 15% of its cost. The company has followed Straight Line Method of depreciation policy. At the end of year 2017, company sold the machine at Rs. 25,000 and purchased other machine for Rs. 75,000 on the same date. Prepare Machinery account and Depreciation account for three years ending December 2018.
4. A company acquired a plant on 1.1.2013 for Rs. 50,000 and spent Rs. 5,000 on its installation. Another plant costing Rs. 20,000 was purchased on 1st July 2013. The firm writes off depreciation @ 10% p.a. of the original cost every year. The books are closed on

31st December every year. On 1st July 2014, the second plant got out of order and was sold for Rs. 15,000. Prepare plant account and Depreciation account for 2013 to 2014.

5. On January 1, 2010, a company purchased a machine for Rs. 45,000. On January 1, 2011, another machine costing Rs. 60,000 has been purchased. On December 31, 2012 the company sold out the machine purchased in 2010 for Rs. 22,000. Depreciation is provided @ 10% on diminishing balance method. Prepare Machinery account for 2010 to 2012 showing profit or loss on sales of machine.
6. ABC company has purchased certain machinery for Rs. 152,000 on 1st January, 2007 and spent Rs. 18,000 for its installation. On July 1, 2007 another machinery for Rs. 70,000 was acquired. On 1st July 2010 the machinery purchased on 1st January 2007 having become obsolete and sold for Rs. 36,000 and on the same date fresh machinery was purchased at a cost of Rs. 90,000. Depreciation was provided for annually on 31st December at the rate of 15% on WDV basis. Prepare Machinery a/c and Depreciation a/c up to 31 December 2010.
7. Rohit started businesses in Ashad 2069. He acquired some machines for Rs. 200,000 on 1.4.2069. He acquired another machine for Rs. 50,000 on 1.3.2071. He sold machines, original cost of which was Rs. 60,000 for Rs. 35,000 on 31.10.2070. Assuming depreciation @ 15% under WDV basis, compute the depreciation amount and prepare deprecation account for the year ended 31.3.2070 and 31.3.2071. Depreciation is to be calculated to the nearest rupee.
8. On January 1, 2010 a company purchased Furniture for Rs. 50,000. The company was following straight-line method for depreciation. Depreciation rate was @10% p.a. But on 1 January, 2012 management of the company decided to change its policy of depreciation and adopted diminishing balance method with same rate having retrospective effect. Prepare furniture account for 2010, 2011 and 2012.
9. ABC Ltd. purchased machinery on Baisakh 1, 2060 for Rs. 120,000. The company was following written down value method with 15% p.a. for depreciation. The company decided to change its depreciation policy from WDV to straight-line method with effect from Baisakh 1, 2062. The rate of depreciation for straight-line method is 20% p.a. Prepare machinery account for 2060 to 2062.
10. Hanuman Enterprises purchased on 1.4.2012 certain machinery for Rs. 72,800 and paid Rs. 2,200 on its installation. On 1.10.2012, another machinery for Rs. 25,000 was acquired. On 1.4.2013 the first machinery was sold at Rs. 50,000 and on the same date fresh machinery was purchased at a cost of Rs. 45,000.

    Depreciation was annually provided on 31st March at 10% p.a. on written down value. On 1.4.2014, however, the firm decided to change the method of providing depreciation and adopted the method of providing depreciation @ 10% p.a. on the original cost with retrospective effect. Ascertain the value of machinery as on 31.3.2015.
11. Matrix Ltd. purchased on January 1, 2008 a second hand plant for Rs. 60,000 and immediately spent Rs. 40,000 in putting the same in working condition. On July 1, 2008 additional machinery costing Rs. 40,000 was purchased. On January 1, 2010 the plant purchased on January 1, 2008 became obsolete and was sold for Rs. 50,000. On July 1, 2010 new machinery was purchased at a cost of Rs. 120,000. The firm provided depreciation on straight-line method at 10% p.a. on the original cost of the asset. In 2011, the company

decided to provide depreciation on written down value basis at 15% p.a. with retrospective effect. Show machinery account for the calendar years 2008 to 2011.

12. Depreciation has been charged for the years from 2009 to 2012 @ 10% on reducing balance method on opening balance of each item of plant and machinery in use. The balance of plant and machinery account at the end of December 31, 2009 was Rs. 54000. There were no sales during these days, purchases were Rs. 16,000 in September 2012 and Rs. 11,400 in December, 2008. The management decided that depreciation should be charged @ 20% on the same method but calculated on the closing balance of each year with retrospective effect from 2012. You are required to pass journal entry for giving effect to the revised basis at the end of 2012.
12. Kopila Co. Ltd. purchased a machine for Rs. 200,000. Estimated useful life and scrap value were 9 years and Rs. 20,000 respectively. The machine was put to use on 1.1.2002. Show machinery account and depreciation account in their books for 2002 to 2012 by using sum of years digits method.
13. Zenus Enterprises acquired a building for Rs. 1,800,000 on 1.1.2010 having useful life 8 years with zero scrap value. On 30.9.2013 the building was sold at Rs. 790,000. You are asked to prepare building account upto disposal by using sum of years digits method.
14. A machine is purchased by PS Pvt. Ltd. for Rs. 50,000 on 1.1.2060. The scrap value is estimated at Rs. 5,000 at the end of 5 years useful life of the asset. The machine is depreciated by double declining balance method. Books of accounts are closed at Chaitra End every year. You are asked to prepare machinery account for 5 years.
15. On 1.4.2010, Z Ltd. purchased equipment for Rs. 100,000 and incurred Rs. 10,000 towards installation charges. It was estimated that the equipment will have a residual value of Rs. 9,000 at the end of its useful life which is 4 years. Prepare equipment account and depreciation account under double declining method.
16. A plant was purchased on 1.4.2011 for a five year at a cost of Rs. 50,000. It is proposed to depreciate the lease by annuity method charging 5% interest with scrap value Rs. 2,000. Show the plant account for 5 years and also the relevant entries in the profit and loss account. The reference to the annuity table shows that to depreciate Rs. 1 by annuity method over 5 years by charging interest at 5% one must write off a sum of Rs. 0.230975 every year.
17. Reliable Traders purchased on 1.1.2012 some machinery for Rs. 1,200,000. On 1.7.2014 a part of machinery purchased on 1.1.2012 for Rs. 80,000 was sold for Rs. 45,000 and new machinery at a cost of Rs. 158,000 was purchased and installed on the same date. The company has adopted the method of providing 10% p.a. depreciation on the original cost of the asset. Show machinery account, provision for depreciation account and machinery disposal account upto 2014.
18. Akhil Ltd. imported a machine on 1.7.2011 for Rs. 188,000, paid customs duty and freight Rs. 64,000 and incurred erection charges Rs. 48,000. Another machinery costing Rs. 80,000 was purchased on 1.1.2012. On 1.7.2013, a portion of the imported machinery (value one third) got out of order and was sold for Rs. 27,840. Another machinery was purchased to replace the same for Rs. 40,000. Depreciation is to be calculated 20% p.a. under written down value method. Prepare machinery account, provision for depreciation account and machinery disposal account for the year 2011, 2012 and 2013.

19. Ms. Mayur & Co. purchased a machine on 1.1.1996 for Rs. 2,000,000. Estimated useful life was 10 years and scrap value at the end was expected to be Rs. 200,000. On 1.1.2001, the written down value of the machine was revalued to be up by 20%, useful life was re-estimated as 13 years and scrap value as Rs. 280,000. The company follows straight line method of charging depreciation. Show machinery account and provision for depreciation account for the year ended 31.12.2001.
20. From the following information pass necessary journal entries and prepare plant account for the year ended 31.12.2071 in the books of Ms. PD Pvt. Ltd.

Balance in plant account on 1.1.2070	Rs. 450,000
Balance of Revaluation Reserve Account on 1.1.2070	Rs. 22,000
Rate of depreciation (under WDV)	15% p.a.
Downward revaluation of plants on 1.7.2071 by 10%	

21. Ms. Himal Traders purchased machinery on 1.1.2010 for Rs. 200,000. Depreciation rate is 25% p.a. under straight-line method. Sinking fund method is adopted for recording of depreciation. Return on sinking fund investment is 10% p.a. On 31.12.2012, the machinery was sold for Rs. 40,000. Prepare machinery account, sinking fund account and sinking fund investment account for 2010 to 2012.
22. Ms. Takura Enterprises acquired a vehicle for Rs. 1,000,000 on 1.7.2014. Depreciation rate is 20% p.a. under WDV method. Return on sinking fund investment was Rs. 7.5% p.a. paying at the end of each year. The firm acquired another vehicle for Rs. 1,200,000 on 1.1.2015. Due to the defect in engine, the vehicle purchased in 2014 was sold for Rs. 475,000 on 1.5.2016. You are asked to prepare vehicle account, sinking fund account, sinking fund investment account and vehicle disposal account for the year 2014 to 2017.

ANSWER

Multiple Choice Questions (MCQs)

1	D	6	A	11	A	16	C
2	B	7	C	12	C		
3	C	8	B	13	A		
4	C	9	D	14	D		
5	B	10	B	15	C		

CHAPTER- 4

Accounting treatment of Inventory

Partnership Accounts

Learning Objectives

1. *Understand the various methods of inventory valuation. Link inventory valuation to gross profit.*
2. *Be familiar with the various cost components of the inventories.*
3. *Be familiar with the provisions of the accounting standards relating to inventories.*
4. *Understand the perpetual and periodic inventory system.*
5. *Calculate cost of merchandise acquisition.*
6. *Compute income and inventory values using the four principal inventory valuation method.*

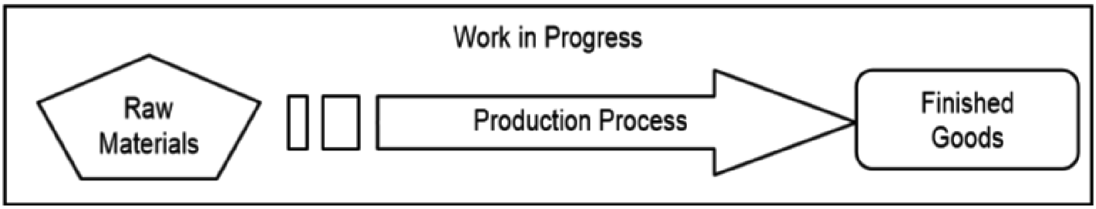
4.1 INTRODUCTION

As per Nepal Accounting Standard on Inventories (NAS) -02, Inventories are assets; that are:

a. held for sale in the ordinary course of business (finished goods);or
b. in the process of production for such sale (work in progress); or
c. in the form of materials or supplies to be consumed in the production process or in the rendering of services (raw materials).

Inventories encompass goods purchased and held for resale including, for example, merchandise purchased by a retailer and held for resale, or land and other property held for resale. Inventories also encompass finished goods produced, or work in progress being produced, by the entity and include materials and supplies awaiting use in the production process. In the case of a service provider, inventories include the costs of the service, for which the entity has not yet recognized the related revenue. So, for manufacturing concern, inventory consist of raw material, work in progress and finished goods and for trading concern inventory consist of finished goods only.

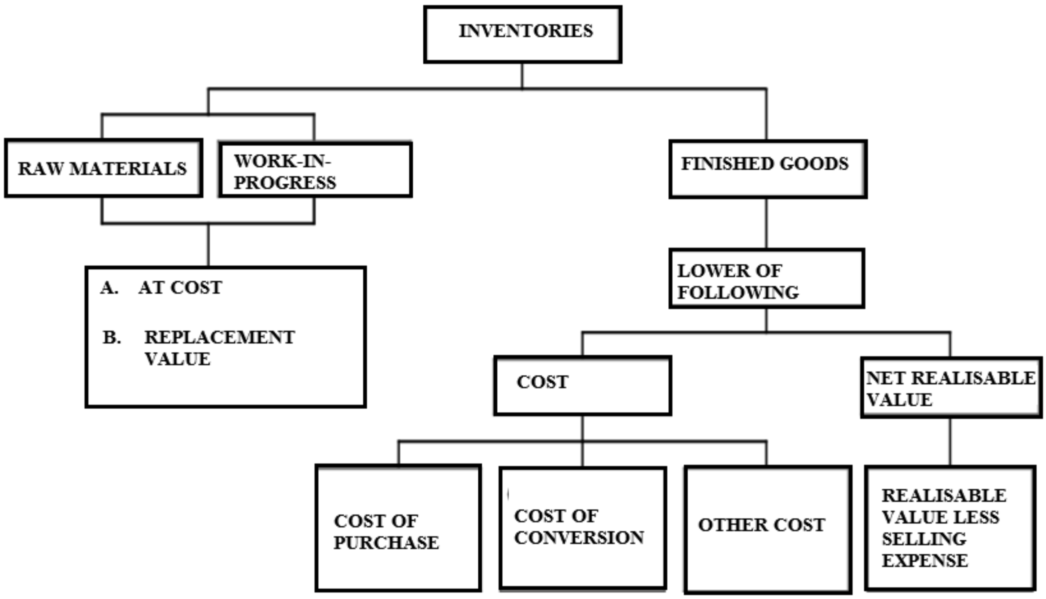
Inventory do not include machinery spare parts which can be used only in connection with an item of fixed asset and whose use is expected to be irregular; such machinery spares are accounted for in accordance with accounting for Fixed Assets.



4.2 MEASUREMENT OF INVENTORIES

Inventories shall be measured at the lower of cost and net realizable value. The net realizable value means the estimated selling price in the ordinary course of business less the estimated costs of completion and the estimated costs necessary to make the sale.

INVENTORIES



4.3 COST OF INVENTORIES

The cost of inventories shall comprise all costs of purchase, costs of conversion and other costs incurred in bringing the inventories to their present location and condition.

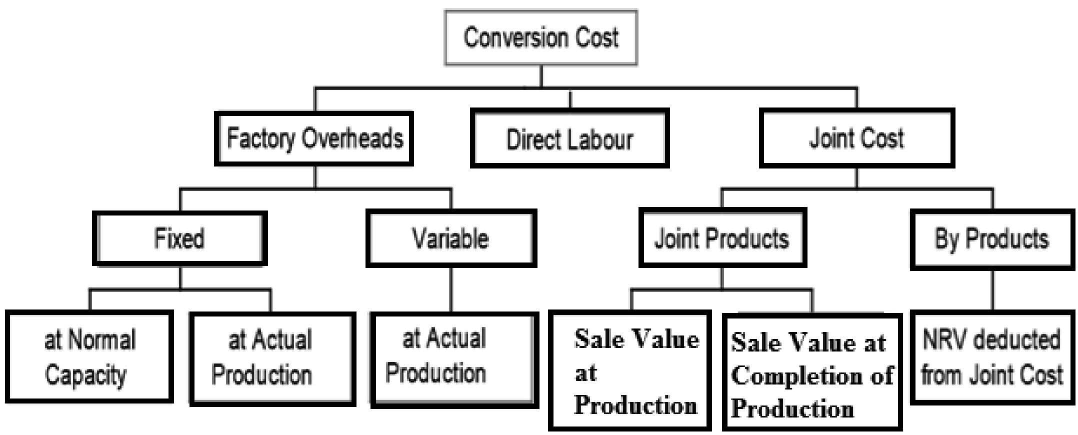
a. Cost of Purchase

The costs of purchase of inventories comprise the purchase price, import duties and other taxes (other than those subsequently recoverable by the entity from the taxing authorities), and transport, handling and other costs directly attributable to the acquisition of finished goods, materials and services. Trade discounts, rebates and other similar items are deducted in determining the costs of purchase.

b. Costs of Conversion

The costs of conversion of inventories include costs directly related to the units of production, such as direct labor. They also include a systematic allocation of fixed and variable production overheads that are incurred in converting materials into finished goods. Fixed production overheads are those indirect costs of production that remain relatively constant regardless of the volume of production, such as depreciation and maintenance of factory buildings and equipment, and the cost of factory management and administration. Variable production overheads are those indirect costs of production that vary directly, or nearly directly, with the volume of production, such as indirect materials and indirect labor. The allocation of fixed production overheads to the costs of conversion is based on the normal capacity of the production facilities. Normal capacity is the production expected to be achieved on average over a number of periods or seasons under normal circumstances, taking into account the loss of capacity resulting from planned maintenance. The actual level of production may be used if it approximates normal capacity. The amount of fixed overhead allocated to each unit of production is not increased as a consequence of low production or idle plant. Unallocated overheads are recognized as an expense in the period in which they are incurred. In periods of abnormally high production, the amount of fixed overhead allocated to each unit of production is decreased so that inventories are not measured above cost. Variable production overheads are allocated to each unit of production on the basis of the actual use of the production facilities.

A production process may result in more than one product being produced simultaneously. This is the case when joint products are produced or when there is a main product and a by-product. When the costs of conversion of each product are not separately identifiable, they are allocated between the products on a rational and consistent basis. The allocation may be based, for example, on the relative sales value of each product either at the stage in the production process when the products become separately identifiable, or at the completion of production. Most by-products, by their nature, are immaterial. When this is the case, they are often measured at net realizable value and this value is deducted from the cost of the main product. As a result, the carrying amount of the main product is not materially different from its cost.



c. ***Other Costs***

Other costs are included in the cost of inventories only to the extent that they are incurred in bringing the inventories to their present location and condition. For example, it may be appropriate to include non-production overheads or the costs of designing products for specific customers in the cost of inventories.

4.4 COST OF INVENTORIES OF A SERVICE PROVIDER

To the extent that service providers have inventories, they measure them at the costs of their production. These costs consist primarily of the labor and other costs of personnel directly engaged in providing the service, including supervisory personnel, and attributable overheads. Labor and other costs relating to sales and general administrative personnel are not included but are recognized as expenses in the period in which they are incurred. The cost of inventories of a service provider does not include profit margins or non-attributable overheads that are often factored into prices charged by service providers. Materials and other supplies held for use in the production of inventories are not written down below cost if the finished products in which they will be incorporated are expected to be sold at or above cost. However, when a decline in the price of materials indicates that the cost of the finished products will exceed net realizable value, the materials are written down to net realizable value. In such circumstances, the replacement cost of the materials may be the best available measure of their net realizable value. Some inventories may be allocated to other asset accounts, for example, inventory used as a component of self-constructed property, plant or equipment. Inventories allocated to another asset in this way are recognized as an expense during the useful life of that asset

4.5 BASIC CONCEPT OF INVENTORY ACCOUNTING

In theory, accounting for inventory is very simple. Suppose, Mr. Keshav sells Garments, periodically, he orders many shirts of various sizes, styles and colors. He orders more garments when he sells the garments previously purchased, and his business operation cycle continues on in this way. After a year, Mr. Keshav prepares financial statements to evaluate his success. To calculate the value of inventory on hand, he counts all the inventory items remaining at year-end. He then develops a cost valuation by assigning a specific value from the historical cost records to each item in ending inventory. If the shirts cost Rs. 300 each and there 100 shirts remaining in inventory, Mr. Keshav's total inventory is Rs. 30,000. Suppose he had no shirts at the beginning of the year and total purchase for the year were Rs. 530,000. His cost of goods sold would be thus Rs. 500,000 (Rs. 530,000 of available -Rs. 30,000 of unsold shirts). Notice that the key to calculating the cost of goods sold is accounting for the remaining inventory

4.6 INVENTORY SYSTEMS

Whether a company is involved in manufacturing or merchandising, an accurate accounting system with up-to-date records is essential. Sales and customers may be lost if products ordered by customers are not available in the desired style, quality, and quantity. Also, businesses must monitor inventory levels carefully to limit the financing costs of carrying large amounts of inventory. Companies use one of two types of systems for maintaining accurate inventory records—the perpetual system or the periodic system.

a. Perpetual Inventory System

Under a perpetual inventory system, a continuous record of changes in inventory is maintained in the Inventory account. That is, all purchases and sales (issues) of goods are recorded directly in the Inventory account as they occur. The accounting features of a perpetual inventory system are as follows.

1. Purchases of merchandise for resale or raw materials for production are debited to Inventory rather than to Purchases.

2. Freight-in, purchase returns and allowances, and purchase discounts are recorded in Inventory rather than in separate accounts.
3. Cost of goods sold is recognized for each sale by debiting the account, Cost of Goods Sold, and crediting Inventory.
4. Inventory is a control account that is supported by a subsidiary ledger of individual inventory records. The subsidiary records show the quantity and cost of each type of inventory on hand.

The perpetual inventory system provides a continuous record of the balances in both the Inventory account and the Cost of Goods Sold account.

Under a computerized recordkeeping system, additions to and issuances from inventory can be recorded nearly instantaneously. The popularity and affordability of computerized accounting software have made the perpetual system cost-effective for many kinds of businesses. Recording sales with optical scanners at the cash register has been incorporated into perpetual inventory systems at many retail stores.

Perpetual inventory system works as follows:

		Assets	=		**Liabilities**	+	**Shareholders 'equity**
a. Purchase	+	Increase Merchandize inventory	=	+	Increase Accounts Payable		
b. Sales	+	Increase Accounts Receivables	=			+	Increase Sales Revenue
Cost of goods (inventory) sold	-	Decrease Inventory	=			-	Increase Cost of Goods Sold

In the perpetual inventory system, the journal entry will be:

a. When inventory is purchased:

Merchandize Inventory A/c	Dr.	xxxx	
To, Accounts Payable			xxxx

b. When inventory is sold:

Accounts Receivable A/c or Cash	Dr.	xxxx	
To, Sales Revenue			xxxx
Cost of goods sold A/c	Dr.	xxxx	
To, Inventory			xxxx

Thus, in the perpetual inventory system, we record the sale of an item and the accompanying inventory reduction simultaneously.

b. Periodic inventory system works as follows:

Under a periodic inventory system, the quantity of inventory on hand is determined only periodically, as its name implies. Periodic inventory system does not involve a day-to-day record of inventories or of the cost of goods sold. Instead the cost of goods sold are computed and inventory balance are updated only at the end of an accounting period, i.e. on the date of physical count of inventory. The physical count allows management to remove damaged or obsolete goods from inventory and thus helps reveal inventory shrinkage, which refers to losses of inventory from theft, breakage, and loss. Inventory shrinkage can be quite large in some businesses.

All acquisitions of inventory during the accounting period are recorded by debits to a Purchases account. The total in the Purchases account at the end of the accounting period is added to the cost of the inventory on hand at the beginning of the period, to determine the total cost of the goods available for sale during the period. To compute the cost of goods sold, ending inventory is subtracted from the cost of goods available for sale. Note that under a periodic inventory system, the cost of goods sold is a residual amount that is dependent upon a physically counted ending inventory.

Unlike the perpetual system, which computes cost of goods sold instantaneously as a company sells goods, under the periodic system, computing cost of goods sold would be delayed until physical count is completed

Beginning inventory	+	Purchases	-	Ending inventory	=	Cost of goods sold
Goods available for sale			-	Inventory left over	=	Cost of goods sold

4.7 PHYSICAL INVENTORY

Good inventory control procedures require a physical count of items held in inventory at least annually in both periodic and perpetual inventory systems. The physical count is an imposing, time-consuming, and expensive process. To simplify counting and valuation, firms often choose end of the accounting periods where inventories are low. The physical inventory is so important to income determination that statutory auditors usually observe the client's physical count and confirm the accuracy of the subsequent valuation. Some audit firm hire outside experts to assist them. For example, a jeweler's inventory might require an expert to test the color, size, clarity and imperfections in the diamonds on hand. Similarly, the client and auditor might rely on an engineer to measure the physical dimensions of an electric utility's coal pile so they can accurately estimate the volume and weight without actually weighing the coal itself.

4.8 ADJUSTMENT FOR INVENTORY DISCREPANCIES

To portray the real picture, the periodic physical count of inventory should be employed even in cases where there is inventory accounting by continuous recording. A stock-taking program must be employed. The program should entail a checklist for carrying out the physical count completely and correctly. It should provide for tagging of the goods counted to avoid duplication in counting, stoppage of inflow and outflow of inventory when stock-taking is carried on, and cut off procedures of identifying the last invoice and last supplier bill connected with the inventories under stock and so on. The quantum of stock alone is ascertained in physical counts. The values are then assigned by a suitable cost formula. i.e. FIFO or LIFO or weighted average cost. The inventory book will be opening stock plus purchases minus cost of goods sold. But due to shrinkage, theft, and pilferage, the actual valuation of the inventory might be difference from what they ought to be. The discrepancies should be weighed against the materiality of the item and value. The causes should be discerned to spot the weaknesses in internal control. If the discrepancies are due to normal factors like shrinkage, spoilage, etc., the same may be absorbed in cost of goods sold. The journal entry would be:

Cost of goods sold	Dr.	xxx	
To, Inventory			xxx

If the causes of inventory discrepancies are abnormal and require investigation, a provision for possible loss is created in Statement Of Profit or Loss. We avoid debiting to cost of goods sold because the gross margin or gross profit will not affected due to this avoidable loss. The entry will be:

Abnormal loss of inventory A/c	Dr.	xxx
To, provision for inventory loss		xxx

The provision for inventory loss is deducted from the book value of inventory in the Statement of Financial Position. Abnormal loss of inventory is an expense and it appears in the Statement of Profit or Loss along with other operating expense.

4.9 ADJUSTMENT FOR OBSOLESCENCE

The physical count also helps analyze the condition of the goods as they are in bays and bins. They may have deteriorated, or sometimes, may lie without movement for a long period. The balance of inventory account as obtained from continuous record may contain a value for those goods which, in fact, are worthless or of value less than their book figures. To record the possible loss on this score, entry for all the losses incurred by damage or obsolescence should be done. The entry would be:

Loss by Obsolescence A/c	Dr.	xxx	
To, Provision for Inventory Loss A/c			xxx

The treatment of the above accounts is the same as it is with the loss of abnormal nature. The aging of inventory is also obtained by Excel Sheet of the computer to decide items that remain old with less or infrequent issues.

4.10 COST OF INVENTORY IN THE BOOKS

Regardless of whether the periodic or perpetual system is used, the basis of inventory accounting system is the cost of the merchandise to be carried in the account. There are expenses incurred related to the merchandise like; invoice price, transportation charges, trade and cash discounts, cost of handling and placing in stock, storage, purchasing department, receiving department, and other indirect charge etc. In practice, accountants usually consider the cost of merchandise to include only the invoice price plus the directly identifiable inbound transportation charges less any offsetting discounts. Accountants treat the costs of the purchasing and receiving departments as period costs and charge them on the Statement Of Profit or Loss as they occur.

The entity should have such a system, which should disclose all the facts relating to inventory so that valuation of inventory should be correct. Maintaining store ledger/stock book is one of the best ways to keep proper record of inventories.

4.11 PRINCIPAL INVENTORY VALUATION METHODS

Each period, accountants must identify the cost of beginning inventory and purchased merchandise in the cost of goods sold and cost of items remain in ending inventory. Under a perpetual system, a cost for each item sold should be determined. Under a periodic system, specific costs of the items remaining in ending inventory should be determined. In both the inventory system ,the costs of individual items by some inventory valuation method must be determined. Generally there are four principal inventory valuation methods such as Specific Identification; First-In-First Out (FIFO); Last-In-First Out (LIFO); and Weighted Average. However, the Nepal Accounting Standard on Inventory (NAS 2) states that cost of inventories shall be assigned by using the Specific Identification method, First in First Out Method and Weighted Averaged method.

Usually stock is valued at the lower of the historical cost and net realizable value. Historical cost means cost of purchase, cost of conversion and other costs incurred in a normal course of business in bringing the inventory up to their present location and condition. Net realizable value is actual or estimated selling price in the ordinary course of business less costs incurred in order to make the sale. There is no unique formula for determination of historical cost of inventories.

Let’s take one example for valuation of stock under various methods: A trader has the following record of purchases and sale of good during the month.

Date	Quantity (Unit)	Price per unit (Rs.)
Jan 4	900	5.00
Jan 10	400	5.50
Jan 11	300	5.50
Jan 19	200	6.00
Jan 28	800	4.75
Total	**2,600**	

Issues were made as follows:

Jan 5	600
Jan 12	400
Jan 29	600
Total	**1,600**

4.11.1 Specific Identification Method

The specific identification method refers to the tracking and costing of inventory based on the movement of specific, identifiable inventory items in and out of stock. In other words, this method attributes specific costs to identified goods that have been purchased or manufactured and are segregate for a specific purpose. The historical cost of such specific purpose inventories may be determined on the basis of their specific purchase price or production cost. This method is applicable when individual items can be clearly identified, such as with a serial number, stamped receipt date,.

The principle requirements of a specific identification tracking system are:

- Be able to track each inventory item individually. The easiest method is a durable metal or paper label that contains a serial number.
- Be able to track the cost of each item individually. The accounting system should clearly identify the cost of each purchased item, and associate it with a unique identification number.
- Be able to relieve inventory for the specific cost associated with an inventory item when it is sold.

The specific identification method introduces a high degree of accuracy to the cost of inventory, since the exact cost at which something was purchased can be recorded in the inventory records, and charged to the cost of goods sold when the related item is sold.

However, this method is rarely used, because there are few purchased products that are clearly identified in a company's accounting records with a unique identification code. Thus, it is typically restricted to unique, high-value items for which such differentiation is needed. Most organizations instead sell products that are essentially interchangeable, and so are more likely to use a FIFO, LIFO, weighted average, or similar system.

It is also very time-consuming to track inventory on an individual unit basis, which restricts its use to smaller inventory quantities.

4.11.2 First-In-First Out (FIFO) Method

FIFO refers to first-in first out. According to FIFO method, the items of inventory, which were purchased or produced at first, should be consumed or sold at first and consequently the items remaining in inventory at the end of the period are those most recently purchased or produced.

The FIFO method is a cost assignment method and does not track the actual physical flow of individual items. For identical units, it assigns the cost of the earliest acquired units to cost of goods sold. As a result, we assign the costs of the newer one to the units in ending inventory. By using the more recent costs to measure the ending inventory, FIFO provides inventory valuations that closely approximate the actual market value of the inventory at the Statement Of Financial Position date. In addition, in period of rising prices, FIFO leads to higher net income.

In the above example, the closing stock is 1,000 units (2,600-1,600) and would consist of

800 units received on 28th Jan @ Rs. 4.75	Rs. 3,800
200 units received on 19th Jan @ Rs. 6.00	1,200
Total	**5,000**

4.11.3 Last-In-First Out (LIFO) Method

LIFO refers to Last-In First-Out. According to LIFO method, the items of inventory, which were purchased or produced at last, should be consumed or sold at first and consequently the items remaining in inventory at the end of the period are those first purchased or produced.

FIFO associates the most recent costs with ending inventories; LIFO assigns the most recent costs to cost of goods sold. The LIFO method assumes that a company sells the stock acquired most recently before it sells the older stock. Though actual issues are made out of the earliest lot on hand to prevent unnecessary deterioration in value, it is sometimes assumed that the issue to be valued is to be according to the price paid for the latest consignments on hand. The closing stock then is assumed to consist of earlier consignments and its value is then calculated according to such consignments. This method of valuing stock is known as LIFO basis. In the absence of details of issue, the price paid for the earliest consignments is used for valuing closing stock. In simple, as per the above example, the value of 1,000 units of closing stock on LIFO method would be:

900 units @ Rs. 5.00	4,500
100 units @ Rs. 5.50	550
Total	**5,050**

But if the details of the issue are available, as they are in this example, the particular consignments not yet exhausted should be ascertained and the relevant price should be used for valuing the stock. In this example, the consignments not yet fully exhausted and the quantities concerned together with value are given below.

Date	Receipt			Issues			Balance		
	Qty. Units	Rate Rs.	Amount Rs.	Qty. Units	Rate Rs.	Amount Rs.	Qty. Units	Rate Rs.	Amount Rs.
4	900	5.00	4,500				900	5.00	4,500
5				600	5.00	3,000	300	5.00	1,500
10	400	5.50	2,200				300	5.00	1,500
							400	5.50	2,200
11	300	5.50	1,650				300	5.00	1,500
							700	5.50	3,850
12				400	5.50	2,200	300	5.00	1,500
							300	5.50	1,650
19	200	6.00	1,200				300	5.00	1,500
							300	5.50	1,650
							200	6.00	1,200
28	800	4.75	3,800				300	5.00	1,500
							300	5.50	1,650
							200	6.00	1,200
							800	4.75	3,800

29				600	4.75	2,850	**300**	**5.00**	**1,500**
							300	**5.50**	**1,650**
							200	**6.00**	**1,200**
							200	**4.75**	**950**

The value of closing stock under LIFO method using store ledger is Rs. 5,300.

4.11.4 Weighted Average Method

Average price for computing value of stock is a very simple approach. (All the different prices are added together and then divided by the number of prices. The closing stock is valued according to the price ascertained. The simple average in given example is- [(5.00+5.50+6.00+4.75)/4] = Rs. 5.32

1,000 units valued at Rs. 5.32 would be Rs. 5,320.

Since, simple average does not taken in to account the quantities that have been in stock. Therefore, it is more logical to compute weighted average price to calculate the value of closing stock. The weighted average method computes a unit cost dividing the total acquisition cost of all items available for sale by the number of units available for sale.

Following is a store ledger is maintained according to weighted average method.

Date	**Receipt**			**Issues**			**Balance**		
	Qty. Units	**Rate Rs.**	**Amount Rs.**	**Qty. Units**	**Rate Rs.**	**Amount Rs.**	**Qty. Units**	**Rate Rs.**	**Amount Rs.**
4	900	5.00	4,500				900	5.00	4,500
5				600	5.00	3,000	300	5.00	1,500
10	400	5.50	2,200				700	*5.28	3,700
11	300	5,50	1,650				1,000	**5.35	5,350
12				400	5.35	2,140	600	5.35	3,210
19	200	6.00	1,200				800	5.51	4,410
28	800	4.75	3,800				1,600	5.13	8,210
29				600	5.13	3,078	1,000	5.13	5,132

* {(300*5)+(400*5.5)}/(300+400) = 5.28

** {(3700+1650)}/(700+300) = 5.35

Illustration 1

The following are the details of a spare part of M/s. Sitaram Enterprises:

1.1.2019	Opening Stock	Nil
1.1.2019	Purchases	100 units @ Rs. 30 per unit.
15.1.2019	Issued for consumption	50 units
1.2.2019	Purchases	200 units @ Rs. 40 per unit.
15.2.2019	Issued for consumption	100 units

20.2.2019	Issued for consumption	100 units
1.3.2019	Purchases	150 units @ Rs. 50 per unit.
15.3.2019	Issued for consumption	100 units

Find out the value of stock as on 31.3.2019 if the company follows:

1. First in first out Method
2. Weighted Average Method

Solution

M/s. Sitaram Enterprises

Calculation of the value of stock as on 31-3-2019

1. FIFO

Date	**Receipt**			**Issued**			**Balance**		
2019	**Units**	**Rate Rs.**	**Amount Rs.**	**Units**	**Rate Rs.**	**Amount Rs.**	**Units**	**Rate Rs.**	**Amount Rs.**
1-Jan	Balance						-	-	-
1-Jan	100	30	3,000				100	30	3,000
15-Jan				50	30	1,500	50	30	1,500
1-Feb	200	40	8,000				50 200	30 40	1,500 8,000
15-Feb				50 50	30 40	1,500 2,000	150	40	6,000
20-Feb				100	40	4,000	50	40	2,000
1-Mar	150	50	7,500				50 150	40 50	2,000 7,500
15-Mar				50 50	40 50	2,000 2,500	100	50	5,000

Therefore, the value of stock as on 31-3-2019: 100 units @ Rs. 50 = Rs. 5,000

2. **Weighted Average Method**

Date	**Receipt**			**Issued**			**Balance**		
2019	**Units**	**Rate Rs.**	**Amount Rs.**	**Units**	**Rate Rs.**	**Amount Rs.**	**Units**	**Rate Rs.**	**Amount Rs.**
1-Jan	Balance						-	-	-
1-Jan	100	30	3,000				100	30	3,000
15-Jan				50	30	1,500	50	30	1,500
1-Feb	200	40	8,000				250	38	9,500
15-Feb				100	38	3,800	150	38	5,700

20-Feb				100	38	3,800	50	38	1,900
1-Mar	150	50	7,500				200	47	9,400
15-Mar				100	47	4,700	**100**	**47**	**4,700**

Therefore, the value of stock as on 31-3-2019: 100 units @ Rs. 47 = Rs. 4.700

4.12 LOWER OF COST OR NET REALIZABLE VALUE

This concept is based on the prudence principle that requires the probable expected profits to be ignored while recording in the books of accounts. The cost of inventories may not be recoverable if those inventories are damaged, or if they have become wholly or partially obsolete, or if their selling prices have declined. The cost of inventories may also not be recoverable if the estimated cost of completion or the estimated costs necessary to make the sale have increased. The practice of writing down inventories below cost to net realizable value is consistent with the view that assets should not be carried in excess of amounts expected to be realised from their sale or use. An assessment is made of net realizable value as at each Statement Of Financial Position date.

All the inventories should be valued at lower of historical cost and net realizable value subject to following exceptions:

1. Inventory of consumable stores and maintenance supplies should ordinarily be valued at cost. In appropriate circumstances, however, this may be valued at below cost.
2. Inventory of by products, the cost of which cannot be separately determined, should be valued at net realizable value.
3. Inventory of non-reusable waste should be valued at net realizable value.
4. Inventory of reusable waste is valued on the following basis:
   (i) Where facilities (either in house or external) exist for reprocessing of such wastes, and such facilities are being used for reprocessing, the stock of waste is valued at the raw material cost less reprocessing cost.
   (ii) Where reprocessing facilities are not available, the inventory is valued at "net realizable value".
5. Material and other supplies held for use in the production of inventories are not written down below cost if the finished products in which they will be incorporated are expected to be sold at or above cost. However, when there has been a decline in the price of materials and it is estimated that the cost of the finished products will exceed net realizable value, the materials are written down to net realizable value. In such circumstances, the replacement cost of the materials may be the best available measure of their net realizable value.

Illustration 2:

Ashok Motor Ltd a dealer in second hand cars has 5 vehicles in stock at the end of the financial year 2018-19 These are

Brand of car	**Fiat**	**Ambassdor**	**Maruti**	**Sujuki**	**Toyota**	**Total**
Cost (Rs)	90,000	115,000	275,000	320,000	450,000	1,250,000
Net Realisable Value	95,000	135,000	265,000	350,000	480,000	1,325,000

Required

Calculate the value of stock to be included in the Statement of Financial Position (Balance sheet)

Solution

The value of stock at the Lower of cost or net realizable value is as follow

Car	Fiat	Ambassador	Maruti	Sujuki	Toyota	Total
Value	90,000	115,000	265,000	320,000	450,000	1,240,000

Illustration 3:

X Ltd has included in its account an item of stock which had cost it Rs 50,000. The business has no furher use for this stock. It can be scrapped for Rs 25,000 or sold for the following;

Particular	Amount
Sales Proceed	40,000
Less ; Trade Discount	4,000
	36,000
Less: Cash discount	1,000
	35,000
Less : Cost of disposal	2,500
	32,500

Required ; What is the amount included in the account for this item

Solution:

a. Cost of Item: 50,000

b. Net realizable Value of Item

Sales Proceed	40,000
Less ; Trade Discount	4,000
	36,000
Less : Cost of disposal	2,500
	33,500

So, Lower of cost and Net realizable value = Rs 33,500

**** It should be noted that cash discount would appear in the Statement of Profit or Loss.**

4.13 COMPARISON OF COST AND NET REALISABLE VALUE

The comparison of historical cost with net realizable value can be made by any of the following methods:

(a) **Item by Item Method:** Under this method, the cost of each time of inventory is compared with the net realizable value thereof and each item is valued at lower of the cost or net realizable value.

(b) **Gr\oup Method:** Under this method, first, the groups of similar or interchangeable items are formed. Then the cost of each such group is compared with the net realizable value thereof and each group is valued at lower of the cost or net realizable value.

(c) **Aggregate Method:** Under this method, the total cost of all the items (whether similar or dissimilar) is compared with the net realizable value of all items and the total inventory is valued at lower of cost or net realizable value.

Of the above methods, NAS-2 permits the use of Item by Item Method and Group Method . The comparison of the historical cost and the net realizable value should be made separately in respect of each item of inventory, or for groups of similar (or interchangeable) items. However, to compare the aggregate of the net realizable value of all dissimilar and non-interchangeable items in a class of business, or all the inventories on an overall basis, with the aggregate of the cost of all those items, is not prudent because it amounts to setting off loss against unrealized profit.

Illustration 4

From the following data, calculate the value of stock, to be shown

(i) by the Aggregate Method,
(ii) by the Group Method, and
(iii) by the Item by Item Method.

Article	Group	No. of units	Cost (Rs) Per Unit	Realizable Value (Rs) Per unit	Realization Expenses (Rs.)
1	A	100	100	120	8.33%
2	B	200	200	200	10%
3	A	300	150	156	8.33%
4	B	400	250	290	10%

Solution

(I) Statement showing the valuation of Stock according to Aggregate Method

Article	Cost (Rs) Per Unit	NRV (Rs.)	Lower of Cost/NRV (Rs.)
1	10,000	11,000	
2	40,000	36,000	
3	45,000	42,900	
4	100,000	104,400	
	195,000	**194,300**	**194,300**

(II) Statement showing the valuation of Stock according to Group Method

Group "A"

Article	Cost (Rs) Per Unit	NRV (Rs.)	Lower of Cost/NRV (Rs.)
1	10,000	11,000	
3	45,000	42,900	
	55,000	**53,900**	**53,900**

Group "B"

Article	Cost (Rs) Per Unit	NRV (Rs.)	Lower of Cost/NRV (Rs.)
2	40,000	36,000	
4	100,000	104,400	
	140,000	**140,400**	**140,000**

(III) Statement showing the valuation of Stock according to Item by Item Method

Article	Cost (Rs) Per Unit	NRV (Rs.)	Lower of Cost/NRV (Rs.)
1	10,000	11,000	10,000
2	40,000	36,000	36,000
3	45,000	42,900	42,900
4	100,000	104,400	100,000
			188,900

4.14 STOCK TAKING

Normally all operations are suspended for one or two days during the financial year and a physical inventory is taken of everything in the godown or the store periodically. For the year-end inventory valuation, physical stock taking is done during the last week of the financial year, if stock taking is finished on 26thAshad, whereas accounting year ends on 31stAshad, purchases and sales subsequent to 26thAshad are then separately adjusted. Later, a value is put on each item. The principle of cost or market price, whichever is lower, is applied either for the inventory as a whole or item by item.

Often, stock taking cannot be carried out on the closing day. It is carried out a few days later or sometimes even a few days earlier. In such a case, the actual value of the stock must be so adjusted as to relate it to the end of the year concerned. For doing so, it will be necessary to take into account the goods that have come in (purchases and sales returns) and those that have gone out (sales and purchase returns) during the interval between the close of the year and date of actual stock-taking. Further, the adjustment of all goods must be on the basis of cost.

A. STOCK TAKING

ON A DATE PRIOR TO STATEMENT OF FINANCIAL POSITION DATE

STATEMENT SHOWING THE COMPUTATION OF VALUE OF INVENTORY

Particular	Amount
Value of Inventory as per book as on Stock Taking Date	
Less:	
: Cost of Goods Sold after stock Taking till Statement Of Financial Position date	
: Purchase return after Stock Taking till Statement Of Financial Position Date	
: Cost of Unsold Goods lying with us on behalf of other	
On Cost of good sent on Approval Basis	
On cost of Good sent on Consignment Basis	
On Cost of Good sent on Joint Venture Basis	
On cost of Good sent to Branch	
On Cost of Good sent to Hire Purchase Basis	
Add:	
: Cost of Unsold goods lying with other on our behalf (sent before stock taking)	
On Cost of good sent on Approval Basis	
On cost of Good sent on Consignment Basis	
On Cost of Good sent on Joint Venture Basis	
On cost of Good sent to Branch	
On Cost of Good sent to Hire Purchase Basis	
: Cost of Sales Return after Stock Taking till Statement Of Financial Position Date	
: Purchase after Stock Taking till Statement Of Financial Position Date	
Value of Inventory as per book as on Statement Of Financial Position Date	

A. STOCK TAKING

ON A DATE AFTER THE STATEMENT OF FINANCIAL POSITION DATE

STATEMENT SHOWING THE COMPUTATION OF VALUE OF INVENTORY

Particular	Amount
Value of Inventory as per book as on Stock Taking Date	
Less:	
: Cost of Sales Return after Statement Of Financial Position Date till Stock Taking	
: Purchase after Statement Of Financial Position Date till Stock Taking	
: Cost of Unsold goods lying with us on behalf of Other (sent before stock taking)	
On Cost of good sent on Approval Basis	
On cost of Good sent on Consignment Basis	
On Cost of Good sent on Joint Venture Basis	
On cost of Good sent to Branch	
On Cost of Good sent to Hire Purchase Basis	
Add:	
: Cost of Goods Sold after Statement Of Financial Position Date till Stock Taking	
: Purchase Return after Statement Of Financial Position Date till Stock Taking	
: Cost of Unsold Goods lying with Other on our behalf	
On Cost of good sent on Approval Basis	
On cost of Good sent on Consignment Basis	
On Cost of Good sent on Joint Venture Basis	
On cost of Good sent to Branch	
On Cost of Good sent to Hire Purchase Basis	
Value of Inventory as per book as on Statement Of Financial Position Date	

Illustration 5

Following are information for valuation of closing stock as on 31.3.2076 :

Stock taken on 26.3.2076 was Rs. 124,870. Total purchases between stock taken and the year end was Rs. 70,250. Manufacturing expenses during the period was Rs. 12,350. Total sales during the period were Rs. 200,000. Profit margin on sales is 25 % on cost.

Solution:

VALUATION OF CLOSING STOCK

Particular	**Amount**
Value of Stock of given date (26.3.2076)	124,870
Add: Net purchase from 26.3.2076 to 31.3.2076	70,250
Add: Manufacturing Expenses	12,350
Less: Cost of net sales (200,000 = Cost + 25% of Cost)	-160,000
Value of stock at the yearend (31.3.2076)	**47,470**

Illustration 6

From the following particulars ascertain the value of stock as on 31st March 2019 and also the profit for the year:

Stock as on 1-4-2018	21,375
Purchases	114,375
Manufacturing Expenses	22,500
Selling Expenses	9,075
Administration Expenses	4,500
Financial Charges	3,225
Sales	186,750

At the time of valuating stock as on 31st March 2018 a sum of Rs. 2,625 was written off on a particular item which was originally purchased for Rs. 7,500 and was sold during the year of Rs. 6,750. Barring the transaction relating this item, the gross profit earned during the year was 20 percent on sales.

Solution

Statement of stock in trade as on 31st March,2019

Particular	**Rs.**	**Rs.**
Stock as on 1-4-2018	21,375	
Less: Book value of abnormal stock (7,500-2,625)	-4,875	16,500
Add: Purchase	114,375	
Manufacturing Expenses	22,500	136,875
		153,375

Less: Cost of sale		
Sales as per books	186,750	
Less: sales of abnormal items	-6,750	
	180,000	
Less: Gross Profit @ 20%	36,000	144,000
Stock in trade as on 31st March, 2019		**9,375**

Net profit earned during the Year

Particular	Rs.	Rs.
Gross Profit Normal Sales		36,000
Add: Profit on Abnormal item:		
Sales Value	6,750	
Less: Book value on 31st March 2018	-4,875	1,875
		37,875
Less: Overhead Expenses:		
Selling Expenses	9,075	
Administration Expenses	4,500	
Financial Charges	3,225	16,800
Net Profit for the year		**21,075**

Illustration 7 The Head Office sends goods to its branch @ 20% profit on cost, freight and duties amounting to 10% on invoice value being paid by branch. Branch sells a 20% G.P. on selling prices.

The stock taking date is 31.12.2012 but was taken on 10.1.2013. The price for stock was agreed to be the cost to Head Office to be increased by actual expenses incurred by the Branch less Rs. 6,000. Stock on 10.1.2013 (at branch cost) amounted to Rs. 64,600. Rs. 6,000 stock (invoice value) was received from Head Office after 31-12-2012 but before 10.1.2013. Sales in this period amounted to Rs. 10,000.

Ascertain the agreed price of stock as on 31.12.2012.

Solution

Statement of valuation of stock as on 31st December, 2012

Particular	Rs.	Rs.
Stock as on 10th January 2013		64,600
Less: Stock received after 31st December, 2012		
Invoice price	6,000	

Expenses (10% of 6,000)	600	-6,600
		58,000
Add: Cost of goods sold after 31st December, 2012		
Sales	10,000	
Less: Mark up (20% of 10,000)	-2,000	8,000
		66,000
Less: Profit included in Branch Stock*		-10,000
		56,000
Less: Agreed deduction		-6,000
Value of stock at branch as on 31st December, 2012		**50,000**

		Rs.
*Suppose Cost to H.O.		100
Mark up while invoicing		20
Invoice Price	120	
Branch Expenses	12	
Branch Cost		132

Unrealized profit in branch cost is 20/132
Therefore, unrealized profit on stock of Rs. 66,000 is Rs. 10,000 [Rs. 66,000 X 20/132]

Illustration 8

The stock was physically verified on 24th December 2012 and was valued at Rs 200,000.Goods are normally sold by the trader at a profit of 25% on cost. After stock taking the following transaction have taken place till 31stDecember.

Sales of Rs 221,600 which includes:

(i) Sales of Rs 10,800 at 20% more than the normal selling price.
(ii) Sales of Rs 10,800 at 10% less than the normal selling price.

Required: Determine the value of stock to be taken to the Statement Of Financial Position of M/s. Prabhat Concern Trading Pvt. Ltd. as at 31st December 2012.

Solution

Statement showing the valuation of stock as at 31st December 2012

Particular	**Rs.**	**Rs.**
Value of Stock as at 24th December 2012		200,000
Less: Cost of Goods sold		
Normal Sales [80% of (Rs 221,600 -10,800-10,800]	- 160,000	
Abnormal Sales (i) [80% of ((10,800/120) x 100)]	- 7,200	
(ii) [80% of ((10,800/90)x 100)]	-9,600	-176,800
C. Value of Stock as at 31st December 2012		**23,200**

4.15 SALE ON APPROVAL BASIS

Sale of goods on approval or return basis is an arrangement where the seller sends goods to its customer on condition to accept the goods as purchase or return the goods as rejection of purchase within stipulated time period. So, this arrangement should contain time limit upto when the goods can be returned by the receiver otherwise it will be treated as actual sales. The main fundamental of this basis is that actual sales arise only when the receiver accept/retained/ approve the goods or the stipulated time period expires. So, if the receiver approves the goods or retained the goods after expiry of time period then only such transaction should be taken as actual sales and necessary entry should be passed.

If the goods sent under this basis remains with customer at year end then cost of such goods should be included in closing stock of the sender.

In addition the cost of unsold goods lying with customer on behalf of company, which were sent before the date of stock taking (for example, goods sent to customers before date of stock taking on approval basis but not yet approved till Statement Of Financial Position date) is added to the value of physical inventory. Similarly, the cost of unsold good lying with company on behalf of customer, which were received before the date of stock taking (for example, Goods received from Consignor before the date of stock taking on consignment basis but not yet sold till Statement Of Financial Position date) is subtracted from the value of physical inventory.

Illustration 9

The stock was physical verified on 24th December 2012 and was valued at Rs. 200,000. Goods are normally sold by the trader at a profit of 25% on cost. Determine the value of stock to be taken to the Statement Of Financial Position of *M/s. Summi Concern Trading Pvt. Ltd*. as at 31st December 2012 in each the following alternative cases:

Case (a) On 21st Dec, goods of the sales value of Rs. 100,000 were sent on sale or return basis to a customer, the period of approval being two weeks.

Case (b) On 21st Dec, goods of the sale value of Rs. 100,000 were sent on sale or return basis to a customer, the period of approval being two weeks. He returned 20% of the goods on 31st Dec.

Case (c) On 21st Dec, goods of the sale value of Rs. 100,000 were sent on sale or return basis to a customer, the period of approval being two weeks. He approved 80% of the goods on 31st Dec.

Case (d) On 21st Dec, goods of the sale value of Rs. 100,000 were sent on sale or return basis to a customer, the period of approval being two weeks. He returned 20% of the goods and approved the remaining on 31st Dec.

Case (e) On 21st Dec, goods of the sale value of Rs. 100,000 were sent on sale or return basis to a customer, the period of approval being two weeks. He returned 20% of the goods and approved 80% of the remaining on 31st Dec.

Case (f) On 21st Dec, goods of the sale value of Rs. 100,000 were sent on sale or return basis to a customer, the period of approval being two weeks but it was known that he had pledged 80% of goods with bank on 31st Dec.

Solution

Case (a)

Statement showing the valuation of stock as at 31st Dec 2012

	Particulars	Rs.
A.	Value of stock as at 24th December	200,000
B.	Add: Cost of goods sent on approval and still with the Customer [Sales – Gross profit] [Rs. 100,000-20% of Rs. 100,000, since 25% of cost is equivalent of 20% of sales price]	80,000
C.	**Value of stock on 31st December**	**280,000**

Case (b)

Statement showing the valuation of stock as at 31st Dec 2012

	Particulars	Rs.
A.	Value of stock as at 24th December	200,000
B.	Add: Cost of goods sent on approval and still with the Customer Received Back [20% of Rs. 100,000-20% of 20% of Rs.100,000]	16,000
	Still with Customer [80% of Rs. 100,000-20% of 80% of Rs.100,000]	64,000
C.	**Value of stock on 31st December**	**280,000**

Case (c)

Statement showing the valuation of stock as at 31st Dec 2012

	Particulars	Rs.
A.	Value of stock as at 24th December	200,000
B.	Add: Cost of goods sent on approval and still with the Customer [20% of Rs. 100,000-20% of 20% of Rs.100,000]	16,000
C.	**Value of stock on 31st December**	**216,000**

Case (d)

Statement showing the valuation of stock as at 31st Dec 2012

	Particulars	Rs.
A.	Value of stock as at 24th December	200,000
B.	Add: Cost of goods sent on approval and returned back [20% of Rs. 100,000-20% of 20% of Rs.100,000]	16,000
C.	**Value of stock on 31st December**	**216,000**

Case (e)

Statement showing the valuation of stock as at 31st Dec 2012

	Particulars	Rs.
A.	Value of stock as at 24th December	200,000
B.	Add: Cost of goods sent on approval and returned back [20% of Rs. 100,000-20% of 20% of Rs.100,000]	16,000
	Cost of goods sent on approval and still with customer [20% of 80% of Rs. 100,000-20% of 20% of 80% Rs.100,000 = .2X.8XRs.100,000- .2X.2X.8X Rs. 100,000]	12,800
C.	**Value of stock on 31st December**	**228,800**

Case (f) same as Case (c) Note: Pledging the goods amounts to approval of goods.

Illustration 10

Determine the value of sock to be taken to the Statement Of Financial Position of M/s. Tuladhar Enterprises as at March 31st, 2013 from the following information:
The stock was physically verified on 24th March and was valued at Rs. 1,200,000. After stock taking, the following transactions had taken place till 31st March.

(a) Purchase Rs. 600,000 out of which 20% of goods were returned.
(b) Sale of goods Rs. 600,000 out of which 20% of goods was returned by the customers.
(c) Sale of defective units Rs. 540,000 at 10% less than the normal selling price.
(d) On 21st March, goods of the sale value of Rs. 600,000 were sent on sale or return basis to a customer, the period of approval being two weeks. He returned 20% of the goods and approved 80% of the remaining on 31st March.
(e) On 23rd March, goods of the sale value of Rs. 600,000 were sent on consignment basis. 80% of these goods had been sold on 31st March.
(f) On 23rd March, goods costing Rs. 600,000 were received for sale on consignment basis. 80% of these goods had been sold on 31st March.

Note: (1) Goods are sold by the trader at a profit of 25% on cost.
(2) The sales referred to in (d), (e) and (f) are not included in (b) above.

Solution

Statement showing the valuation of stock as on 31st March, 2013

	Particular	Rs.
A.	Stock as per physical verification as at 24th March	12,00,000
B.	Add: Cost of net goods purchased after stock taking till 31st March (Rs. 600,000-20% of Rs. 600,000)	480,000
C.	Less: Cost of Net Goods sold after stock taking till 31st March	
	Good units: [80% of (Rs. 600,000-20% of Rs. 600,000)]	(384,000)
	Defective Units: [80% of (Rs. 540,000 + 1/9th of Rs. 540,000)]	(480,000)
D.	Add: Cost of goods returned by Customers to whom goods were sent on approval [80% of (20% of Rs. 600,000)]	96,000
E.	Add: Cost of unsold goods lying with other on our behalf:	76,800
	Goods sent on consignment [80% of (20% of Rs. 600,000)]	96,000

F.	Less: Cost of goods received for sale on Consignment basis included in stock as on 24th March.	(600,000)
	G. Stock as per books as at 31st March	**484,800**

Illustration 11

Determine the value of stock to be taken to the Statement Of Financial Position of *M/s. Humagai Trading Pvt. Ltd.* as at 31st December, 2012.

The stock was physical verified on 7th January, 2013 and was valued at Rs. 400,000. After 31st December the following transactions had taken place till the date of stock taking.

(a) Purchases Rs. 200,000 out of which 20% of goods were returned.

(b) Sales of good units Rs. 200,000 out of which 20% goods were returned by the customers.

(c) Sales of defective units Rs. 180,000 at 10% less than the normal selling price.

(d) On 26th Dec., goods of the sale value of Rs. 200,000 were sent on sale or return basis to a customer, the period of approval being two weeks. He returned 20% of the goods and approved 80% of remaining on 6th January.

(e) On 27thDec., goods of the sales value of Rs. 200,000 were sent on consignment basis. 80% of these goods had been sold on 6th January.

(f) On 28th Dec., goods costing Rs. 200,000 were received for sale on consignment basis. 80% of these goods had been sold on 6th January.

Notes: (i) Goods are sold at a profit of 20% on selling price.
(ii) The sales referred to in (d), (e) and (f) are not included in (b) above.

Solution

Statement showing the valuation of Stock as on 31st December, 2012

Particular	**Rs.**
Stock as per physical verification as at 7thJanuary, 2013	400,000
Less: Cost of Net goods purchased after 31st December [Rs. 200,000-20% of Rs. 200,000]	-160,000
Add. Cost of Net goods sold after 31st December till stock taking	
Goods units: [80% of (Rs. 200,000-20% of Rs. 200,000)]	128,000
Defective units: [80% of (Rs. 180,000+1/9 of Rs. 180,000)]	160,000
Add ; Cost of goods lying with others on behalf as on 31st December	
Goods sent as approval [80% of (Rs. 200,000-20% of Rs. 200,000)]	128,000
Goods sent on consignment [80% of Rs. 200,000]	160,000
Less: Cost of goods lying with as on behalf of others	
Goods received for sale on consignment basis [20% of Rs. 200,000]	-40,000
Stock as per books as at 31st December, 2012	776,000

Notes:

(1) No adjustment has been made in respect of goods returned by customers to whom goods were sent on approval basis because these goods are already included in the stock given on 7th January,2013.

(2) No adjustment has been made in respect of goods sold out of those received for sale on consignment basis since these goods are included in the stock given as on 7th January.

Illustration 12

The draft Statement Of Profit or Loss of *M/s. Pandey Enterprises* showed a net profit of Rs. 102,800 after considering the closing stock of Rs. 67,500 on 31st Ashad 2070. Subsequently following information was obtained from the scrutiny of the books.

(a) Miss. Pandey has taken goods costing Rs. 1,000 for her personal use without making entry in the books.

(b) Miss. Pandey has given away goods costing Rs. 1,000 as free samples for which no entry was made in the books of accounts.

(c) Purchase for the year included a purchase of furniture costing Rs. 200 on 31st Ashad.

(d) Sales included a sale of furniture having a book value of Rs. 900 for Rs 850 on 31st Ashad.

(e) Invoices for goods costing Rs. 1,700 have been entered on 26th Ashad 2070 but the goods have not yet been received till 31st Ashad.

(f) Goods costing Rs, 4,000 have been purchased and received on 27th Ashad but the invoices have not yet been recorded till 31st Ashad.

(g) Invoices of goods of Rs. 1,000 (cost Rs. 800) were entered on 28th Ashad but the goods were not delivered till 31st Ashad.

(h) Goods of Rs. 4,000 (cost Rs, 3,200) sold and delivered on 29th Ashad but the invoices were not entered till 31st Ashad.

(i) Goods (cost Rs. 2,880, selling price Rs. 3,600) were returned by a customer on 30th Ashad and were taken into stock on the same date but no entry was passed in the books.

(j) Stock at the end does not include the goods (cost Rs. 6,000, selling price Rs. 7,500) returned by another customer for which the entry has already been posted.

(k) On 26th Asadh, goods of the sale value of Rs. 200,000 were sent on sale or return basis, the period of approval being two weeks. 20% of these goods have been returned and approved 80% of remaining on 31st Ashad. Those goods were sent at a profit of 25% of cost.

Required: Calculate the value of stock on 31st Ashad 2070 and the adjusted net profit for the year ended on that date.

Solution

Statement showing the valuation of stock as at 31st Ashad 2070

Particulars	**Rs.**
Stock as already stated	67,500
Add: Cost of goods purchased but not received	1,700
Less: Cost of goods sold but not delivered	-800
Add: Cost of goods returned by a customer now included	6,000
Add: Cost of goods sent on approval (neither returned nor retained)	25,600
Adjusted stock as on 31st Ashad 2070	100,000

Profit and Loss Adjustment Account

Particulars	**Rs.**	**Particulars**	**Rs.**
To, Furniture A/c-sale	850	By, Profit as per P/L A/c	102,800
To, Furniture A/c-Loss on sale	50	By, Drawings	1,000
To, Sundry Creditors-Omitted purchased	4,000	By, Furniture A/c-purchase	200
		By, Closing Stock-transit	1,700
To, Closing Stock	800	By, Debtors A/c-omitted sales	4,000
To, Sundry Debtors-omitted returned	3,600	By, Closing Stock-goods returned included	6,000
To, Sundry Debtors-Cancellation of sale	32,000	By, Closing Stock –cost of goods neither returned nor retained)	25,600
To, Adjusted Net profit for the year	100,000		
	141,300		141,300

Summary

Valuation of inventory has a significant role in profitability of business as well as the presentation of financial statement in true and fair manner. It affects the gross profit or in other word it has a link with gross profit because the inventory valuation involves allocating the cost of goods available for sale between costs of goods sold and ending inventory. Generally, there are two system of inventory namely perpetual and periodic inventory system. Under the perpetual system, we continuously track inventories and cost of goods sold by recording cost of goods sold at the time of each sale. Under the periodic inventory system, we compute cost of goods sold using an adjusting entry at year-end. However, accountants conduct a physical inventory at the end of each period under either system. They count the goods on hand and calculate a cost for each item from purchase records. Under the periodic system, the physical inventory is the basis for the year-end adjusting entry to recognize cost of goods sold. Under the perpetual system, the physical inventory is used to confirm the accounting records. Difference, if any, lead to adjustments to cost of goods sold and ending inventory.

Valuation of inventories involves the assignment of specific historical costs of acquisition either to units sold or to units remaining in ending inventory. Four major inventory valuation methods *are in uses which are specific identification, FIFO, LIFO and weighted average. Specific identification is most common for low-volume, high-value product such as automobiles, ship, or jewelry. FIFO attributes the most recent, current prices to inventory items. LIFO attributes the most recent, current prices to cost of sales. When prices are rising and inventories are constant or growing, LIFO net income is less than FIFO net income.*

Generally, inventory is valued by following conservatism principle i.e. at lower of the cost or the market price. However, special cares are taken to deal with the year end purchases and sales. Always there exist possibilities to take year-end purchase in stock without including it in the purchases. Similarly, there exists possibility to incorporate some items in sales without deducting from this stock. With a view to bring about uniformity in inventory valuation practices, the NAS-2 permits the use of only FIFO or weighted average cost formula for determining the cost of inventories where the specific identification of cost of inventories is not possible.

Self-Examination Questions

I. Multiple Choice Questions (MCQs)

1. The term Inventory covers
   a. Raw Materials b. Work in Progress
   c. Finished Goods d. All of the above

2. Average stock = Rs. 12,000. Closing stock is Rs. 3,000 more than opening stock. The value of closing stock = ________
   a. Rs. 12,000 b. Rs. 24,000
   c. Rs. 10.500 d. Rs. 13,500

3. If the profit is 25% of the cost price then it is
   a. 25% of the sales price b. 33.33% of the sales price
   c. 20% of the sales price d. 15% of the sale price

4. The total cost of goods available for sale with a company during the current year is Rs. 1,200,000 and the total sales during the period are Rs. 1,300,000. If the gross profit margin of the company is 33 1/3% on cost, the closing inventory during the current year is
   a. Rs. 400,000 b. Rs. 300,000
   c. Rs. 225,000 d. Rs. 260,000

5. Goods purchased Rs. 100,000. Sales Rs. 90,000.Margin 20% on cost. Closing stock?
   a. Rs. 20,000 b. Rs. 10,000
   c. Rs. 25,000 d. Rs. 28,000

6. Physical inventory system is also known as:
   a. Perpetual inventory system b. Periodic inventory system
   c. Inventory Record System d. None

7. Closing stock is generally valued at:
   a. Cost price
   b. Market price
   c. Cost price or market price whichever is lower
   d. Cost price or market price whichever is higher

8. Calculate the value of Closing Stock:

Opening Stock	Rs. 70,000
Purchase	Rs. 4,16,000
Sales	Rs. 5,22,000
Gross profit earned	Rs. 25% of cost

   a. Rs. 68,400 b. Rs. 36,000
   c. RS. 94,500 d. None

9.

Opening stock	Rs. 10,000
Purchase	Rs. 1,10,000
Closing Stock	Rs. 20,000

   Find out total sales if profit margin is 30% on cost of sales:
   a. Rs. 1,20,000 b. Rs. 1,30,000
   c. Rs. 1,10,000 d. Rs. 1,25,000

10. Cost of Goods sold is equal to:
   a. Opening Stock plus total purchases minus closing stock + Direct costs
   b. Closing Stock plus total purchase
   c. Opening Stock minus total purchase plus closing stock
   d. Opening Stock plus total purchases

11.

Opening Stock	Rs. 40,000
Closing Stock	Rs. 50,000
Purchase	Rs. 5,50,000
Return inward	Rs. 5,000
Return outward	Rs. 20,000
Carriage inward	Rs. 5,000

   If gross profit is 20% of sales, the sales will be:
   a. Rs. 6,95,000 b. Rs. 6,75,000
   c. Rs. 5,40,000 d. Rs. 6,68,000

12. If gross profit is Rs. 1,00,000 and G.P. Ratio is 25%. Find the value of cost of sales:
   a. Rs. 2,00,000 b. Rs. 3,00,000
   c. Rs. 4,00,000 d. Rs. 5,00,000

13. Which of the following statements about the valuation of inventory is correct, according to Nepal Accounting Standard on Inventories?

(a) Inventory items are normally to be valued at the higher of cost and net realisable value
(b) The cost of goods manufactured by an enterprise will include materials and labour only. Overhead costs cannot be included
(c) LIFO is an accepted valuation method for inventory. FIFO is not an accepted valuation method for inventory
(d) Selling price less estimated profit margin may be used to arrive at cost if this gives a reasonable approximation to actual cost

II. Short Descriptive Questions (SDQs)

1. Distinguish between the perpetual and periodic inventory systems.
2. Define cost of inventory.
3. Write Short Note
   (a) Sale or approval Basis
   (b) Weighted Average Method
   (c) Net Realizable Value

III. Practical Questions (PQs)

1. Calculate the value of the inventory from the following information on the basis of (i) FIFO method, (ii) LIFO method and (iii) Weighted Average method.
   Opening stock on 1st January 2013, 200 units @ Rs. 7
   Receipts
   January 8, Purchases 1,100 units @ Rs. 8
   January 25, Purchases 300 units @ Rs. 9
   January 31, Purchases 400 units @ Rs. 10
   Issued for sale
   January 6, 100 units January 9, 200 units
   January 15, 400 units January 27, 600 units

2. The following are the details of spare parts of M/s. Powerful Enterprises:

1.1.2009	Opening stock	50 units @ Rs. 28 per unit	
1.1.2009	Purchases		100 units @ Rs. 30 per unit
15.1.2009	Issued for consumption	50 units	
1.2.2009	Purchases		200 units @ Rs. 40 per unit
15.2.2009	Issued for Consumption	100 units	
20.2.2009	Issued for Consumption		100 units
1.3.2009	Purchases		150 units @ Rs. 50 per unit
15.3.2009	Issued for consumption		100 units

   Find out the value of Stock on 31.3.2009 if the company follows:
   i) Fist In First Out basis
   ii) Last In First Out basis
   iii) Weighted Average basis

3. *M/s. Nepal House* was following LIFO method of valuation of stock. Due to legal restriction, they want to switch over to FIFO method. From the following information:
   (i) Draw up stock ledgers under FIFO and LIFO methods of valuation of stocks.
   (ii) Find out the closing stock and cost of materials consumed under each of the above two methods.

   Opening stock: 5,000 MT @ Rs. 22 per MT Rs. 110,000

Purchases:	1.6.2009	1,000 MT @ Rs. 30 per MT
	5.6.2009	2,000 MT @ Rs. 35 per MT
	10.6.2009	1,500 MT @ Rs. 38 per MT
	15.6.2009	1,500 MT @ Rs. 35 per MT
	20.6.2009	2,000 MT @ Rs. 32 per MT
	25.6.2009	2,000 MT @ Rs. 35 per MT
	30.6.2009	1,500 MT @ Rs. 30 per MT
Issues:	1-5.6.2009	2,000 MT
	6-10.6.2009	3,000 MT
	11-20.6.2009	4,000 MT
	21-25.6.2009	3,000 MT
	26-30.6.2009	3,000 MT

4. Following are information for valuation of closing stock as on 31.12.2012:
   Opening stock as on 1.1.2012 was Rs. 124,870. Total purchases during the year 2012, was Rs. 870,250. Manufacturing expenses during the year 2012 was Rs. 112,350. Total sales during the year 2012 were Rs. 1,200,000. Profit margin on sales is 20 % on cost.

5. From the following information, ascertain the value of stock as on 31.3.2012:

Value of Stock on 1.4.2011	Rs. 70,000
Purchases during the period from 1.4.2011 to 31.3.2012	Rs. 346,000
Manufacturing Expenses during the above period	Rs. 75,000
Sales during the same period	Rs. 522,000

   At the time of valuing stock on 31.3.2011, a sum of Rs. 6,000 was written off a particular item, which was originally purchased for Rs. 20,000 and was sold for Rs. 16,000. But for the other transaction the gross profit earned during the year was 25% on cost.

6. Mr. Sundar Suwal closed his books of account on 31.12.2012 but due to certain difficulties, it was not possible for him to conduct. Physical stock was taken on 7th January, 2013, when it was valued at Rs. 90,000. Other information is as follows: Purchases between 1.1.2013 to 7.1.2013 was Rs. 19,000 and sales for same period are Rs. 24,000. The profit margin is 25 % on sales price. Find out the value of stock as on 31.12.2012.

7. Mr. Pukar's financial year ends on 31st March, 2008, but actual stock is not taken until the following 3rd April 2008, when it is ascertained at Rs. 20,000. The transactions relating to stock between 31st March and 3rd April are as follows:

Sales Rs. 2,000	Purchases Rs. 1,000
Purchases Return Rs. 100	Sales Return Rs. 200

   All sales are made at 20% profit on sales. Calculate the value of stock as on 31.3.2008.

8. Mr. Swapnil who was closing his books on 31.3.2010 failed to take the actual stock, which he did only on 9^{th} April, 2010, when it was ascertained by him to be worth Rs. 25,000.
   It was found that sales are entered in the sales book on the same day of dispatch and return inwards in the returns book as and when the goods are received back. Purchases are entered in the purchases daybook once the invoices are received.
   It was found that sales between 31.3.2010 and 9.4.2010 as per the sales daybook are Rs. 1,720. Purchases between 31.3.2010 and 9.4.2010 as per the purchases daybook are Rs. 120, out of which goods amounting to Rs. 50 were not received until after the stock was taken.
   Goods invoiced during the month of March Rs. 200 but out of which goods costing Rs. 75 were received only on 4^{th} April, 2010. Rate of gross profit is 1/3 of cost.
   Ascertain the value of stock as per book on 31.3.2010

9. Accounting year of X & Co. ends on 31.3.2065. However, it was not possible to conduct physical verification of the stock till 11.4.2065. It is a rule that purchases are entered into books once the invoices are received. From the following facts find out the physical stock as on 31.3.2065:
   i) Stock as on date of physical verification Rs. 51,250
   ii) Sales between 1.4.2065 to 11.4.2065 amounting to Rs. 22,400
   iii) Invoices for goods amounting to Rs. 25,000 have been entered in purchases book on 27^{th} Ashad 2065, but the goods were received only on 5.4.2065.
   iv) Purchases between yearend to stock taken date are 10,500 out of which goods worth Rs. 2,500 still to be received.
   v) Goods costing Rs. 3,000 was sent to customer on sale or return basis on 29.3.2065 with a term of approval being two weeks.
   vi) Gross profit margin is 1/3 on cost.

10. *M/s. Apple Enterprises* prepared accounts upto 31^{st} March each year. Its stock taking couldn't be undertaken until 3^{rd} April 2009 on which date the stock stood at cost amounted to Rs. 240,000.
    An examination of inventories and related records, it was disclosed that between 1^{st} and 3^{rd} April;
    a. Sales totaled Rs. 40,000 including (i) Rs. 2,000 in respect of goods which left the warehouse on 29^{th} March and (ii) Rs. 4,000 in respect of goods not delivered until 12^{th} April. The rate of gross profit to sales was 30%.
    b. Returns from customers totaled Rs. 6,000
    c. Purchases totaled Rs. 18,000 which includes (i) Rs. 6,000 for goods received in March and (ii) Rs. 3,000 for goods received in 10^{th} April
    d. Returns to suppliers totaled Rs. 4,000
    e. There were arithmetical errors in the stock on 3^{rd} April, resulting in an overvaluation of Rs. 4,600

    Statement of company's closing stock on March 31, 2009

11. The Statement Of Profit or Loss of Mr. Chintamani for the year ended 31st December 2009 showed a net profit of Rs. 2,800 after taking into account the closing stock of Rs. 4,720. On a scrutiny of the books the following information could be obtained.
    a. Mr. Chaintamani has taken goods valued Rs. 1,500 for his personal use without making entry in the books.
    b. Purchases of the year included Rs. 600 spent on acquisition of a ceiling fan for his shop.
    c. Invoices for goods amounting to Rs. 4,000 have been entered on 29th December, but such goods were not included in stock.
    d. Rs. 500 have been included in closing stock in respect of goods purchased and invoiced on 28th December, but included in purchase for January 2010.
    e. Sale of goods amounting to Rs. 610 sold and delivered in December had been entered in January sales.

    Ascertain the correct amount of closing stock as on 31st December, 2009 and the adjusted net profit for the year ended on that date.

12. The Statement Of Profit or Loss of Miss. Sonika showed a net profit of Rs. 60,000, after considering the closing stock of Rs. 37,500 on 31st March, 2007. Subsequently the following information was obtained from scrutiny of the books:
    a. Purchases for the year included Rs. 1,500 paid for new electric fittings for the shop.
    b. Miss. Sonika gave away goods valued at Rs. 4,000 as free samples for which no entry was made in the books of accounts.
    c. Invoices for goods amounting to Rs. 25,000 have been entered in purchases book on 27th March, 2007, but the goods were not included in stock.
    d. In March, 2007 goods of Rs. 20,000 sold and delivered were taken in the sales for April, 2007.
    e. Goods costing Rs. 7,500 were sent on sale or return basis in March, 2007 at a margin of profit of 1/3 on cost. Though approval was given in April 2007, these were taken as sales for March, 2007.

       Calculate the value of stock on 31st March 2007 and the adjusted net profit for the year ended on that date.

13. From the following information of *M/s. Peoples' House* find out the value of stock as on 31.3.2010:
    a. Cost of physical stock on 31.3.2010 was Rs. 320,000
    b. Cost of stock held as consignee was Rs. 160,000
    c. Stock was expected to realize the normal selling price of 150% of cost except for the following goods:
       - Goods costing Rs. 20,000 were damaged and an expenditure of 10% of normal selling price was necessary to realize normal selling price.
       - Goods costing Rs. 15,000 were damaged beyond repair and were expected to realize Rs. 2,000 only.

14. Physical verification of stock was done on 23rd Ashad. The value of stock was Rs. 480,000. Following transactions took place between 23rd Ashad to 31st Ashad.
    a. Out of goods sent on consignment, goods costing Rs. 24,000 were unsold.

b. Purchases of Rs. 40,000 were made, out of which goods worth Rs. 16,000 were delivered on 5th Shrawan.
c. Sales were Rs. 136,000 which includes goods worth Rs. 32,000 sent on approval basis. Half of these goods were returned before 31st Ashad, but no intimation is available regarding the remaining goods. Goods are sold at cost plus 25%. However, goods costing Rs. 24,000 had been sold for Rs. 12,000.

You want to determine the value of stock on 31st Ashad. You start with physical stock on 23rd Ashad.

ANSWER

Multiple Choice Questions (MCQs)

1	d	6	d	11	d
2	d	7	c	12	c
3	c	8	a	13	d
4	c	9	b		
5	c	10	a		

CHAPTER- 5

Accounting for Special Transactions

UNIT 1:

Consignment Accounting

Learning Objectives

1. *Understand the special features of consignment business and terminologies like consignee and consignor*
2. *Practice the accounting treatments for consignment transactions and events in the books of consignor and consignee.*
3. *Appreciate the concepts of Invoice price and Loading charges.*
4. *Learn the technique of computing valve of closing stock lying with the consignee.*
5. *Learn the technique of computing cost of abnormal loss and normal loss*
6. *Understand the different types of commission paid to consignee.*

1.1 INTRODUCTION

Now-a-days, it has become common that the business organizations dispatch their goods to their agents as an alternative to increase the sales. It is very expensive for the manufactures to sell the goods directly either in home market or in foreign market. But the knowledge of the agent of the local conditions where the agent resides proves useful in increasing the sales. Therefore, different agents are appointed for different places. Consignment is a kind of business expansion without actually opening branches in a new potential market. The person sending the goods is called the consignor and the agent who receives the goods is called consignee.

1.2 CONSIGNMENT ACCOUNT

To consign means to send. Consignment is specific commercial agreement in which the manufacturer or wholesaler send goods to outstation trader or consignee to be sold by the consignee on behalf of the former (Consignor) for mutually agreed commission. In accounting, the "consignment account" relates to accounts dealing with a situation where one person (or firm) sends goods to another person (or firm) on the basis that the goods will be sold on behalf of and at the risk of the former.

Some terminologies used in consignment accounting.

1. Consignment- Consignment means the transaction of sending goods by one person to another, who is to sell those goods on behalf of the sender.
2. Consignor and Consignee- The person who sends the goods is known as ‘consignor’ and to whom the goods are sent is known as 'consignee'.
3. Account Sale: The statement send by consignee to the consignor stating all detail regarding consignment goods is called account sale.
4. Outward/Inward Consignment – The consignment is 'outward consignment' for the person who sends the goods for sale and an 'inward consignment' for the person who receives the goods for sale.
5. Proforma invoice- A statement that looks like an invoice but is really not one. The objective of the proforma invoice is only to convey information to the agent regarding particulars of the goods sent.

1.3 FEATURES OF CONSIGNMENT

1. The ownership of the goods, i.e. the property in the goods, remains with the consignor or the principal- the agent does not become their owner even though they are in his possession.
2. The relationship between consignor and consignee is that of principal and agent.
3. Risk of goods remains with the consignor because ownership of goods remain with the consignor.
4. The consignor does not send an invoice to the agent. He sends only a proforma invoice.
5. Consignee is entitled to reimbursement of expenses incurred by him on behalf of the consignor as per agreement. This however can be changed by agreement between the two parties.

6. Consignee is also entitled to an agreed remuneration i.e. commission that will be calculated on the basis of gross sale. For ordinary commission the agent is not responsible for any bad debt that may arise. If the agent is to be made responsible for bad debts, he is to be paid a commission called del-credere commission. It is calculated on total sales, not merely on credit sales.
7. It is also usual for the agent to give an advance to the principal in the form of cash or a bill of exchange. It is adjusted against the sale proceeds of the goods.
8. Periodically, the agent sends to the principal a statement called *Account Sale*; it sets out the sales made by the agent, the expenses incurred on behalf of the principal, the commission earned by the agent and the balance due to the principal.

1.4 DISTINCTION BETWEEN CONSIGNMENT AND SALES

The following points summarize clearly, the difference between consignment and sales

S.No	Basis of Distinction	Consignment	Sales
1	Property in goods i.e ownership	Ownership of the goods rests with the consignor till the time they are sold by the consignee, even though the goods are transferred to the consignee.	The ownership of the goods transfers with the transfer of goods from the seller to the buyer.
2	Relations	The relationship between the consignor and the consignee is that of a principal and agent.	The relationship between the seller and the buyer is that of a creditor and a debtor.
3	Risk and damage	Consignee holds the goods at the risk of the consignor therefore the subsequent damage to goods is the loss of the consignor	Any subsequent damage to the goods is the loss of the buyer
4	Return of goods	The consignee can return the unsold goods to the consignor.	Goods sold are the property of the buyer and can be returned only if the seller agrees.
5	Expenses after delivery	Expenses done by the consignee to receive the goods and to keep it safely is borne by the consignor.	Expenses incurred by the buyer are to be borne by the buyer himself after the delivery of goods.
6	Forwarding letter	profoma invoice	invoice bill.

1.5 ACCOUNTING FOR THE CONSIGNMENT

The primary objective of preparing the Consignment Account is to ascertain the profit or loss on the consignment separately. For that, the consignor prepares a Consignment Account for each consignment. This special account is always named with either the consignee or the place, for example "Consignment to M/s ... ." or "Consignment to Kathmandu” etc. In fact, the consignment account is a combination of Trading and Profit and Loss A/c related solely to the consignment.

1.5.1 JOURNAL ENTRIES IN THE BOOKS OF CONSIGNOR ARE AS FOLLOW:-

1	**For goods sent on consignment to consignee** Consignment A/c To Goods Sent on Consignment Account	 Dr.
2	**For expenses incurred by consignor** Consignment A/c To Cash / Bank A/c	 Dr.
3	**When a bill is drawn by the Consignor on Consignee and when Consignee accepts the bill** Bills Receivable A/c To Consignee A/c	 Dr.
4	**When the Consignor discounted the bill with his banker** Bank A/c Consignment A/c To Bills Receivable A/c	 Dr. Dr.
5	**For the expenses incurred by Consignee** Consignment A/c To Consignee A/c	 Dr.
6	**For Commission payable to Consignee** Consignment A/c To Consignee A/c	 Dr.
7	**For Sales effected by the Consignee and on receipt of Account Sales** Consignee A/c To Consignment A.c	 Dr.
8	**Entry for Stock Transfer** Consignment Stock A/c	 Dr.

	To Consignment A/c
9	**<u>In the Consignment A/c, if the debit side is greater (Loss)</u>** Profit and Loss A.c Dr. To Consignment A.c
10	**<u>In Consignee A/c, if the credit side is greater</u>** Consignee A/c Dr. To Cash / Bank A/c
11	**<u>In Consignee A/c, if the debit side is greater</u>** Cash / Bank A/c Dr. Bill Receivable A/c Dr. To Consignee
12	**<u>To close the Goods Sent on Consignment A/c</u>** Goods Sent on Consignment A/c Dr. To Trading Account

Illustration :1

On 1st March 2012 Krishna of Ilam sends 1,200 boxes of organic tea to Madhav of Kathmandu on consignment basis. Each box cost Rs. 5,000. Krishan pays transport charge Rs. 10,000 and insurance Rs. 8,000 and draws upon Madhav a bill of exchange for Rs. 500,000 for three months which is accepted and returned.

On 30th September, 2012 Madhav forwards an account sales to Krishna showing that 500 boxes have been sold @ Rs. 5,600 each while 300 boxes were sold @ Rs. 5,500 each and 200 boxes were sold @ Rs. 5,400 each. The expenses incurred by Madhav consisted of carriage charges Rs. 5,000 and rent of storage Rs. 35,000. Madhav is entitled to a commission 2% on gross sale proceeds. He enclosed a cheque for the balance due to Krishna.

JOURNAL VOUCHER

Particular	**Debit**	**Credit**
1. Open Consignment Account and debit it with the cost of goods and credit it with "Goods sent on Consignment Account". In the above case.		
Consignment to Madhav A/c Dr. To, Goods sent on Consignment A/c (1200 boxes @ Rs 5,000 each)	Rs. 60,00,000	Rs. 60,00,000

2. For the expenses incurred by the consignor debit consignment A/c and credit Cash A/c

Consignment to Madhav A/c Dr.	Rs. 18,000	
To, Cash A/c		Rs. 18,000

3 If the consignee sends an advance, Debit cash or Bank or Bills Receivable and Credit the consignee's personal A/c

Bills Receivable A/c Dr.	Rs. 500,000	
To, Madhav A/c		Rs. 500,000

4 For discounting the Bills Receivable with bank before maturity date.

Bank A/c Dr.	Rs. 500,000	
To, Bills Receivable A/c		Rs. 500,000

Note: If such bill is discounted by consignor with the bank before maturity, pass usual entry for discounting a bill. The discount on bills may either be treated as consignment expense to charge to consignment A/c or it may be treated as general financial charges and charged to Profit & Loss A/c.

5 On receipt of Account Sale

(a) For sales made by the consignee, debit his personal account and credit consignment account.

Madhav A/c Dr.	Rs. 55,30,000	
To, Consignment to MadhavA/c		Rs. 55,30,000

(b) For expenses incurred by the consignee as well as bad debts suffered by him on behalf on the consignor, debit Consignment A/c and Credit consignee.

Consignment to Madhav A/c Dr.	Rs. 40,000	
To, Madhav A/c		Rs. 40,000

(c) For commission due to the consignee, debit Consignment A/c and credit consignee.

Consignment to Madhav A/c Dr.	Rs. 110,600	
To, Madhav A/c		Rs. 110,600

(d) For the remittance that may accompany the Account Sales, debit Bank and credit the consignee.

Bank A/c Dr. To, Madhav A/c	Rs. 48,79,400	 Rs. 48,79,400

6 For the goods that may remain unsold (valuation basis will be discussed in later on) debit the Consignment Stock A/c and credit consignment A/c.

Stock on Consignment A/c Dr. To, Consignment to Madhav A/c	Rs. 10,03,000	 Rs. 10,03,000

Note:

(i) Calculation of Unsold stock

Cost (200 boxes X Rs. 5,000)	10,00,000
Proportionate expenses incurred by consignor	
(18,000/1200) X 200	3,000
Value of unsold stock	**10,03,000**

(ii) Stock on consignment is an asset. It will be shown in the Statement Of Financial Position of the consignor and next year it will be transferred to the debit of consignment A/c.

7 At this stage the Consignment Account will reveal profit or loss. The profit or loss will be transferred to the Profit and Loss Account by debit to consignment A/c.

Consignment to Madhav A/c Dr. To, General Profit and Loss A/c	Rs. 3,64,400	 Rs. 3,64,400

Consignment to Madhav Account

Date	Particulars	Rs.	Date	Particulars	Rs.
2012			2012		
1 March	To, Goods sent on consignment A/c	60,00,000	30 Sept.	By, Madhav A/c-sales proceeds	55,30,000
	To, Cash A/c	18,000		By, Stock on Consignment	10,03,000
30 Sept.	To, Madhav A/c-Expenses	40,000			
	To, Madhav A/c-commission	110,600			

	To, General P/L A/c-transfer of profit	3,64,400			
		65,33,000			65,33,000

8. The Goods sent on Consignment Account should be closed by transfer to the Trading Account/Purchase A/c:

Goods sent on Consignment A/c Dr. Rs. 60,00,000
To, Trading/Purchase A/c Rs. 60,00,000

Goods sent on Consignment A/c

Date	Particulars	Rs.	Date	Particulars	Rs.
2012 30 Sept.	To, Trading/Purchase A/c	60,00,000	2012 1 March	By, Consignment to Madhav A/c	60,00,000
		60,00,000			60,00,000

Stock on Consignment Account

Date	Particulars	Rs.	Date	Particulars	Rs.
2012 1 March	To, Consignment to Madhav A/c	10,03,000	2012 30 Sep	By, Balance c/d	10,03,000
		10,03,000			10,03,000

Madhav A/c

Date	Particulars	Rs.	Date	Particulars	Rs.
2012 30 Sept.	To, Consignment to Madhav A/c-sales proceeds due	55,30,000	2012 1 March	By, Bills Receivable A/c	500,000
			30 Sept.	By, Consignment to Madhav-expenses incurred	40,000
				By, Consignment to Madhav-Commission	110,600
				By, Bank	48,79,400
		55,30,000			55,30,000

1.5.2 Valuation of Consignment Stock

The principle is that stock should be valued at cost or net realizable value whichever is lower, the same principle as is practiced for preparing final accounts. Cost, in case of consignment stock, would include the cost at which the goods are consigned plus, the proportionate non-recurring expenses. All the non-recurring expenses, whether incurred by the consignor or by the consignees, are to be taken into account. But expenses incurred after the goods have reached the consignee's go-down (such as go-down rent, insurance of go-down, delivery charges) are not treated as part of the cost of goods for valuating stock on hand. Following steps should be followed for valuation of unsold stock lying with consignee:

1. Cost of goods, proportion of consigner's expenses and proportion of expenses incurred up to the goods reach the premises/go-down of consignee should be considered.
2. In case of lack of adequate information regarding consignee's expenses, proportion of non-recurring expenses incurred by consignee should be considered.
3. If information is not clear about expenses incurred by consignee, then such expenses should be excluded for valuation of unsold stock by writing suitable note.

If the expected selling price of stock on hand is less than the cost then the value put on the stock should be expected net selling price only, i.e. expected selling price less delivery expenses, etc.

Illustration 2:

A company sends 300 bales of cotton to its consignee at profit 20% on sale. The cost of each bale to company is Rs.600 per bale. The following are the expenses incurred in connection with this consignment

(a) Rs.900 paid by the consignor for dispatching goods.
(b) Rs.2,000 paid by the consignee by way of freight, duty and landing charges.
(c) Rs.1,000 paid by the consignee by way of godown rent, salaries of salesman.

Required :
The Valuation of stock at the end (at invoice price) if the consignee sells away 2/3rd of the consignment.

Solution :

Total bales sent	300	
Less bales sold (2/3rd)	200	
Bales unsold	100	
Cost price of 100 bales at Rs.600 per bale		60,000
Add Profit at 20% on sale or 25% on cost		15,000
		75,000
Add 1/3rd direct expenses :		
Non Recurring Expenses paid by Consignor	900	
Non Recurring Expenses paid by Consignee	2,000	
	2,900	
1/3rd thereof	2,900	967
Stock at the end (at Invoice Price)		**75,967**

Note : In the consignment account, stock reserve account will appear at Rs.15,000 on the debit side.

1.5.3 Goods Invoiced Above Cost/ Loading

Sometimes, the consignor may prefer to send goods to the consignee at a priced not at cost but above cost i.e. at selling or near selling price and prepares the 'Proforma Invoice' by adding desired profit on cost to realize the highest possible price. The purpose is to hide the real profit on the consignment from the competitive eye of the consignee, the stock remaining unsold will initially be valued on the basis of the invoice price but profit or loss can be ascertained only if sales proceeds plus stock on hand valued on cost basis, is compared with the cost of the goods concerned together with expenses. Hence, if entries are first made on invoice basis, the effect of the loading (i.e. amount added to arrive at the invoice price) must be removed by additional entries.

The method of preparation of accounts is the same as in the goods consigned on cost basis, except for a few adjustments.

Accounting entries in the books of consignor when goods are invoiced at cost or loaded price are as under

S. No	When goods are invoice at Cost	When goods are invoiced at loaded price(Mark-up)
1	**For goods sent on consignment to consignee** Consignment A/c Dr. To Goods Sent on Consignment A/c (with the cost of goods sent on consignment)	**For goods sent on consignment to consignee** Consignment A/c Dr. To Goods Sent on Consignment Account (with the invoice price of goods sent on consignment) Goods Sent on Consignment Account Dr To Consignment A/c (With the amount of loading)
2	**For Goods returned by consignee** Goods sent on Consignment A/c… Dr To Consignment A/c (With the cost of goods)	**For Goods returned by consignee** Goods sent on Consignment A/c………. Dr To Consignment A/c (with the invoice Price of the goods Consignment A/c……………… Dr To Goods sent on Consignment Account (with the amount of Loading)
3	**For Opening Stock** Consignment A/c………………..Dr	**For Opening Stock** Consignment A/c………….Dr

	To Stock on Consignment A/c (With the cost of Opening Stock)	To Stock on Consignment A/c (With the invoice Price of Opening Stock) Stock reserve A/c………… Dr To Consignment A/c (With the amount of Loading)
4	**For Closing Stock** Stock on Consignment A/c …... Dr To Consignment A/c (With the cost of Closing Stock)	**For Closing Stock** Stock on Consignment A/c …………. Dr To Consignment A/c (With the invoice price of Closing Stock) Consignment A/c ………………… Dr To Stock reserve A/c (With the amount of Loading)

Illustration 3

Suppose in the illustration 1, goods are send to consignee at the invoice price i.e cost plus 20%,amounting to Rs.6,000 per box. The entries will be initially:

JOURNAL VOUCHER

Date	Particular		Debit	Credit
1	Consignment to Madhav A/c To, Goods sent on Consignment A/c	Dr.	Rs. 72,00,000	Rs. 72,00,000
2	Consignment to Madhav A/c To, Cash A/c	Dr.	Rs. 18,000	Rs. 18,000
3	Bills Receivable A/c To, Madhav A/c	Dr.	Rs. 500,000	Rs. 500,000
4	Bank A/c To, Bills Receivable A/c	Dr.	Rs. 500,000	Rs. 500,000
5				

(a)	Madhav A/c	Dr.	Rs. 55,30,000	
	To, Consignment to Madhav A/c			Rs. 55,30,000
(b)	Consignment to Madhav A/c	Dr.	Rs. 40,000	
	To, Madhav A/c			Rs. 40,000
(c)	Consignment to Madhav A/c	Dr.	Rs. 110,600	
	To, Madhav A/c			Rs. 110,600
(d)	Bank A/c	Dr.	Rs. 48,79,400	
	To, Madhav A/c			Rs. 48,79,400
6	Stock on Consignment A/c	Dr.	Rs. 12,03,000	
	To, Consignment to Madhav A/c			Rs. 12,03,000

Note: (i) Calculation of Unsold stock

Cost of 200 boxes (200 X Rs.6,000)	12,00,000
Proportionate expenses incurred by consignor (18,000/1200) X 200	3,000
Value of unsold stock	**12,03,000**

You will see that except for difference in the amounts in entries (1) and (6), these and other entries are the same as those already given. Additional entries before ascertaining profit or loss to remove the effect of loading:

(a)	Goods sent on Consignment A/c	Dr.	Rs. 12,00,000	
	To, Consignment to Madhav A/c			Rs. 12,00,000
	[Entry (1) reversed to the extent of loading in order to debit the Consignment A/c on cost basis]			
(b)	Consignment to Madhav A/c	Dr.	Rs. 200,000	
	To, Stock Reserve Account			Rs. 200,000
	(The amount of loading included in the value of the closing stock is unrealized profit, hence reserve created by debit to the Consignment Account).			

The Consignment Account will now reveal a profit of Rs. 3,64,400 the same as before by posting above two entries in Consignment A/c. It will be transferred to the Profit & Loss A/c.

The accounts (except whose account will be the same as already shown) are given below:

Consignment to Madhav Account

Date	Particulars	Rs.	Date	Particulars	Rs.
2012			2012		
1 March	To, Goods sent on consignment A/c	7,200,000	30 Sept.	By, Madhav A/c- sales proceeds	5,530,000
	To, Cash A/c	18,000		By, Stock on Consignment	1,203,000
30 Sept.	To, Madhav A/c- Expenses	40,000		By, Goods sent on consignment A/c- loading	1,200,000
	To, Madhav A/c- commission	110,600			
	To, Stock Reserve A/c	200,000			
	To, General P/L A/c-transfer of profit	364,400			
		7,933,000			7,933,000

Goods sent on Consignment A/c

Date	Particulars	Rs.	Date	Particulars	Rs.
2012			2012		
30 Sept.	To, Consignment to Madhav A/c	1,200,000	1 March	By, Consignment to Madhav A/c	7,200,000
	To, Trading/Purchase A/c	6,000,000			
		7,200,000			**7,200,000**

Stock on Consignment Account

Date	Particulars	Rs.	Date	Particulars	Rs.
2012			2012		
1 March	To, Consignment to Madhav A/c	1,203,000	30 Sept.	By, Balance c/d	1,203,000
		1,203,000			**1,203,000**

Stock Reserve Account

Date	Particulars	Rs.	Date	Particulars	Rs.
2012			2012		
30 Sept.	To, Balance c/d	200,000	30 Sept.	By, Consignment to Madhav A/c	200,000
		200,000			**200,000**

The last two accounts will be carried forward to the next year and their balance will then be transferred to the Consignment A/c- Rs. 12,03,000 on debit side and Rs. 200,000 on the credit. This year in the Statement Of Financial Position the net amount of Rs. 10, 03,000 will be shown on the assets side as shown below:

Stock on Consignment	Rs. 12,03,000
Less: Reserve	Rs. 200,000
	Rs. 10,03,000

1.5.4 Abnormal Loss

There are the losses which are accidental and not natural like theft, fire, etc. Abnormal loss may occur in the godown of the consignee or in transit. When the abnormal loss occurs in the godown of the consignee the valuation of closing stock is not affected because the expenses incurred after they reach the godown of the consignee are not to be taken into account for the purpose. Hence, the normal formula will be followed for the valuation of closing stock. When the abnormal loss occurs in transit, the treatment in accounts will depend upon whether the unforeseen loss has been insured against or not. In case of insurance the consignment account will be credited but the insurance companies account will be debited with the amount of loss (which shall be calculated like valuation of stock on consignment i.e. including proportionate non-recurring expenses of both the consignor and the consignee). If the goods are not insured, instead of Insurance Company's Account being debited, Profit and Loss Account will be debited and consignment account will be credited. In this way the final net profit on consignment is not adversely affected.

Accounting entries for the abnormal Loss:

S.no	Books of Consignor	Books of Consignee
1	**For the cost of Abnormal Loss** Abnormal Loss A/c Dr To Consignment A/c	**For the cost of Abnormal Loss** No entry
2	**For the insurance Claim received by Consignor** Insurance Company A/c Dr (if Due) Cash/ Bank A/c Dr (If received) To Abnormal Loss A/c	**For the insurance Claim received by Consignor** No Entry
3	**For the Insurance Claim Received by Consignee** Consignee A/c.. Dr To Abnormal Loss A/c	**For the Insurance Claim Received by Consignee** Insurance Company A/c Dr (if Due) Cash/ Bank A/c Dr (If received) To Consignor A/c

4	**For transferring the Net Loss** General Profit/ Loss A/c Dr To abnormal Loss A/c	**For transferring the Net Loss** No Entry

1.5.5 Normal Loss

Normal losses are inevitable and unavoidable. These may arise due to natural causes like breaking in bulk, evaporation, leakage, drying, etc. No effort can prevent these losses. The normal losses would be spread over the entire consignment while valuing stock. The total cost plus expenses incurred should be divided by the quantity available after the normal loss to ascertain the cost per unit. In consignment normal loss leads to exclude only quantity not cost of the lost stock from consignment account. So in case of normal loss quantity of the goods decreases but the total cost of the goods remains same as before. It means that the amount of normal loss spread over the remaining goods. There is no need to pass any entry for normal loss. Suppose 1,000 kg of apples are consigned to a wholesaler, the cost being Rs. 30 per Kg. plus Rs. 4,000 of freight. It is known that a loss of 15% is unavoidable. The cost per kg will be Rs, 34,000/850 = Rs. 40. If the stock is 100 kg its value will be Rs. 4,000.

Illustration 4 :

S of Kathmandu consigned 10,000 kg. of oil to D of Dharan. The cost of oil was Rs.2 per kg. S paid Rs.5,000 as freight and insurance. During transit 250 kg were accidentally destroyed for which the insurers paid directly to the consignors Rs.450 for full settlement of the claim.

D reported that 7,500 kg were sold @ Rs.3 per kg. The expenses being on godown rent Rs. 200, on advertisement Rs.1,000 and on salesman salary Rs.2,000. D. is entitled to a commission of 3% plus 1.5% del credere. D reported a loss of 100 kg. due to leakage. D. settled the accounts by bank draft.

Prepare the accounts is the books of S.

Solution

Consignment A/c

Particular	Rs.	Particular	Rs.
To Goods on Consignment A/c	20,000	By Bank (Ins. Co.)	450
To Bank—Freight & Insurance	5,000	By P & L A/c (abnormal loss)	175
To D—Expenses	3,200	By D—(Sale proceeds)	22,500
To D—Commission		By Consignment Stock A/c	5,431
Ordinary 3% 675		By P & L A/c—Loss	657
Del Credere 1.5% 338	1,013		
	29,213		**29,213**

Goods Sent on Consignment A/c

Particular	Rs.	Particular	Rs.
To Trading A/c	20,000	By Consignment to Dharan A/c	20,000

Consignment Stock A/c

Particular	Rs.	Particular	Rs.
To Consignment to Dharan A/c	5,431	By Balance c/d	5,431

D's A/c

Particular	Rs.	Particular	Rs.
To Consignment to Dharan A/c — (sale proceeds)	22,500	By Consignment to Dharan A/c (Exp) By Consignment to Dharan A/c (commission) By Bank	3,200 1,013 18,287
	22,500		**22,500**

Working Notes :

(A) Cost of Goods destroyed Rs.

Cost of 10,000 kg.@Rs.2		20,000
Freight	5,000	
Total cost of 10,000 kg	25,000	

(B) Value of Stock still unsold Kg.

Quantity received by D	= 9,750 (excluding accidental loss)
Less Normal leakage	=100
	9,650

Cost of 9,650 kg = Rs.25,000 (total cost) -Rs, 625 (Cost of abnormal loss) = Rs.24,375

Cost of 2,150 kg. = 100 / 125 * 2150 = Rs.5,431

1.5.6 Commission

The consignee selling the goods on consignment basis is entitled, as remuneration, to a commission on sales. Commission is the remuneration paid by the consignor to the consignee for the service rendered to the consignor for selling the consigned goods. This commission may take different forms depending on the agreement between the Consignor and the Consignee..

In general three types of commission can be provided by the consignor to the consignee as per the agreement. They are

a. Ordinary Commission

This is the most common form of commission in consignment accounting which is generally provided as certain percentage of sales amount or certain fixed amount per unit sold.

b. Del Credere Commission

The ownership of the goods lies with the consignor. The risk in the business is completely borne by the consignor and at the same time the total returns belong to the consignor. The consignee also takes certain risk in terms of putting his efforts for sale, stocking the goods etc. If the goods are not sold, the consignor would be at a greater loss compared to the consignee. The consignee would be selling the goods on credit (if so advised by the consignor) only if the risk of collecting the sale proceeds is not with him. If credit sales are made, the consignor cannot assume that the consignee has to give him the sale proceeds unless the consignee receives them from the consignment debtors. This results in the consignor having to take the total risk in the sale and also make the efforts to collect the sale proceeds. Since the customers to whom the consignee makes the sales are customers known to the consignee, it would be easier for him to pursue them for collecting the sale proceeds. Therefore to bind the consignee with the responsibility of collecting the sale proceeds relating to credit sales an additional commission known as "Del Credere Commission" is given by the consignor.

Such commission is also given as a fixed percentage of total sales unless otherwise stated in the agreement. Once the ‘ Del credere’ Commission is paid , the amount of bad debts will be borne by the consignee

Accounting entries for the credit sale and delcredere commission is paid:

S. No	Books of Consignor	Books of Consignee
1	**For credit Sales** Consignee A/c .. Dr To Consignment A/c	**For Credit Sales** Consignor Debtor A/c Dr To Consignor A/c
2	**For payment received from Debtor** No Entry	**For payment received from Debtor** Cash/ Bank A/c Dr To Consignment Debtor A/c
3	**For Bad Debt Incurred** No Entry	**For Bad Debt Incurred** Bad Debt A/c Dr To Consignment Debtor A/c
4	**For Del-Credere Commission** Consignment A/c Dr To Consignee	**For Del-Credere Commission** Consignor A/c Dr To commission Earned A/c
5	**For Transferring Bad Debt account** No entry	**For Transferring Bad Debt account** Commission Earned A/c Dr To Bad Debt A/c

c. Overriding Commission

A commission paid to general agents or agency managers in addition to the commission paid to the soliciting agent or broker. In the process of making extra efforts for pushing through the sale of newly introduced products or slow moving products, the consignor may promise to give additional commission over and above the regular commission being paid. This is termed the "overriding commission."

Illustration 5

X of Kathmandu sent on 15th January, 2014, a consignment of 500 toys bicycles costing Rs. 100 each. Expenses of Rs. 700 met by the consignor. Y of Butwal spent Rs. 1,500 for clearance and the selling expenses were Rs. 10 per bicycle. Y sold, on 4th April 2014, 300 pieces @ Rs. 160 per piece and again on 20th June 2014, 150 pieces @ Rs. 172. Y was entitled to a commission of Rs. 25 per piece sold plus one fourth of the amount by which the gross proceeds less total commission thereon exceeded a sum calculated at the rate of Rs. 125 per piece sold. Y sent the amount due to X on 30th June 2014. You are required to show the Consignment Account and Y's Account in the books of X.

Solution

CONSIGNMENT A/C

Date	Particular	Rs.	Date	Particular	Rs.
15-Jan	To goods sent on consignment a/c (500 pieces@ Rs. 100)	50,000	4-Apr	By Y-sale of 300 @ Rs. 160	48,000
15-Jan	To Bank A/c - Exp	700	20-Jun	By Y-sale of 150 Pieces @ 172	25,800
	To Y-Clearing Exp	1,500	30-Jun	By consignment stock A/c	5,220
4-Apr	To Y-selling Exp	3,000			
20-Jun	To Y- selling Ex	1,500			
30-Jun	To Commission A/c	12,510			
30-Jun	To Profit & Loss A/c	9,810			
		79,020			**79,020**

Y ACCOUNT

Date	Particular	Rs.	Date	Particular	Rs.
4-Apr	To Consignment A/c	48,000	4-Apr	By Consignment A/c (clearing exp.)	1,500
4-Apr	To Consignment A/c	25,800	4-Apr	By Consignment A/c (selling exp.)	3,000
			20-Jun	By Consignment A/c (selling exp.)	1,500
			30-Jun	By Consignment A/c commission (2	12,510
			30-Jun	By Bank	55,290
		73,800			**73,800**

Working Note

1. **Valuation of Closing stock**

50 pieces @ Rs. 100 each		Rs. 5,000
Add : Proportionate Expenses		
Expenses incurred by X on 500 pieces	Rs. 700	
Clearing expenses incurred by Y	Rs. 1500	
Total Expenses	Rs. 2,200	
Therefore, expenses on 50 pieces 2200x50/500		Rs. 220
		Rs. 5,220

2. **Calculation of Commission**

Let Total Commission of Y be a
a = No. of pieces sold x Rs. 25 + ¼ [Gross sale proceeds - (Rs. 125x No. of pieces sold] - (a)
a = 450 x Rs. 25 + ¼ [R. 73,800 - (Rs. 125 x 450] -a)
a = Rs. 45,000 + Rs(17550-a))1/4
5a = Rs. 62, 550
Therefore :
a = 62,550/5 = Rs. 12,510

1.6 ACCOUNTING IN THE BOOKS OF THE CONSIGNEE

The consignee is not concerned when goods are consigned to him or when the consignor incurs expenses. He is concerned only when he sends an advance to the consignor, makes a sale, incurs expenses on the consignment and earns his commission. He debits or credits the consignor for all these as the case may be. The entries on the basis of the illustration as given above are as follows in the books of Madhav (consignee):

Journal Entries in the Books of Consignee

1	**For Bills Payable accepted** Consignor A/c Dr. To Bills Payable A/c
2	**For Sales effected on behalf of Consignor - Cash Sales** Cash / Bank A/c Dr. To Consignor A/c
3	**For Sales effected on behalf of Consignor – Credit Sales** Debtors A/c Dr. To Consignor A/c

4	**For expenses incurred on behalf of Consignor - if paid** Consignor A/c Dr. To Cash / Bank A/c
5	**For expenses incurred on behalf of Consignor - if payable** Consignor A/c Dr. To Creditors A/c
6	**For commission receivable** Consignor A/c Dr. To Commission A/c Commission A/c Dr. Profit and Loss A/c
7	**For Collections made from Debtors** Cash / Bank A/c Dr. Debtors A/c
8	**When Bad debts occur - if delcredere commission is paid** Bad debts A/c Dr. To Debtors A/c P & L A/c (or) Commission A/c Dr. To Bad Debts A/c
9	**When Bad debts occur - if delcredere commission is not paid** Consignor A/c Dr. To Debtors A/c
10	**For final settlement to Consignor -** Consignor A/c Dr. To Cash / Bank A/c (or) Cash / Bank A/c Dr.

	To Consignor A/c

Illustration :6

On 1st March 2018 Krishna of Ilam sends 1,200 boxes of organic tea to Madhav of Kathmandu on consignment basis. Each box cost Rs. 5,000. Krisha pays transport charge Rs. 10,000 and insurance Rs. 8,000 and draws upon Madhav a bill of exchange for Rs. 500,000 for three months which is accepted and returned.

On 30th September, 2018 Madhav forwards an account sales to Krishna showing that 500 boxes have been sold @ Rs. 5,600 each while 300 boxes were sold @ Rs. 5,500 each and 200 boxes were sold @ Rs. 5,400 each. The expenses incurred by Madhav consisted of carriage charges Rs. 5,000 and rent of storage Rs. 35,000. Madhav is entitled to a commission 2% on gross sale proceeds. He enclosed a cheque for the balance due to Krishna. Record the transactions in the books of Madhav.

Date	Particular		Debti	Credit
1	On sending the acceptance to Krishna			
1 March, 2018	Krishna A/c	Dr.	Rs. 500,000	
	To, Bills Payable A/c			Rs. 500,000
	(Being bill accepted)			
2	On meeting his acceptance			
4 June, 2018	Bills Payable A/c	Dr.	Rs. 500,000	
	To, Bank A/c			Rs. 500,000
	(Being bill discharged)			
3	On meeting expenses on the consignment			
30 Sep, 2018	Krishna A/c	Dr.	Rs. 40,000	
	To, Bank A/c			Rs. 40,000
	(Being expenses incurred on behalf of consignment recorded)			
4	On sales being effected			
	Bank A/c	Dr.	Rs.55,30,000	
	To, Krishna A/c			Rs. 55,30,000
	(Being Sales made)			
5	On earning the commission:			
	Krishna A/c	Dr.	Rs.110,600	
	To, Commission Earned A/c			Rs. 110,600
	(Being commission income recorded)			

6	On settling the account of Krishna Krishna A/c Dr. To, Bank A/c (Being consignor's account settled)	Rs. 48,79,400	Rs. 48,79,400

Note:If the commission includes del-credere commission also, he would not be able to debit Krishna A/c for the bad debt. In that case the debit should be the Commission Earned A/c and net balance will be treated as commission income.

Illustration 7

M/s. Jagadish Traders consigned 10,000 units to *M/s Rahul Agencies* on 1st January 2018 on the following terms:

(a) All units to be sold 50% above the cost of Rs. 40. Any deficiency in selling price is to be borne by *M/s. Rahul Agencies* who is also entitled to retain 50% of any surplus price realized.
(b) *M/s. Rahul Agencies* is to be paid 3% commission and 2% Del-Credere commission on all sales at specified sales price. Consignor incurred packing, freight, insurance charges of Rs. 95,000 in consigning these goods. *M/s. Rahul Agencies* remitted Nepal Bank DD No. 345 dated 1st January 2018 for Rs. 100,000 as an advance. *M/s. Rahul Agencies* sent Account Sales on 31st March 2018 disclosing 2,500 kg sold @ Rs. 60 per Kg. 2,000 kg. sold @ Rs. 56 per Kg. and 3,000 Kg. sold Rs. 64 per Kg.

The Agent had incurred unloading charges of Rs, 19,600 and selling expenses of Rs. 32,900. He had collected the entire sale proceeds from all customers except from one who paid only 75 paisa in rupee for his debt of Rs. 8,000 and from another who deducted Rs. 300 because of a dispute regarding quality. On 31st March 2018 *M/s. Rahul Agencies* remitted the balance due vide Nepal Bank Draft No. 580.

You are required to prepare Account Sales with required workings.

Solution

Calculation of Commission

S.No.	Particulars	Rs.
1	2,500 units @ Rs.60	150,000
2	2,000units @ Rs. 60	120,000
3	3,000 units @ Rs. 60	180,000
		450,000
A	Normal commission @ 3% on Rs. 450,000	13,500
B	Del-Credere commission @ 2% on Rs. 450,000	9,000
C	Amount entitled to extra commission 3,000 units @ Rs.4	12,000
D	Extra commission @ 50% on Rs. 12,000	6,000
	Total commission due to consignee (A+ B +D)	**28,500**

Account Sales

S.No.	Particulars	Rs.	Rs.
1	Actual sales	454,000	
	Add: Deficit @ Rs.4 on 2,000 Kg.	8,000	462,000
2	Less:		
	Expenses incurred by consignee		
	a. Unloading charges	19,600	
	b. Selling Expenses	32,900	
	Commission due	28,500	
	Non-realization of Rs. 300 because of dispute regarding quality	300	81,300
			380,700
3	Less: Credit for advance given vide by Nepal Bank Draft No.345 dated 1st January 2018		100,000
4	Balance due remitted vide Nepal Bank Draft No. 580 dated 31st March, 2018		**280,700**

E & O.E

For M/s Rahul Agencies
Dated: 31st March, 2018
Rahul
Partner

Illustration 8

M/s. CG Electronic Company consigned 1,000 TV sets costing Rs. 20,000 each to M/s. Birat Enterprises of Biratnagar on 1st July 2012. M/s. CG Electronic Company incurred the following expenses on sending the consignment.

Carriage	Rs. 75,000
Freight	Rs. 270,000
Insurance	Rs. 142,500

M/s. Birat Enterprises received the delivery of 980 TV sets only. An account sale dated 30th November 2012 showed that 750 sets were sold for Rs. 1,95,00,000 and M/s. Birat Enterprises incurred Rs. 145,000 for carriage and Rs. 375,000 for local taxes at the time of taking the delivery.

M/s. Birat Enterprises was entitled to commission 5% on the sales affected by the Enterprises. M/s. Birat Enterprises incurred expenses amounting 250,000 for repairing the damaged TV sets remaining in the stock.

M/s. CG Electronic Company lodged a claim with the insurance company, which was admitted at Rs. 150,000. Show the Consignment Account and M/s. Birat Enterprises Account in the books of M/s. CG Electronic Company.

Solution

Books of M/s. CG Electronic Company

Consignment to M/s. Birat Enterprises of Biratnagar

Particular	**Rs.**	**Rs.**	**Particular**	**Rs.**	**Rs.**
To, Goods sent on Consignment A/c		20,000,000	By, M/s. Birat Enterprises		19,500,000
To, Cash/Bank			Insurance Co.		150,000
Carriage	75,000		By, Profit and Loss A/c (Abnormal loss)		259,750
Freight	270,000		By, Consignment Stock		4,834,166
Insurance	142,500	487,500			
To, M/s. Birat Enterprises					
Carriage	145,000				
Local taxes	375,000				
Repairs	250,000				
Commission	975,000	1,745,000			
To, Profit & Loss A/c		2,511,416			
		24,743,916			**24,743,916**

Working Notes:

1. Abnormal Loss (Loss in Transit)

Cost to the consignor: 20 sets @ Rs. 20,000	400,000
Add: Proportionate expenses incurred by the consignor (20 X487,500)/1000	9,750
Total Cost	409,750
Less: Insurance Claim	150,000
Net Loss in Transit	**259,750**

2. Valuation of Stock

230 sets @ Rs. 20,000	4,600,000
Add: Proportionate expenses incurred by the consignor (230 X 487,500)/1000	112,125
Proportionate expenses incurred by the consignee (230 X 520,000)/980	122,041
Total cost of unsold stock	**4,834,166**

Illustration 9

M/s. Sitaram Milks of Kathmandu sent to M/s. Ganapati Store of Birgunj 5,000 Kgs of baby food packed in 2,000 tins of net weight 1 kg and 6,000 packets of net weight ½ kg for sale on consignment basis. The consignee's commission was fixed at 5% of sale proceeds. The cost price and selling price of the product were as under:

	1 kg tin	½ kg packet
	Rs.	Rs.
Cost price	10	6
Selling price	15	7

The consignment was booked on freight "To Pay" basis, and freight charges came to 2% of selling value. One case containing 50 - 1kg tins was lost in transit and the transport carrier admitted a claim of Rs. 450.

At the end of the first half-year, the following information is gathered from the "Account Sales" sent by the consignee:

(i)	Sale proceeds:	1,500	1-kg tins
		4,000	½ kg packets
(ii)	Store rent and insurance charges Rs. 600		

Find out the value of closing stock on consignment. Show the consignment A/c and the Consignee's A/c in the books of M/s. Sitaram Milks assuming that the consignees had paid the amount due from them.

Solution

M/s. Sitaram Milks Company

Consignment to M/s. Ganapati Store Birgunj A/c

Particular	**Rs.**	**Rs.**	**Particular**	**Rs.**	**Rs.**
To, Goods sent on Consignment A/c			By, Ganapati Stores		
2,000 1-kg tins	20,000		1500 1kg tins	22,500	
6,000 ½ kg pkts	36,000	56,000	4000 ½ kg pkts	28,000	50,500
			By, Insurance (Claim)		450
To, Ganapati Stores			By, Profit and Loss A/c-Abnormal loss		65
Freight	1,440		By, Consignment Stock		16,915
Rent and insurance	600				
Commission	2,525	4,565			
To, Profit and Loss A/c-Profit		7,365			
		67,930			**67,930**

Ganapati Stores, Birganj A/c

Particular	**Rs.**	**Rs.**	**Particular**	**Rs.**	**Rs.**
To, Consignment to Birganj A/c-Sales Proceeds		50,500	By, Consignment to Birganj A/c		

			Freight		1,440
			Rent and insurance		600
			Commission		2,525
			By, Bank A/c		45,935
		50,500			**50,500**

Working Notes:

(i) Sales value of total consignment:

2,000 1-kg tins			30,000
6,000 ½-kg pkts.			42,000
			72,000

(ii) Freight @ 2% of above 1,440

(iii) Stock at the end:

450 1kg. tins @ Rs. 10 (selling price Rs 6,750)	4,500		
2,000 ½ kg. pkts @ Rs. 6 (selling Price Rs. 14,000)		12,000	
			16,500
Add: Freight 2% of (Selling Price Rs. 20,750)			415
			16,915

(iv) Loss in transit:

Cost of 50 1kg tins @ Rs. 10	500
Freight @ 2% of selling Price Rs. 750	15
	515
Less: Claim	450
Loss	65

Illustration 10

On 1st January 2013 M/s. K.L. Dugar of Kathmandu consigned 10,000 kg of Sunflower Oil, costing Rs. 80 per Kg to M/s. Bindibasini Store of Pokhara, by paying Rs. 80,000 as freight and insurance. Out of consignment 200 kg of Oil were lost in transit. The insurance claim was settled for Rs. 15,000 and was paid to the consignor directly. M/s. Bindibasini Store took delivery of remaining consignment on 20th January 2012, and accepted a bill drawn upon them by M/s. K.L. Dugar for Rs. 400,000 for 2 months. On 31st March 2012 an Account Sales was received from M/s. Bindibasini Stores containing the following information:

(i) 8,000 kg were sold @ Rs. 110 per kg.; (ii) unloading charges Rs. 19,000; (iii) Go-down rent Rs. 2,500; (vi) Printing and Advertisement Rs. 20,000 and (v) 200 kg were lost due to leakage which is considered as a normal. M/s. Bindibasini Store is entitled in a commission @ 5% on sales. They paid the amount due in respect of the consignment on 31st March itself. You are required to show: (i) Consignment to Pokhara, (ii) M/s. Bindibasini Store Account; and (iii) Abnormal Loss Account in the Books of M/s. K.L. Dugar.

Solution

Books of M/s. K.L. Dugar

Consignment to Pokhara A/c

Particular	**Rs.**	**Particular**	**Rs.**
To, Goods sent on Consignment A/c	800,000	By, Bindibasini Stores (Sales)	880,000
To, Cash/Bank A/c (Freight & Insurance)	80,000	By, Abnormal loss A/c (Note 1)	17,600
To, Bindibasini Stores		By, Consignment Stock (Note 2)	146,900
Unloading			
Godown rent	19,000		
Printing and Advertisement	2,500		
Commission	20,000		
	44,000		
To, Profit and Loss A/c-Profit	79,000		
	1,044,500		1,044,500

M/s. Bindibasini Stores A/c

Particular	**Rs.**	**Particular**	**Rs.**
To, Consignment to Pokhara A/c-Sales Proceeds	880,000	By, Bills Receivable A/c	400,000
		By, Consignment to Pokhara A/c	
		Unloading	19,000
		Godown rent	2,500
		Printing and Advertisement	20,000
		Commission	44,000
		By, Bank A/c	394,500
	880,000		**880,000**

Abnormal Loss A/c

Particular	**Rs.**	**Particular** **Rs.**	**Rs.**
To, Consignment to Pokhara A/c-	17,600	By, Bank A/c	15,000
		By, Profit & Loss A/c	2,600
	17,600		**17,600**

Working Note:

1. Valuation of goods lost in transit

Cost of 10,000 kg oil @ Rs. 80 per kg		800,000
Add: Freight & Insurance up to accident	80,000	
Total cost of 10,000 kg of Oil	880,000	
Value of 200 kg = [(880,000/10,000)X200)	17,600	

2. Valuation of goods in hand at the end

Total cost of 10,000 kg of Oil		880,000	
Less: Cost of destroyed			17,600
Cost of 9,800 kg (10,000-200)		862,400	
Add: Unloading Charge			19,000
Total cost of	9800		881,400
Less: Normal loss	200		-
Total cost of 9,600 kg			881,400
Therefore, value of 1,600 kg [(881,400/9,600) x 1,600)]			**146,900**

Illustration 11

M/s. Grand Wools Company of Kathmandu Purchased 10,000 pieces of woolen sweater @ Rs. 600 per sweater. Out of these 6,000 sweaters sent on consignment to M/s. Cool wear stores of Jhapa at the selling price of Rs. 720 per sweater. The Grand Wools Company paid Rs. 15,000 for packaging and freight.

M/s. Cool wear stores sold 5,000 sweaters at Rs. 750 per sweater and incurred Rs. 6,000 for selling expenses and remitted Rs. 30,00,000 to Kathmandu on Account. M/s. Cool wear stores is entitled to a commission of 5% on total sales plus a further 20% commission on any surplus price realized over Rs. 720 per sweater. M/s. Grand Wools Company sold 3,000 sweaters at Rs. 660 per sweater.

Owing to fall in market price, the value of the stock of sweater in hand is to be reduced by 10%. Prepare the consignment Account and Trading & PL Account in the books of M/s. Grand Wools Company and their account in the books of the M/s. Cool Wear Stores.

Solution

Books of M/s. Grand Wools Company

Consignment to Jhapa Account

Particular	Rs.	Particular	Rs.
To, Goods sent on Consignment A/c	4,320,000	By, Cool Wear Stores-Sales	3,750,000
To, Bank (Expenses)	15,000	By, Goods sent on Consignment-Loaded price	720,000
To, Cool wear stores -Expenses	6,000	By, Stock out on Consignment	650,250
-Commission	217,500		
To, Stock Reserve A/c	108,000		
To, Net Profit	453,750		
	5,120,250		**5,120,250**

Trading & PL Account for the period ending

Particular	Rs.	Particular	Rs.
To, Purchase 60,00,000 Less: Goods on Consignment 36,00,000	2,400,000	By, Sales By, Closing Stock	1,980,000 540,000
To, Net Profit	120,000		
	2,520,000		**2,520,000**
To Net Profit	573,750	By Gross Profit	120,000
		By, Profit on consignment	453,750
Total	**573,750**	**Total**	**573,750**

Books of M/s Cool Wear Stores, Jhapa
M/s. Grand Wools Company (Kathmandu) A/c

Particular	Rs.	Particular	Rs.
To, Bank-Expenses	6,000	By, Bank - Sales	3,750,000
To, Commission	217,500		
To, Bank-Remit	3,000,000		
To, Balance c/d	526,500		
	3,750,000		**3,750,000**

Working Notes:

1. Commission Payable

	Rs.
5% on Rs. 3,750,000	187,500
20% on 150,000	30,000
	217,500

2. The closing Stock on consignment will be:

1,000 sweaters @ Rs. 720	720,000
Add: proportionate expenses [15,000 X 1,000/6,000]	2,500
	722,500
Less: 10%	72,250
Consignment Stock	**650,250**
Loading = (Rs.120 X 1,000-10%)	**108,000**

Illustration 12

M/s. Mohan Trading Ltd. of Palpa consigned 1,000 pieces of "Karuwa" costing Rs. 450 each to M/s. Harati Metal Stores of Kathmandu. M/s. Mohan Trading Ltd. pays following expenses in connection with consignment:

Carriage	Rs. 4,500
Freight	13,500
Coolies for loading	4,500

M/s. Harati Metal Stores sells 700 "Karuwa" at Rs. 630 per piece and incurs the following expenses.

Clearing Charges 3,825
Warehousing and Storage 7,650
Packing and Selling expenses2,700

It is found that 50 pieces of "Karuwa" have been damaged in transit and 100 pieces are still in transit. M/s. Harati Metal Stores is entitled to a commission of 10% on gross sales. Prepare the Consignment Account and M/s. Harati Metal Stores in the books of M/s. Mohan trading Ltd.

Solution

M/s. Mohan Trading Ltd.
Consignment to Kathmandu Account

Particular		Rs.	Particular		Rs.
To, Goods sent on Consignment A/c		450,000	By, Harati Metal Stores-Sales		441,000
To, Bank (Expenses)			By, Loss on transit		23,625
Carriage	4,500		50 pieces @		
Freight	13,500		[450+(22,500/1,000)]		
Coolies for loading	4,500	22,500			
			By, Stock out on Consignment		
			In hand		
To, Harati Metal Stores			(150 pieces @ Rs. 477	71,550	
Clearing Charges	3,825				
Warehousing and Storage	7,650		In transit		118,800
Packing and selling exp.	2,700	14,175	(100 pieces @ Rs. 472.5047,250		
To, Harati Metal Stores - Commission		44,100			
To, P/L A/c- Profit		52,650			
Total		**583,425**	**Total**		**583,425**

M/s. Harati Metal Stores Account

Particular	Rs.	Particular		Rs.
To, Consignment to Kathmandu A/c-sales	441,000	By, Consignment to Kathmandu A/c		
		Clearing Charges	3,825	
		Warehousing & Storage	7,650	
		Packing and Selling exp.	2,700	
		Commission	44,100	58,275
		By, Balance c/d		382,725
Total	**441,000**	**Total**		**441,000**

Working Notes:

1. Consignor's expenses on 1,000 pieces of "Karuwa" amounts Rs. 22,500; it comes Rs. 22.5 per piece. So, the cost of "Karuwa" damaged will be computed at Rs. 472.50 per piece.
2. M/s. Harati Metal Stores has incurred Rs. 3,825 on clearing 850 pieces of "Karuwa", i.e. Rs. 4.50 per piece; while valuating unsold stock with the agent Rs. 4.50 per piece has been added to "Karuwa" in hands with the Harati Metal Stores.

Summary

Consignment is the special business transaction in order to expand their sales volume beyond local area without opening own branch network. Principal or consignor sends merchandise to agent without transferring ownership. For recording the transaction, generally consignor opens a consignment account and consignee's personal account in his books. Similarly, consignee just receives the delivery and undertakes a sales activity on the behalf of their principal. To keep the record regarding these transactions, consignee opens consignment account and consignor's personal account. Very often the consignor sends goods to the consignee above the cost. While determining profit or loss arising from consignment business it is required to adjust the loaded price charge at the time of sending goods and also it is required to make stock reserve for unrealized profit. Special attention is needed to apportion the cost incurred between items sold, items abnormally lost and items lying with the consignee.

Self-Examination Questions

I. Multiple Choice Questions (MCQs)

1. Consignee's account is a:
   a. Personal account b. Real account
   c. Nominal account d. Profit & Loss A/c

2. Salman sends out goods costing Rs. 224,000 to Amir at cost plus 25%, consignor's expenses Rs. 5,000. $1/10^{th}$ of Goods were lost in transit. Insurance claim received Rs. 5,000. The net loss on account of abnormal loss is:
   a. Rs. 27,900 b. Rs. 22,900
   c. Rs. 17,900 d. Rs. 22,400

3. Kuku sends out goods costing Rs. 200,000 to Muku. Consignor's expenses Rs. 5,000. Consignee's expenses relating to sales Rs. 3,000, $4/5^{th}$ of the goods were sold at 20% above original cost. The Profit on consignment will be:
   a. Rs. 24,000 b. Rs. 32,000
   c. Rs. 29,800 d. Rs. 25,000

4. At the end, the balance of 'Goods sent on consignment account' will be transferred to
   a. Consignee's Account b. Consignment Account
   c. Profit & Loss Account d. Trading Account

5. Big of Bhaktapur sends 500 radios @ Rs. 200 each to Small of Kathmandu. All the radios are sold by Small at a profit of 25% on cost. Small is entitled to a commission of Rs. 25 per radio sold plus 20% of gross sale proceeds as exceeds an amount calculated @ 20% profit on cost. Calculate commission:
   a. Rs. 12,500 b. Rs. 13,500
   c. Rs. 11,500 d. Rs. 10,500

6. Mr. Top sends out 200 boxes to Mr. Bottom costing Rs. 100 each. Consignor's expenses Rs. 4,000, Consignee's non-recurring expenses Rs. 900. 1/10th of the boxes were lost in transit. 2/3rd of the boxes received by consignee were sold for Rs. 20,000. The amount of consignment stock will be:
   a. Rs. 7,000 b. Rs. 7,500
   c. Rs. 7,200 d. Rs. 6,000

7. Sagar consigns 500 bags to Himal costing Rs. 400 each at an inflated price of Rs. 450 each. Consignor's expenses Rs. 4,000. Consignee's expenses fright Rs. 1,000 and selling Rs. 2,000. 400 Bags were sold. The amount of stock reserve at the end will be:
   a. Rs. 10,200 b. Nil
   c. Rs. 10,000 d. Rs. 5,000

8. The abnormal loss on consignment is credited to:
   a. Consignment A/c b.Profit & Loss A/c
   c.Consignee's personal A/c d.All of the above

9. Commission provided by the consigner to the consignee to promote credit sale is known as:
   a. Ordinary commission b. Del credere commission
   c. Over – riding commission d. Special commission

10. On 1st Sept. 2013 goods costing Rs. 33,000 were consigned by X to his agent Y at a price which was plus one sixth profit on invoice price. What is the invoice price of goods?
    a. Rs. 39,000 b. Rs. 39,600
    c. Rs. 40,000 d. Rs. 45,000

11. J of Janakpur sends 500 radios @ Rs. 200 each to D Dharan. All the radios are sold by D at a profit of 25% on cost. D is entitled to a commission of Rs. 25 per radio sold plus 20% of gross sale proceeds as exceeds an amount calculated @ 20% profit on cost. Calculate commission.
    a. Rs. 12,500 b. Rs. 13,500
    c. Rs. 11,500 d. Rs. 10,500

12. X sends out 4,000 boxes to Y costing Rs. each. Consignor's expenses 10,000. 1/10th of boxes were lost in consignee's go down and treated as normal loss. 2400 boxes were sold by consignee. The value of consignment stock will be:
    a. Rs. 1,36,667 b. Rs. 1,23,000
    c. Rs. 1,20,000 d. Rs. 1,20,500

13. If del-credere commission is allowed for bad debt, consignee will debit the bad debt account to
    a. Consignor's A/c b. Commission Earned A/c
    c. Debtors A/c d. General Profit & Loss A/c

14. The owner of consignment stock lying with consignee is
    a. Consignor b. Consignee
    c. Both Consignor & Consignee d. None of the above

15. Out of the following at which point the treatment of 'sales' and 'consignment' is same
    a. Ownership transfer b. Money received
    c. Stock Outflow d. Risk

16. Consignee done not pass any entry for
    a. Goods sent on consignment b. Profit/Loss on Consignment
    c. Consignment Stock d. All of the above

17. Which of the following statement is not true:
a. If del-credere commission is allowed, bad debt will not be recorded in the books of consignor
b. If del-credere commission is allowed, bad debt will be debited in consignment
c. Del credere commission is allowed by consignor to consignee
d. Del- credere commission is generally relevant for credit sales

18. Goods of the Invoice value Rs 3,60,000 sent out to consignee at 20% profit on cost. The loading amount will be:
    a. 60,000 b. 62,000
    c. 59,000 d. None

19. X sent out certain goods to Y of Dharan. 1/10 of the goods were lost in transit. Invoice value of goods lost Rs 23,500. Invoice value of goods sent out on consignment will be:
    a. Rs 2,35,000 b. Rs 2 34,000
    c. Rs 2,36,000 d. Rs 2,37,000

20. Prabin consigned goods for the value of Rs 9700 to Rajan of Illam and paid freight etc. of Rs 980 and insurance Rs 60000. He drew a bill on Rajan for 3 months after date for Rs 5,030 as an advance against consignment, and discounted the bill for Rs 4,960. Further, he received Account Sales from Rajan showing that, part of the goods had realized gross Rs 9,350 and that his expenses and commission amounted to Rs 1270. The Inventories unsold was valued at Rs 3250. Consignee wants to remit a draft for the amount due. The amount of draft will be:
    a. Rs 3,050 b. Rs 30 60
    c. Rs 3120 d. Rs 8,080

21. X of Kathmandu sends out goods costing Rs 1,50,000 to Y of Dharan . 3/5th of the goods were sold by consignee for Rs 120,000. Commission 3% on sales plus 20% of gross sales less all commission exceeds cost price. The amount of Commission will be:
    a. Rs 8,350 b. Rs 8,500
    c. Rs 8,000 d. Rs 8,400

22. X of Kathmandu send out 2,000 bags to Y of Dharan costing Rs 320 each. Consignor's expenses Rs 4,000. Y's expenses non-selling Rs 1000, selling Rs 2000. 100 bags were lost in transit. Value of lost in transit will be:
(a) Rs 32800 (b)Rs 32,250
(c)Rs 32,200 (d)Rs 32,150

23. X of Kathmandu sends out 600 bags to Y of Dharan costing Rs 260 each. Consignor expense Rs 6000. Y's administrative expense Rs 4500 and selling expense Rs 1000. 450 bags were sold by Y . Value of consignment inventories will be :
(a) Rs 41,425 (b)Rs 41,735
(c) Rs 41,525 (d) Rs 41,625

24. X of Kathmandu sends out 1500 bags to Y of Dharan costing Rs 1750 each. 900 bags were sold at 20% above cost price. Sales value will be:
(a) Rs 18,70,000 (b) Rs 18,80,000
(c) Rs 18,00,000 (d) Rs 18,90,000

25. Goods sent on consignment Rs 960,000 Opening consignment Inventories Rs 78,000. Cash sales Rs 890,000. Consignor's expenses Rs 34,000. Consignee's expenses Rs 12,000. Commission Rs 29,000. Closing consignment Inventories Rs 450,000 The profit on consignment is:
(a) Rs 227,000 (b) Rs 256,00
(c) Rs 305,000 (d) None

26. X of Kathmandu sends out 1500 boxes to Y of Dharan costing Rs 100 each. Consignor's expenses Rs 1,000. Consignee's selling expenses Rs 500. 3/5th of the goods sold by consignee, 1/2 of the balance goods were lost in consignee's godown due to fire. The value of abnormal loss will be:
(a) Rs 30,700 (b) Rs 30,200
(c) Rs 30,300 (d) None

27. X of Kathmandu sends out 2000 boxes costing Rs 200 each to Y of Dharan. 1/10th of the boxes were lost in transit. 2/3m of the remaining boxes sold by consignee at cost + 25%. The sale value will be:
(a) Rs 3,00,000 (b) 3,40,000
(c) Rs 3,20,000 (d) Rs 3,10,000

28. Goods sent out on consignment Rs 500,000 Consignor's expenses Rs 5,000. Consignee's expenses Rs 2,000. Cash sales Rs 3,00,000, credit sales Rs 2,30,000. Consignment Inventories Rs 40,000. Ordinary commission payable to consignee Rs 3,000. Del-credere commission Rs 6,000. The amount irrecoverable from customer Rs 2,000. What will be the profit on consignment?
(a) Rs 54,000 (b) 53,800
(c) Rs 52,000 (d) Rs 56,000

29. X of Kathmandu sends out 1,000 boxes to Y of Dharan costing Rs 200 each. Consignor's expenses Rs 2,0000. 4/5th of the boxes were sold at Rs 250 each. The profit on consignment will be:
(a) Rs 24,000 (b) Rs 20,000
(c) Rs 30,000 (d) Rs 30,500

II. Short Descriptive Questions (SDQs)

1. How do you consider the consignment transaction is special transaction?
2. What is del-credere commission? Why is it given to the consignee?
3. Differentiate between normal and abnormal loss.
4. State the procedure of valuation of closing stock on consignment.
5. Write Short Note
   (a) Account Sale
   (b) Commission to Consignee
   (c) Normal Loss

III. Practical Questions (PQs)

1. Ram sent 150 pieces of Pants to Laxman on consignment basis. The consignee is entitled to receive 15% commission on sales. The cost of Pants is Rs. 400 per piece. Ram incurred Rs. 3,000 for freight and Rs. 4,500 for insurance to send Pants to Laxman. Laxman received the goods and remitted Rs. 40,000 immediately. He incurred Rs. 2,250 for transportation and Rs. 5,000 for rent. He sold 140 pants for Rs. 600 each and remitted remaining amount to Ram by cheque.
   Show the journal entries in the books of Ram and Laxman and prepare necessary accounts in the books of both the parties.

2. On 1.1.2013 Amar Mills of Duhabi consigned 5,000 kg of oil to Maruti Store of Birganj. Each kg of oil costs Rs. 80. Amar Mills paid Rs. 3,600 as carriage, Rs. 5,000 as freight and Rs. 2,000 insurance. During transit, 500 kg were accidentally destroyed for which the Insurance Company paid directly to consignor Rs. 25,000 in full settlement of the claim. On 1.4.2013, Maruti Stores of Birganj reported that 3,500 kg of oil were sold @ Rs 95 per kg and expenses being godown rent Rs. 4,000 and salesman's salary Rs. 7,500. Maruti Stores is entitled to a 5% commission on sales. Maruti Stores also reported a loss of 20 kg due to leakage. Show (i) Consignment to Birganj Account, (ii) Maruti Stores Account in the books of Amar Mills.

3. Mr. Kedarnath sold goods on behalf of M/s. Manohar Sales Corporation on consignment basis. On January 1, 2012, he had with him a stock of Rs. 200,000 on consignment. Mr. Kedarnath had instructed to sell goods at cost plus 25% and was entitled to a commission of 4% on sales. In addition to 1% del credere commission on total sales for guaranteeing collection of the entire sale proceeds. During the year ended 31st December, 2012, cash sales were Rs. 12,00,000, Credit sales Rs. 10,50,000 and Mr. Kedarnath's expenses relating to the consignment Rs. 30,000 being salaries and insurance. Bad debt was Rs. 15,000 and goods sent on consignment Rs. 20,00,000. From the above, prepare Consignment Account in the books of M/s. Manohar Sales Corporation, and important ledger account in the books of Mr. Kedarnath.

4. The following are the transactions relating to consignment of goods received by M/s. Mool & Co. Bhaktapur from M/s. Roopana & Co. Dharan:

   2012 July 10, Consignment sent by M/s. Roopana & Co. together with an invoice at cost Rs. 600,000. They paid expenses cartage Rs. 10,000 and Freight Rs. 15,000. July 28 M/s. Roopana & Co. received an Account Sales from M/s. Mool & Co.

Sold goods	Rs, 10,00,000
Expenses	Rs. 50,000
Commission	Rs. 60,000
M/s. Mool & Co enclosed a cheque for	Rs. 890,000

   Show the entries in the books of both the consignor and the consignee.

5. Mr. Achyut of Kathmndu consigned 100 units of a commodity to Mr. Raj of Dhankutta. The goods were invoiced at Rs. 150 so as to yield a profit of 50 percent on cost. Mr. Achyut incurred Rs. 1,000 on freight and insurance. Mr. Raj incurred Rs. 500 on freight and Rs. 800 on rent. Before December 31, 2012, he sold 50 units for cash at Rs. 160 per unit, 20 units for Rs. 175 on credit. He retained his commission at 5% and 1% for the del credere arrangement and remitted the balance on December 31, 2012. Mr. Raj noticed that 10 units were damaged on account of bad packing and he could sell them for Rs. 80 per unit. A debtor for Rs. 1,000 to whom the goods were sold by Mr. Raj became insolvent and only 50 paisa in a rupee was recovered. Mr. Raj sent an Account Sales on March 31, 2013 detailing the transactions for the quarter ended on that date he remitted the balance due. Make necessary ledger accounts in the books of Mr. Achyut and Mr. Raj assuming that Mr. Achyut closes his books every 31st march.

6. Rohit consigned to Rojee goods to be sold at invoice price, which represents 120% of cost. Rojee is entitled to a commission of 10% on sales at invoice price and 25% of any excess realized over invoice price. The expense on freight and insurance incurred by Rohit were Rs. 10,000. The account sales received by Rohit shows that Rojee has effected sales amounting to Rs. 105,000 in respect of 80% of the consignment. His expenses to be reimbursed were packing Rs. 5,000 and selling Rs. 8,000. 5% of consignment goods of the value of Rs. 6,000 were destroyed in fire at the Rojee's godown and the insurance company paid Rs. 8,000 net of salvage. Rojee remitted the balance in favor of Rohit.
   Prepare consignment account and the account of Rojee in the books of Rohit along with necessary workings.

7. B was appointed agent by A & Co. You are given the following particulars relating to transactions between them:
   i. Cost of goods invoiced by the company on consignment to Rs. 400,000, which was 25% above cost.
   ii. Insurance and carriage expenses incurred for goods invoices were Rs. 10,000 and Rs. 6,000 respectively.
   iii. Goods of invoice price of Rs. 300,000 were sold for Rs. 480,000.
   iv. Goods of the invoice price of Rs. 40,000 were taken by agent.
   v. Goods of the invoice price of Rs. 20,000 were lost through negligence of agent.

vi. Clearance charge Rs. 3,000 and selling expenses Rs. 10,000 paid by agent.

The agent is entitled to a commission of 10% on sales. Any goods taken by agent and lost through consignee's negligence would be valued at cost and to be recovered from consignee. Agent paid the amount due by bank draft on closing date.

Prepare consignment account and B's account in the books of A & Co. and consignor's account in the books of B.

8. K of Kathmandu appointed D of Dharan as its selling agent on the following terms:

a. Goods to be sold at invoice price or over.
b. A to be entitled to a commission of 7.5% on the invoice price and 20% of any surplus price realized above invoice price.
c. The principal is to draw on the agent a 30 days bill for 80% of the invoice price.

On 1st Magh 2065, one thousand cycles were consigned to D, each cycle costing Rs. 3,500 including freight and invoiced at Rs. 4,200 each. D incurred Rs. 25,000 for currier charge to receive the consignment.

Before 31st Chaitra 2065, D met his acceptance on the due date; sold of 820 cycles at an average price of Rs. 4,500 per cycle, the selling expenses being Rs. 15,000 and remitted the amount due by means of Bank draft.

Twenty of the unsold cycles were shop soiled and were to be valued at a depreciation of 50%.

Show by means of ledger accounts how these transactions would be recorded in the books of K and find out the value of closing stock lying with D.

9. S Oil Mills consigned 10,000 kg of castor oil to D on 1st January 2003. The cost of the oil was Rs. 23 per kg. S Oil mills paid Rs. 20,000 for packing, freight and insurance.

During transit, 250 kgs were accidentally destroyed for which the insurer paid directly to the consignor Rs. 4,500 in full settlement of the claim.

D took delivery of the consignment on the 10th January. On 31st March, 2006 D reported that 7,500 kg were sold @ Rs. 30 per kg. The expenses being on godown rent Rs. 3,000 on advertisement Rs. 4,000 and on salesmen's salaries Rs. 6,400. D is entitled to a commission of 3% plus 1.5% Del-Credere commission. A party which had purchased 1,000 kg was able to pay only 80% of the amount due from him.

D reported a loss of 100 kg due to leakage. Assuming D paid the amount due by bank draft, show the accounts in the books of S Oil Mills as its books closes on 31st March every year.

10. Mr. Khusdin is working for Reliance Insurance Co. Ltd. His main task is to sale different product of the company. He is entitled to get commission of 2.5% on face value of every product and 5% of the premium paid for the year by the customers. He has given Rs. 500,000 as security deposit to the company.

He has established an office at Baneshwor with monthly rent of Rs. 7,500. He conducted his assignment from Mangsir 2067. Till Ashad End 2068, following transactions were took place during the course:

Particular	Face Value	Annual Premium
Miss. Jenu Suwal (Life Insurance Policy)	1,400,000	32,350
Mr. Himal Gurung (Mutual Fund Policy)	900,000	180,000
Mr. Kiran Upadhaya (Life Insurance Policy)	1,275,000	27,900
Mr. Upendra Shrestha (Investment Policy)	720,000	120,000
Miss. Upasana Upreti (Accidental Policy)	1,695,000	33,540
Mrs. Susma Shah (Children Welfare Policy)	700,000	20,250
Miss. Kohinoor Silwal (Endowment Policy)	550,000	43,200
Mr. Bibek Mainali (Double Dhamaka Policy)	600,000	25,500

In connection with the work he has done following expenses; refreshment Rs. 8,900; office maintenance Rs. 16,800 and miscellaneous expenses Rs. 24,600 (including Rs. 6,600 for gift to customers). Company agreed to reimburse gift expenses in full and 25% of the other expenses.

You are asked to prepare Company's account in the books of Mr. Khusdin.

ANSWER

Multiple Choice Questions (MCQs)

1	a	6	a	11	b	16	d	21	c	26	b
2	c	7	d	12	b	17	b	22	c	27	a
3	c	8	a	13	b	18	b	23	d	28	a
4	d	9	b	14	a	19	a	24	d	29	a
5	d	10	b	15	a	20	a	25	a		

CHAPTER- 5

Accounting for Special Transactions

UNIT 2:

Joint Venture Account

Learning Objectives

1. Understand special features of Joint Venture transactions.
2. Be familiar with the use of Memorandum Joint Venture Account.
3. Learn the technique of preparing Joint Venture Account and also the Settlement.
4. Learn the technique of deriving venture profit and its allocation among the ventures.

2.1 MEANING OF JOINT VENTURE AND MEMORANDUM JOINT VENTURE ACCOUNT

A joint venture is a very short duration partnership "business" (generally, confined to a single transaction, like buying some surplus stores and selling them) entered into two or more persons jointly. It is form of partnership which is limited to a specific venture. It may seem to be exactly the same as partnership, with the exception that it is one of a business that is to be terminated. Since the business is to be concluded after completion of the venture, a firm name is not generally used. On the completion, profits or losses are divided according to mutual agreement but, if there is no agreement, the profit of loss is shared equally by all the parties, called co-venturers or joint – venturers.

The profit or loss is ascertained by putting down all costs and expenses on one side and all the proceeds and income on the other. There will be profit if the credit side is higher and if the debit side is higher then the joint venture incurred a loss.

2.2 FEATURES OF JOINT VENTURE ACCOUNT

Some important features of joint venture business are as follows:

(i) It is short duration special purpose partnership. Parties in venture are called co-venturers or joint-venturers.
(ii) Co-venturers may contribute funds for running the venture or supply stock from their regular business.
(iii) Co-venturers share profit of the venture at an agreed ratio likewise in partnership.
(iv) Generally profit of the venture is computed on completion of venture.
(v) Going concern assumption of accounting is not appropriate for joint venture accounting. There does not arise problem of distinction between capital and revenue expenditure.

2.3 METHODS OF RECORDING JOINT VENTURE TRANSACTIONS

The main objectives of recording joint venture transactions are to find out performance of the venture and final settlement between the co-venturers. So, every method of recording the joint venture transactions should fulfill at least these two objectives. Generally there are three methods of recording joint venture transactions.

a. Maintaining separate set of books for recording joint venture transactions
b. Not maintaining separate set of books for recording joint venture transactions
   (i) Recording own transactions only by each co-venturer (Joint venture investment a/c)
   (ii) Recording all transactions by each/any co-venturer

2.4 MAINTAINING SEPARATE JOINT VENTURE BOOKS

Generally separate books are kept for the joint venture. Under this method, all the joint venture transactions are recorded in a separate set of books maintained for this purpose.
Generally, the following accounts are opened in a separate set of books.

(a) **Joint Bank Account** on which all cash and bank transactions are recorded including contribution made by co-venturers. Contributions by the co-venturers are deposited in this account; as far as possible payments on account of the joint venture are made out of this bank account. Receipts on account of the joint venture are also deposited in this account.

(b) **Co-venturers' Accounts** which are personal account in nature are used to record their dealings with the joint business and to ascertain the amount due to/from them and

(c) **Joint Venture Account** which is nominal in nature, is used to calculate the profit/loss on joint venture.

Journal Entries

1	**For amount contributed by the co-venturers in cash** Joint Bank A/c To, Co-Venturer's A/c (individually)	 Dr.
2	**For contribution made by co-venturers in other than cash** Joint Venture A/c To, Co-Venturer's A/c (individually)	 Dr.
3	**For purchase of goods for joint venture:** Joint Venture A/c To, Joint Bank A/c	 Dr.
4	**For expenses incurred:** Joint Venture A/c To, Joint Bank A/c	 Dr.
5	**For sale made:** Joint Bank A/c To, Joint Venture A/c	 Dr.
6	**If Co-venture takes a part of the stock:** Co-venturer's A/c To, Joint Venture A/c	 Dr.
7	**In case of profit on the venture:** Joint Venture A/c To, Co-venturer (in the profit sharing ratio) The entry will be the reverse if this is a loss.	 Dr.

8	**For settlement of the account of each party:** Co-venturer's Dr. To, Joint Bank A/c

Illustration 1

A & B entered into joint venture agreeing to share profits and losses in the ratio of 2:1. The following transactions took place during the course of the venture:

		A	B
(a)	Deposited into the joint Bank	Rs. 50,000	Rs. 25,000
(b)	Goods brought in by	Rs. 10,000	Rs. 5,000
(c)	Expenses incurred by	Rs. 5,000	Rs. 2,500

(d) Joint transactions (i) Goods brought –from X for Rs. 20,000 and issued a current dated cheque, from Y on credit Rs. 40,000, (ii) Payment to Y by cheque in full settlement –Rs. 39,400 (iii) Expenses paid- Rs, 1,800, (iv) Goods sold to D for Rs. 40,000 and received a current dated cheque, to E on credit Rs. 50,000 for 3 months. (v) E accepted a Bill Receivable which was discounted @ 18% p.a.

(e) A agreed to take over the balance of stock at an agreed valuation of Rs. 2,700.

Pass the necessary journal entries and prepare the necessary ledger accounts assuming that the final settlement between A and B was made by cheque.

Solution

Journal Entries

Particulars	L.F	Dr. (Rs.)	Cr. (Rs.)
Joint Bank A/c Dr.		75,000	
To, A's A/c			50,000
To, B's A/c			25,000
(For contribution of Rs. 50,000 and Rs. 25,000 by A and B respectively)			
Joint Venture A/c Dr.		15,000	
To, A's A/c			10,000
To, B's A/c			5,000
(For goods brought in by A and B)			
Joint Venture A/c Dr.		7,500	
To, A's A/c			5,000
To, B's A/c			2,500
(For expenses incurred by A and B)			
Joint Venture A/c Dr.		60,000	
To, Joint Bank A/c			20,000
To, Y's			40,000
(For goods bought in cash and credit)			
Joint Bank A/c Dr.		40,000	
E's A/c Dr.		50,000	
To, Joint Venture A/c			90,000

(For goods sold on cash and credit)				
Joint Venture A/c	Dr.		1,800	
To, Joint Bank A/c				1,800
(For payment of expenses)				
Bills Receivable A/c	Dr.		50,000	
To, E's A/c				50,000
(For acceptance of bills received from E)				
Y's A/c	Dr,		40,000	
To, Joint Bank A/c				39,400
To, Joint Venture A/c				600
(For final payment made to Y)				
Joint Bank A/c	Dr.		47,750	
Joint Venture A/c	Dr.		2,250	
To, Bills Receivable A/c				50,000
(For Bills discounted @ 18% p.a.)				
A's A/c	Dr,		2,700	
To, Joint Venture A/c				2,700
(For goods taken by Mr. A)				
Joint venture A/c	Dr.		6,750	
To, A's A/c				4,500
To, B's A/c				2,250
(For allocation of profit on joint venture)				
A's A/c	Dr.		66,800	
B's A/c	Dr.		34,750	
To, Joint Bank A/c				101,550
(For final payment made to A and B)				

Joint Venture A/c

Dr. Cr.

Particulars	Rs.	Particulars	Rs.
To, A (Goods)	10,000	By, Joint Bank A/c-cash sale	40,000
To, A (Expenses)	5,000	By, E-Credit sales	50,000
To, B (Goods)	5,000	By Discount	600
To, B (Expenses)	2,500	By, A (Goods taken)	2,700
To, Joint Bank A/c (Goods)	20,000		
To, Joint Bank A/c (Expenses)	1,800		
To, Y (Credit Purchase)	40,000		
To, Bill Receivable A/c (discount)	2,250		
To, Profit transferred to			
A 4,500			
B 2,250	6,750		
	93,300		**93,300**

Co-venturers' Accounts

Dr. **Cr.**

Particulars	A Rs.	B RS.	Particulars	A Rs.	B RS.
To, Joint Venture A/c	2,700	-	By, Joint Bank A/c-Deposit	50,000	25,000
To, Joint Bank A/c	66,800	34,750	By, Joint Venture A/c- Goods	10,000	5,000
			By, Joint venture A/c	5,000	2,500
			By, Joint Venture A/c	4,500	2,250
	69,500	**34,750**		**69,500**	**34,750**

Joint Bank A/c

Dr. **Cr.**

Particulars	Rs.	Particulars	Rs.
To, A	50,000	By, Joint Venture A/c	20,000
To, B (Goods)	25,000	By, Y	39,400
To, Joint Venture A/c	40,000	By Joint Venture A/c	1,800
To, Bills Receivable A/c	47,750	By, A	66,800
		By, B	34,750
	162,750		**1,62,750**

2.5 RECORDING OWN TRANSACTIONS ONLY BY EACH CO-VENTURER (JOINT VENTURE INVESTMENT A/C)

If any co-venturer record transaction related with oneself in a separate account then that is called Joint Venture Investment Account. A simple way to record the transaction will be for each party to open a Joint Venture Investment Account (Joint Venture with Co-venturer Account) . Generally, the following account are opened under this method.

a. Joint Venture Investment Account : All the expenses incurred and material sent etc are debited to this account and any receipt from joint venture or from co-venture is credited to the account. Similarly, Profit earned is also debited to this account while loss sustained is credited

b. A separate 'Joint Venture Memorandum Account' is prepared to ascertain profit or loss in Joint Venture. It is just like profit and loss account, all the expenses and losses are debited to it and all incomes and gains are credited to it. All the items of personal accounts will also appear on the same side of 'Joint Venture Memorandum Account'. The balance of Joint Venture Memorandum Account shows profits or loss on joint venture and each party makes an entry for his share of profits or losses.

Illustration 2:

A and B entered into a joint venture, A is to purchase goods in Kathmandu and sent it to Pokhara where it is to be sold by B. Profits are to be shared: A 3/5 and B 2/5 after allowing 5 % interest on the amount invested by A and after a commission of 2% on sales to B. The following transactions take place. On 2012 April 5, A purchase goods for Rs, 500,000 and sends it to Pokhara. Goods is received by B who pays freight Rs. 15,000, rent Rs. 12,000, insurance Rs, 5,000 and sundry charges Rs. 1,500. On June 30, B informs A that all the goods has been sold for Rs. 650,000 and remits the amount due to A.

i. Prepare the Joint Venture Investment Account in A's Book
ii. Prepare the Joint Venture Investment Account in B's Book

Solution:

Joint Venture Investment Account in A's Books will be as follows:
Joint Venture with B Account

Date	Particulars	Rs.	Date	Particulars	Rs.
1-Apr	To, Bank -(Commodity purchased)	500,000	30-Jun	By, Bank A/c (Settlement; b/f)	564,600
	To, Interest A/c* (Interest on Rs. 500,000 @ 5% for 3 months)	6,250			
	To Profit & Loss A/c: A (3/5)	58,350			
		564,600			**564,600**

* This amount will be shown on the credit side of the P/L A/c.

Joint venture Investment account in B's will prepare as follows:
Joint Venture with A Account

Date	Particulars	Rs.	Date	Particulars	Rs.
1-Apr	To, Bank A/c (Expenses)	33,500	30-Jun	By, Bank A/c (Sales proceeds)	650,000
30-Jun	To, Commission A/c	13,000			
	To Profit & Loss A/c: (2/5)	38,900			
	To, Bank (Remitted to A)	564,600			
		650,000			**650,000**

Working Note: Calculation of profit of the venture

Memorandum Joint Venture Accont

Dr. **C**

Date	Particulars	Rs.	Date	Particulars	Rs.
	To, A -Goods purchase -Interest	5,00,000 6,250		By, B -sales proceeds	6,50,000
	To, B -Freight -Rent -Insurance	15,000 12,000 5,000 1,500			

	-Sundry Charges -Commission on sales (650000*2%) To, P/L A/c-share of profit A (3/5) B (2/5)	13,000 58,350 38,900			
		6,50,000			**6,50,000**

Illustration 3

Ramesh and Gambhir entered into a joint venture to buy and sell electric appliances, on 1st Jan 2013. On 1.1.2013, Ramesh sent a draft of Rs. 250,000 in favor of Gambhir, and on 4.1.2013, the later purchased 200 sets of DVD Player at a cost of 4,500 each. The DVD players were sent to Ramesh through transporter under 'freight to pay' basis for Rs. 12,000 and were cleared by Ramesh on 15.1.2013.

Ramesh effected sales in the following manner:

Date	No. of units	Sales price	Discount
16 January	20	Rs. 6,750	10%
31 January	100	Rs. 6,300	-
15 February	80	Rs. 6,075	5%

On 25 February 2013, Ramesh settled the account by sending a draft in favor of Gambhir, profit being shared equally. Gambhir does not maintain any books. Show in Ramesh's book.

(i) Joint Venture with Gambhir A/c, and
(ii) Memorandum Joint Venture A/c

Solution

Ramesh's Books
Joint Venture with Gambhir A/c

Date	**Particulars**	**Rs.**	**Date**	**Particulars**	**Rs.**
2013			2013		
1-Jan	To, Bank draft sent on A/c	250,000	16-Jan	By, Bank A/c - sales proceeds	121,500
15-Jan	To, Bank A/c-freight	12,000	31-Jan	By, Bank A/c - sales proceeds	630,000
15-Feb	To, P/L A/c-share of profit	150,600		By, Bank A/c - sales proceeds	461,700
25-Feb	To Bank: draft sent in settlement	800,600	15-Feb		
		1,213,200			**1,213,200**

Memorandum Joint Venture Account

Dr. **C**

Date	Particulars	Rs.	Date	Particulars	Rs.
4-Jan	To, Cost of DVD Player (200 units @ Rs. 4,500)	900,000	16-Jan	By, Bank A/c - sales proceeds	121,500
15-Jan	To, Bank A/c-freight	12,000	31-Jan	By, Bank A/c - sales proceeds	630,000
25-Feb	To, P/L A/c-share of profit		15-Feb	By, Bank A/c - sales proceeds	461,700
	Ramesh	150,600			
	Gambhir	150,600			
		1,213,200			**1,213,200**

2.6 RECORDING ALL TRANSACTIONS BY EACH CO-VENTURER

The alternative way is to make an entry for each transaction whether by oneself or by the other party on account of the venturer. A regular joint venture account is opened and also the account of the other party. All costs and expenses are debited to the joint venture account and credited to cash (or the other party if the payment is made by him). Sale proceeds are credited by debit to cash (or the other party if he receives the payment). If there is profit, the joint venture account is debited-the credit is to the account of the other party for his share and to the Profit and Loss Account for own share.

Illustration 4:

A and B entered into a joint venture, A is to purchased goods in Kathmandu and sent it to Pokhara where it is to be sold by B. Profits are to be shared: A 3/5 and B 2/5 after allowing 5 % interest on the amount invested by A and after a commission of 2% on sales to B. The following transactions take place. On 2012 April 1, A purchase goods for Rs, 500,000 and sends it to Pokhara. Goods is received by B who pays freight Rs. 15,000, rent Rs. 12,000, insurance Rs, 5,000 and sundry charges Rs. 1,500. On June 30, B informs A that all the goods has been sold for Rs. 650,000 and remits the amount due to A.

Required: Prepare the related account with journal entries

Solutions:

Books of A

Journal Entries

Date	Particulars		Debit	Credit
1-Apr	Joint Venture A/c	Dr.	500,000	
	To, Bank			500,000

	(Goods purchased on joint account)		
5-Apr	Joint Venture A/c Dr. To, B's A/c (Expenses incurred by B on joint account)	33,500	 33,500
30-Jun	B's A/c Dr. To, Joint Venture A/c (Sales effected by B on joint account)	650,000	 650,000
	Joint Venture A/c Dr. To, Interest A/c (Interest on Rs. 500,000 at 5% for 3 months)	6,250	 6,250
	Joint Venture A/c Dr. To, B's A/c (Commission due to B at 2% on sales)	13,000	 13,000
	Joint Venture A/c Dr. To, B's A/c To, Profit and Loss A/c [Profit on joint venture credited to B (2/5) and to Profit and Loss A/c (3/5)]	97,250	 38,900 58,350
	Bank A/c To, B's A/c Dr. (Amount due form B received)	 564,600	 564,600

Ledgers

Joint Venture Account

Dr. **Cr.**

Date	Particulars	Rs.	Date	Particulars	Rs.
1-Apr	To, Bank A/c - Goods purchased	500,000	30-Jun	By, B A/c-sales proceeds	650,000

5-Apr 30-Jun	To, B A/c-expenses To, Interest A/c To, B A/c-commission To, Profit to: B-2/5 P/L A/c-3/5	33,500 6,250 13,000 38,900 58,350			
		650,000			**650,000**

B's A/c

Dr. **Cr.**

Date	Particulars	Rs.	Date	Particulars	Rs.
2012			2012		
30-Jun	To, Joint Venture with B A/c-sales	650,000	1-Apr	By, Joint Venture with B A/c-expenses	33,500
			30-Jun	By, Joint Venture with B A/c-commission	13,000
				By, Joint Venture with B A/c- Profit	38,900
				By, Bank A/c	564,600
		650,000			**650,000**

Books of B
Journal Entries

Date	Particulars		Debit	Credit
2012				
1-Apr	Joint Venture A/c To, A's A/c (Goods purchased on joint account)	Dr.	500,000	 500,000
5-Apr	Joint Venture A/c To, Bank A/c (Expenses incurred on joint account)	Dr.	33,500	 33,500
30-Jun	Bank A/c To, Joint Venture A/c (Goods on joint account sold)	Dr.	650,000	 650,000

	Joint Venture A/c Dr. To, A's A/c (Interest due to A on Rs. 500,000 at 5% for 3 months)	6,250	 6,250
	Joint Venture A/c Dr. To, Commission A/c (Commission at 2% on sales)	13,000	 13,000
	Joint Venture A/c Dr. To, Profit and Loss A/c To, A's A/c [Profit on joint venture credited to P/L A/c (2/5) and to A (3/5)]	97,250	 38,900 58,350
	A's A/c Dr. To, Bank A/c (Amount due to B paid)	564,600	 564,600

Ledgers

Joint Venture Account

Dr. **Cr.**

Date	Particulars	Rs.	Date	Particulars	Rs.
2012			2012		
1-Apr	To, A's A/c -Goods purchased	500,000	30-Jun	By, Bank A/c -Sales proceeds	650,000
5-Apr	To, Bank A/c-expenses	33,500			
30-Jun	To, A A/c -Interest	6,250			
	To, Commission A/c	13,000			
	To, Profit to:				
	P/L A/c -2/5	38,900			
	A -3/5	58,350			
		650,000			**650,000**

A's A/c

Dr. **Cr.**

Date	**Particulars**	**Rs.**	**Date**	**Particulars**	**Rs.**
2012		Rs.	2012		
30-Jun	To, Bank A/c -Amount due paid	564,600	1-Apr	By, Joint Venture A/c-Goods purchase	500,000
			30-Jun	By, Joint Venture A/c-Interest	6,250
				By, Joint Venture A/c-Profit	58,350
		564,600			**564,600**

Illustration 5

M and N entered into a joint venture of underwriting the subscription at par of the share Capital of the Bhaktapur Co. Ltd. consisting of 100,000 equity shares of Rs. 100 each and to pay all expenses upto allotment. The profits were to be shared by them in proportions of 3/5 and 2/5. The consideration in return for this agreement was the allotment of 5,000 other shares of Rs. 100 each to be fully paid. M provide the funds for registration fees Rs. 90,000, advertisement expenses Rs. 80,000, for expenses on printing and distributing the prospectus amounting to Rs. 75,000 and other printing and stationery expenses Rs. 15,000. N contributed towards payment of office rent Rs. 30,000, legal charges Rs. 63,750, salary to clerical staff Rs. 75,000 and other petty disbursements of Rs. 7,500.

The prospectus was issued and applications fell short of the issue by 15,000 shares. M took these over on joint account and paid for the same in full. The venturers received the 5,000 fully paid shares as underwriting commission. They sold their entire holding at Rs. 115 less Rs. 1 brokerage per share. The net proceeds were received by M for 15,000 shares and N for 5,000 shares. Write out the necessary accounts in the books of both the parties showing the final adjustments.

Solution:

IN THE BOOKS OF M
JOINT VENTURE A/C

Dr. **Cr.**

Particulars	**Rs.**	**Particulars**	**Rs.**
To, Bank A/c-Registration fees	90,000	By, Bank A/c-sales proceeds of 15,000 shares Rs. 115 each less Rs.1 brokerage	17,10,000
To, Bank-Advertisement	80,000		
To, Bank-Printing & distribution of prospectus	75,000		
To, Bank- Printing & stationery	15,000	By N A/c -sales proceeds of 5,000 shares Rs. 115 each less Rs.1 brokerage	5,70,000
To, N-office rent	30,000		
To, N-Legal charges	63,750		

To, N-Salary of clerical staff	75,000		
To, N- Petty payment	7,500		
To, Bank-cost of shares	15,00,000		
To, Net Profit to:			
P&L A/c-3/5 206,250			
N-2/5 137,500	343,750		
	22,80,000		**22,80,000**

N's Account

Dr. Cr.

Particulars	Rs.	Particulars	Rs.
To, Joint Venture A/c- sales proceeds of 5,000 shares Rs. 115 each less Rs.1 brokerage	570,000	By, Joint Venture A/c-	
		Office Rent	30,000
		Legal Charges	63,750
		Salary of Clerical Staff	75,000
		Petty Payment	7,500
		By, Joint Venture A/c	
		Share of profit	137,500
		By. Bank	256,250
	570,000		**570,000**

In the books of N
Joint Venture A/c

Dr. **Cr.**

Particulars	Rs.	Particulars	Rs.
To, M -Registration fees	90,000	By, M A/c-sales proceeds of 15,000 shares Rs. 115 each less Rs.1 brokerage	17,10,000
To, M-Advertisement	80,000	By Bank A/c -sales proceeds of 5,000 shares Rs. 115 each less Rs.1 brokerage	5,70,000
To, M-Printing & distribution of prospectus	75,000		
To, M- Printing & stationery	15,000		
To, Bank-office rent	30,000		
To, Bank-Legal charges	63,750		
To, Bank-Salary of clerical staff	75,000		
To, Bank- Petty payment	7,500		
To, M-cost of shares	15,00,000		
To, Net Profit to:			
P&L A/c-2/5 137,500			
M-3/5 206,250	343,750		
	22,80,000		**22,80,000**

M's Account

Dr. **Cr.**

Particulars	Rs.	Particulars	Rs.
To, Joint Venture A/c- sales proceeds of 15,000 shares Rs. 115 each less Rs.1 brokerage	17,10,000	By, Joint Venture A/c-	
To, Bank	256,250	Registration fees	90,000
		Advertisement	80,000
		Printing & distribution of prospectus	75,000
		Printing & stationery	15,000
		By, Joint Venture A/c- cost of shares	15,00,000
		By. Joint Venture A/c Share of profit	206,250
	19,66,250		**19,66,250**

Alternatively treating the joint venture account as Memorandum, the accounts in the books of the co-venturers will be as follows:

IN THE BOOKS OF M
JOINT VENTURE WITH N ACCOUNT

Dr. **Cr.**

Particulars	Rs.	Particulars	Rs.
To, Bank A/c-Registration fees	90,000	By, Bank A/c-sales proceeds of 15,000 shares Rs. 115 each less Rs.1 brokerage	17,10,000
To, Bank-Advertisement	80,000	By, Bank (Balance from N)	256,250
To, Bank-Printing & distribution of prospectus	75,000		
To, Bank- Printing & stationery	15,000		
To, Bank-cost of shares	15,00,000		
To, Profit and Loss A/c	206,250		
	19,66,250		**19,66,250**

Illustration 6

Diwakar and Kripa entered into a joint venture for the purpose of buying and selling second had motor cars. Diwakar is to make purchases and Kripa to effect sales. The profit and loss was to be shared equally. Kripa remitted a sum of Rs. 150,000 to Diwakar towards the venture.
Diwakar purchased 5 cars for Rs. 160,000 and paid Rs. 60,000 for their reconditioning and sent them to Kripa. He also incurred an expense of Rs. 5,000 in transporting.

Kripa sold 4 cars for Rs. 240,000 and retained the fifth one for herself at an agreed valuation of Rs. 50,000. Her expenses were; insurance Rs. 1,000; garage rent Rs. 2,000; brokerage Rs. 2,000 and sundry expenses Rs. 400.

Each party's ledger contains a record of own transactions only. Prepare a memorandum joint venture account showing the result of the venture and joint venture investment account in the books of Kripa as it will appear, assuming that the matter was finally settled between the parties.

Solution:

BOOKS OF KRIPA
JOINT VENTURE INVESTMENT ACCOUNT

DR. **Cr.**

Particulars	Rs.	Particulars	Rs.
To, Bank A/c-remittance	150,000	By, Bank A/c-sales	240,000
To, Bank-insurance	1,000	By, Vehicle a/c - taken	50,000
To, Bank-garage rent	2,000		
To, Bank- brokerage	2,000		
To, Bank-sundry expenses	400		
To, Profit and Loss A/c	29,800		
To Bank – final settlement	104,800		
	290,000		**290,000**

MEMORANDUM JOINT VENTURE ACCOUNT

DR. **CR.**

Particulars	Rs.	Particulars	Rs.
To, Diwakar – cost of cars	160,000	By, Kripa-sales	240,000
To, Diwakar – reconditioning	60,000	By, Kripa - vehicle taken	50,000
To, Diwakar - transportation	5,000		
To, Kripa- All Expenses	5,400		
To, Profit and Loss A/c			
- Diwakar 29,800			
- Kripa 29,800	59,600		
	290,000		**290,000**

Illustration 7

Adarsh of Biratnagar and Laxman of Kathmandu entered into a joint venture for purchase and sale of one lot of mopeds. The cost of each moped was Rs. 3,600 and the fixed retail selling price Rs. 4,500. The following were the recorded transactions:

2010	
Jan .1	Adarsh purchased 100 mopeds paying Rs 72,000 in cash on account.
	Adarsh raised a loan from A. Bank for Rs 50,000 at 18% p.a. interest repayable with interest on 1.3.2010.
	Adarsh forwarded 80 mopeds to Laxman incurring Rs. 2,880 as forwarding and insurance charges.
Jan.7	Laxman received the consignment and paid Rs. 720 as clearing charges.
Feb.1	Adarsh sold 5 mopeds for cash. Laxman sold 20 mopeds for cash.
	Laxman raised a loan of Rs. 1,50,000 from B. Bank, repayable with interest at

	18% p.a. on 1.3.2010
	Laxman telegraphically transferred Rs. 1,50,000 to Adarsh incurring charges of Rs 50.
	Adarsh paid balance due for the mopeds.
Feb.26	Adarsh sold the balance mopeds for cash.
	Laxman sold balance mopeds for cash.
	Adarsh paid selling expenses Rs. 5,000.
	Laxman paid selling expenses Rs. 20,000.
Mar.1	Accounts settled between the ventures and loans repaid, profit being appropriated equally.

You are required to prepare the Memorandum Joint Venture A/c.

Solution:

Memorandum Joint venture Account
for the period Jan. 1 to March 1, 2010

Particulars	**Rs.**	**Particulars**	**Rs.**
To Adarsh:		By Sales	
Cost of Mopeds	360,000	Laxman (80×4500)	360,000
Forwarding &Insurance	2,880	Adarsh (20×4500)	90,000
Interest(2 months)	1,500		
Selling Expenses	5,000		
To Laxman:			
Clearing Charges	720		
Interest(one month)	2,250		
Sundry Expenses(Telegraphic transfer charges)	50		
Selling Expenses	20,000		
To Net Profit to			
Adarsh	28,800		
Laxman	28,800		
	450,000		**450,000**

Illustration 8

Ram and Gautham entered into a joint venture to buy and sell TV sets, on 1st July, 1997. On 1.7.97, Ram sent a draft for Rs. 2,50,000 in favour of Gautham, and on 4.7.1997, the latter purchased 200 sets each at a cost of Rs. 2,000 each. The sets were sent to Ram by lorry under freight "to pay" for Rs. 2,000 and were cleared by Ram on 15.7.1997.

Ram effected sales in the following manner:

Date .	No. of Sets	Sale Price Per Set	Discount Sale Price
16.7.1997	20	3,000	10%
31.7.1997	100	2,800	------
15.8.1997	80	2,700	5%

On 25.8.1997, Ram settled the account by sending a draft in favour of Gautham, profits being shared equally. Gautham does not maintain any books. Show in Ram's book:

Required: Joint Venture with Gautham A/c and Memorandum Joint Venture A/c.

Ram's Books

Joint Venture with Gautham A/c

Date	**Particular**	**Amount**	**Date**	**Particular**	**Amount**
1-Jul	To Bank draft sent on a/c	250,000	16-Jul	By Bank-sale proceeds	54,000
15-Jul	To Bank, freight	2,000	31-Jul	By Bank-Sale proceeds	280,000
July 25	To Profit and Loss A/c Share of profit	68,600	Aug.14	By Bank-Sale proceeds	205,200
	To Bank, draft sent in settlement	218,600			
		539,200			**539,200**

Memorandum Joint Venture A/c

Particular	**Amount**	**Particular**	**Amount**
To Cost of 200 sets	400,000	By Sales proceeds(net)	
To Freight	2,000	20sets@Rs.2700net	54,000
To Profit		100sets@Rs.2800net	280,000
Ram	68,600	80sets@Rs.2565net	205,200
Gautam	68,600		
	539,200		**539,200**

Summary

A joint venture is a very short duration "business" (generally, confined to a single transaction) entered into two or more persons jointly. Parties to joint venture usually prepare a memorandum called Memorandum Joint Venture Account to record primarily all revenue and expenses relating to venture mentioning the party who collected the revenue or met the expenses. This memorandum is very useful to determine profit/loss of venture as well as to prepare Joint Venture Account.

Venturers may keep record for venture transactions in three ways:

(i) Simply a joint venture investment account can be maintained wherein the investments made revenue collected, share of profit/loss and final remittance received made are recorded.

(ii) Alternatively a venturer can prepare Joint Venture Account to record all costs and revenues relating to venture and so balance of joint venture account will show profit/loss. In such a case a separate account of co-venturer is maintained.

(iii) Alternatively, separate books can be maintained for joint venture transactions, mainly when a separate Joint Bank Account is opened.

Self-Examination Questions

I. Multiple Choice Questions (MCQs)

1. Memorandum joint venture account is prepared:
   a. When separate set of books are maintained
   b. When each co-venture keeps record of all the transaction himself
   c. When each co-venture keeps records of their own joint venture transaction only
   d. None of these

2. Prabin and Rabin enter into a joint venture where Prabin supplies goods worth Rs. 6,100 and spending Rs. 300 on expenses. Rabin sells the entire lot for Rs. 7,800 meeting selling expenses amounting Rs. 300. Profit sharing ratio is equal. Rabin remits to Prabin amount due. The amount of remittance will be:
   a. Rs. 6,900 b. Rs. 6,950
   c. Rs. 6,800 d. Rs. 7,500

3. When unsold stock is taken away by a co- venturer, then — account is credited:
   a. Joint stock b. Joint venture
   c. Joint bank account d. Co- venturer's capital account

4. Kisan for joint venture with Kumar, purchased goods costing Rs. 200,000. Kumar sold the goods for Rs. 280,000. Unsold material costing Rs. 10,000 was taken over by Kisan at Rs. 8,000. Kisan is entitled to get 1% commission on purchases. Kumar is entitled to get 2% commission on sales, profit on venture will be:
   a. Rs. 80,000 b. Rs. 80,800
   c. Rs. 81,200 d. Rs. 80,400

5. If separate set of books is maintained and discount is received at the time of purchases of goods then such a discount will be treated as:
   a. Will not be recorded in books of account
   b. Credited to co- ventures account
   c. Income of Joint Venture hence credited to joint venture account
   d. Expenses of Joint Venture hence debited to joint venture account

6. Joint venture Accounting follows which concept:
   a. Accrual concept b. Going concern concept
   c. Cost concept d. Cash basis

7. The parties to joint venture are called
   a.Co- ventures b.Partners
   c.Principle and agent d.Friends

8. X and Y enter into a joint venture. X supplied goods to Y worth Rs. 70,000. X incurred expenses amounting to Rs. 6,000 on joint venture. The venture resulted in a total profit of Rs. 15,000 of which their ratio of distribution is 2 : 1. The entire proceeds were received by X from Y in final settlement will be:
   a. Rs. 85,000 b. Rs. 86,000
   c. Rs. 80,000 d. Rs. 75,000

9. A and B into joint venture sharing profits and losses equally. A bought 5,000 Kg of rice @ Rs. 25/Kg. B bought 1,000 Kg of wheat @ Rs. 30/Kg. A sold 1,000 Kg of wheat @ Rs. 35/Kg and B sold 5,000 Kg of rice @ Rs. 30/Kg. the profit on venture will be :
   a. Rs. 55,000 b. Rs. 50,000
   c. Rs. 60,000 d. Rs. 30,000

10. Karim and Rahim enter a joint venture sharing profits in 2:1, Karim purchases goods of Rs. 2,00,000 and Rahim sells goods of Rs. 2,50,000. Karim gets 1% commission on purchases and Rahim gets 5% commission on sales. Find profit on joint venture.
    a. Rs. 35,500 b. Rs. 36,000
    c. Rs. 34,000 d. Rs.38,000

11. Bad debt incurred on account of joint venture sales are
    a. Debited to Bad Debt Acccount b. Credited to Joint Venture Account
    c. Debited to PL Account d. Not recorded in Joint Venture Account

12. If any stock is taken over by venturer, it will be treated as an
    a. Income of joint venture, hence credited to joint venture account
    b. Expense of joint venture, hence debited to joint venture account
    c. To be ignored from Joint venture transaction
    d. It will be treated in the personal book of the venturer and not in the books of joint venture

13. Goods costing Rs. 12,000 destroyed by an accident, insurance claim is nil.
    a. Rs. 12,000 will be credited to joint venture account
    b. No entry will be made in the books of joint venture
    c. Rs. 12,000 will be debited in joint venture account as loss
    d. None of the above

14. A and B enter into a joint venture for purchase and sale of type writer. A purchased typewriter costing Rs. 200,000; Repairing expenses Rs. 20,000; printing expenses Rs. 20,000. B sold it at 20% margin on selling price. The sales value will be:
    a. Rs. 250,000 b. Rs. 300,000
    c. Rs. 200,000 d. Rs. 280,000

II. Short Descriptive Questions (SDQs)

1. 'Joint Venturer is a short duration partnership' Explain.
2. Differentiate between consignment and partnership.
3. Write Short Note
   (a) Joint Venture Investment Account
   (b) Memorandum Joint Venture Account

III. Practical Questions (PQs)

1. A and B entered into a Joint Venture, agreeing to share profits and losses in the equal ratio. The following transactions took place during the course of the ventures.
   a. A and B deposited Rs. 75,000 each into a Joint Bank Account.
   b. Goods purchased for Rs. 112,000, Expenses incurred Rs. 11,250
   c. Goods sold for Rs. 142,000.
   d. Remaining Goods taken over by A at an agreed valuation of Rs. 3,500.

   Pass the necessary journal entries and prepare the necessary ledger accounts.

2. X and Y join together to construct a building for Rs. 1,200,000, sharing profits and losses 2/5 and 3/5 respectively. A bank account is opened in the joint names for X and Y. X paid Rs. 60,000 in cash and Y paid Rs. 70,000 in cash in the bank. Their transactions are as follows:

   Wages paid Rs. 425,000; materials purchased Rs. 321,000; materials supplied by X Rs. 120,000; materials supplied by Y Rs. 75,000; engineer's fees Rs. 55,000; traveling expenses Rs. 18,000; miscellaneous expenses Rs. 49,000.

   The contract was completed and the price duly received. X took over stock of building materials valued at Rs. 45,000. Prepare the necessary ledger accounts.

3. Bachan and Charan enter a joint venture to prepare a film for the Government. The Government agrees to pay Rs. 100,000. Bachan contributes Rs. 10,000 and Charan contributes Rs. 15,000. These amounts are paid into a Joint Bank Account. Payments made out of the joint account were:

Purchase of equipment	Rs. 6,000
Hire of equipment	Rs. 5,000
Wages	Rs. 43,000
Materials	Rs. 10,000
Office expenses	Rs. 5,000

Bachan paid Rs. 2,000 as licensing fees. On completion, the film was found defective and Government made a deduction of Rs. 10,000. The equipment was taken over by Charan at a valuation of Rs. 2,000.

Separate books were maintained for the joint venture whose profits were divided in the ratio of Bachan 3/7 and Charan 4/7. Give ledger accounts.

4. X and Y jointly underwrite 100,000 equity shares of Rs. 10 each issued by Himchuli Ltd. at a premium of Rs. 2 per share. The underwriting commission is 4% as provided in the Articles and is to be paid by issue of equity shares of Rs. 10 each at a price offered to public. Their profit sharing ratio is 3:2. Following expenses were incurred:

   X: Stationery and Advertisement Rs. 40,800

   Y: Registration Fees, Postage etc. Rs. 27,200

   Application money received from the public was Rs. 1,008,000. X arranged 60% of the amount required to take the short subscription and Y arranged the balance amount. They sold all the shares including those allotted for remuneration. X sold 40% of the shares @ Rs. 15 each and Y sold the balance @ Rs. 20 per share. Accounts were settled.

   Prepare necessary ledger accounts assuming the accounts were settled through Joint Bank Account.

5. Ram and Rahim enter into a Joint Venture to take a building contract for Rs. 24,00,000. They provide the following information regarding the expenditure incurred by them:

	Ram	Rahim
Materials	680,000	500,000
Cement	130,000	170,000
Wages	-	270,000
Engineer's fee	100,000	-
License Fees	-	50,000
Plant	-	200,000

   Plant was valued at Rs. 100,000 at the end of the contract and Rahim agreed to take it at the value. Contract amount of Rs. 2,400,000 was received by Ram. Profits or losses are to be shared equally. You are asked to show:

   (i) Memorandum Joint venture Account
   (ii) Joint venture account and Rahim's account in the books of Ram, and
   (iii) Joint venture account and Ram's account in the books of Rahim.

6. Smart and Dull entered into a joint venture for the purpose of buying and selling second-hand type writers, Dull to make purchases and Smart to effect sales. The profit and loss was

to be share in 2:3 ratios respectively. Rs. 15,000 was remitted by Smart to Dull towards the venture.

Dull purchased 22 old typewriters for Rs. 15,000 and paid Rs. 9,000 for their reconditioning and sent them to Smart. His other expenses were: buying commission Rs. 1,000; transportation Rs. 200 and miscellaneous Rs. 100.

Smart took delivery of the typewriters and paid Rs. 270 for Octroi and Rs. 100 for transportation. She sold 12 typewriters at Rs. 2,200 each; 4 typewriters at Rs. 2,100 each and 3 typewriters at Rs. 2,000 each. She retained remaining typewriter for his personal use at an agreed value of Rs. 2,500. Her other expenses: insurance Rs. 250; Rent Rs. 400; Brokerage Rs. 1,200 and miscellaneous Rs. 200.

Each party's ledger contains a record of all transactions of joint venture. Prepare joint venture account and Smart's account in the books of Dull.

7. A and B into a joint venture agreement to share the profit or loss in the ratio 2:1. A supplied goods worth Rs. 60,000 to B incurring expenses amounting to Rs. 2,000 for freight and insurance. During transit, goods costing Rs. 5,000 became damaged and a sum of Rs. 3,000 was recovered from the insurance company. B reported that 90% of the remaining goods were sold at a profit of 30% of their original cost. Towards the end of the venture, a fire occurred and as a result the balance stock lying unsold with B was damaged. The goods were not insured and B agreed to compensate A by paying in cash 80% of the aggregate of the original cost of such goods plus proportionate expenses incurred by A. Apart from the joint venture share of profit, B was also entitled under the agreement to a commission of 5% of net profits of joint venture after charging such commission. Selling expenses incurred by B totaled Rs. 1,000. B had earlier remitted an advance of Rs. 10,000 to A and paid balance at the end.

   You are required to prepare in A's books: a. Joint Venture Account
   b. B's Account

8. Bishal of Birgunj and Kumar of Kathmandu entered into a joint venture for the purpose of buying and selling second hand cars; Bishal to make purchases and Kumar to effect sales. The profit and loss was to be shared equally. Kumar remitted a sum of Rs. 1,500,000 to Bishal towards the venture.

   Bishal purchased 8 Cars for Rs. 1,600,000 and paid Rs. 400,000 for their reconditioning and sent them to Kathmandu. He also incurred an expense of Rs. 50,000 in transporting the cars to Kathmandu.

   Kumar sold 7 cars for Rs. 2,450,000 and retained the remaining for himself at an agreed value of Rs. 360,000. His expenses were: insurance Rs. 10,000; garage rent Rs. 20,000; brokerage Rs. 20,000 and miscellaneous expenses Rs. 7,000.

   Each party's ledger contains a record of his own transactions on joint account. Prepare a statement showing the result of the venture and the joint venture account with Bishal in the books of Kumar as it will finally appear, assuming that the matter was finally settled between the parties.

9. Mr. Madan and Mr. Hari entered into a joint venture to purchase and sell 'Mobile Sets'. Profit was to be shared equally between them. Mr. Madan was to purchase 'Mobile Sets' from Biratnagar and send it to Mr. Hari of Kathmandu who would sell it.

   On 1st Bhadra, 2063 Mr. Madan purchased 'Mobile Sets' worth Rs. 100,000 and incurred the following expenses in sending it to Mr. Hari: forwarding charges Rs. 6,000 and insurance charges Rs. 2,000.

   He immediately drew upon Mr. Hari a bill of exchange for Rs. 100,000 for 3 months. The acceptance was discounted at 18% p.a.

   Mr. Hari paid the following expenses: cartage charges Rs. 3,000; commission to agents Rs. 5,000 and rental charges Rs. 4,000. The whole 'Mobile Sets' were disposed off for Rs. 200,000. He forwarded a cheque to Mr. Madan for the amount due on 30th Ashwin, 2063. You are required to prepare the following accounts:
   i. Memorandum Joint Venture Account
   ii. Joint venture with Mr. Hari account in the books of Mr. Madan
   iii. Joint venture with Mr. Madan account in the books of Mr. Hari

10. Mr. Krishna and Mr. Sudan entered into agreement with 'Sungava Films Ltd.' to take underwrite for Kathmandu Valley of recently pictured film *'Hamro Maya Kasto Chha'*. Their underwriting was for one week with minimum collection of Rs. 600,000 per day. They will bear all expenses of publicity and marketing. Their profit sharing ratio was 4:3. In addition Mr. Krishna is entitled to get Rs. 12,000 per day as in-charge of the project. They deposited Rs. 500,000 each at joint bank account opened with 'CIVIL Bank Ltd.'

    The film was released on 20.4.2068 on Friday in 5 different Cinema Halls in Kathmandu Valley. Following was the status of the collection (in Rs.);

Date	Gopi Krishan	Barahi	Jai Nepal	Bishowjyoti	Citi Centre
Friday	187,500	156,900	231,700	303,300	201,900
Saturday	288,800	75,500	293,300	455,500	306,800
Sunday	108,900	99,900	145,500	397,700	332,250
Monday	55,800	62,300	191,500	223,450	111,100
Tuesday	62,400	45,500	90,700	101,200	38,900
Wednesday	48,800	50,500	80,200	110,100	52,500
Thursday	29,900	49,900	58,400	90,900	45,500

    They spent following expenses; posters Rs. 7,950; transportation Rs. 23,900; entertainment Rs. 48,800; gift and flowers Rs. 5,650 and miscellaneous Rs. 37,700. It's a government rule that 2% of the collection should be deposited as Entertainment Royalty.

    You are asked to prepare necessary ledger accounts to find out the amount finally taken by Mr. Krishna and Mr. Sudan.

11. Surendra and Rajendra joint together to provide personal lending for students who need to show bank balance for VISA purpose of Australia with profit sharing ratio 3:2. Surendra

opened bank account with GLOBAL Bank Ltd. with Rs. 1,800,000 and Rajendra opened bank account with PRIME Bank Ltd. with Rs. 1,500,000.

They were taking 36% p.a. as interest and 0.50% as processing fee for every lending. Their expenses to operate business were; office rent Rs. 18,000; water & electricity Rs. 3,950; stationery and printing Rs. 14,550; Conveyance Rs. 6,600; Salary to staffs Rs. 30,000; wages to sweeper Rs. 6,600. Their activities were as follows:

Name of the Student	Amount	Duration	Discount
Miss. Jenu Suwal	1,400,000	45 Days	5%
Mr. Himal Gurung	900,000	2 Months	-
Mr. Kiran Upadhaya	1,275,000	1 month	2.5%
Mr. Upendra Shrestha	720,000	11 days	-
Miss. Upasana Upreti	1,695,000	40 days	10%
Mrs. Susma Shah	1,110,000	1 month	5%
Miss. Kohinoor Silwal	550,000	2 months	-
Mr. Bibek Mainali	600,000	21 days	7.5%

From the above information prepare the statement showing the result of the venture and final amount taken by each co-venturer.

ANSWER

Multiple Choice Questions (MCQs)

1	c	6	a	10	a	14	a
2	b	7	a	11	a		
3	b	8	b	12	a		
4	d	9	d	13	c		
5	a						

CHAPTER- 5

Accounting for Special Transactions

UNIT 3:

Bills of Exchange

Learning Objectives

1. *Understand the meaning of bills of exchange and promissory notes and also try to grasp their underlying features.*
2. *Practice the accounting treatments relating to issue and acceptance of bills in the books of drawer and drawee. Also practice the accounting treatment relating to bills or notes on discounting, maturity endorsement.*
3. *Learn the technique of accounting relating to accommodation bills.*
4. *Learn the special treatment needed in the case of insolvency as well as early retirement of bill.*

3.1 INDTRODUCTION

The revenue from sales on a credit basis is the largest factor influencing the amount of net income. As a result most of the sellers allow customers a period of credit. When goods are sold on credit, the seller would like the purchaser should give a definite promise in writing to pay the amount of the goods on certain date. Commercial practice has been developed to treat these written promises into valuable instruments of credit so much so that when a written promise is made in proper form and is properly stamped, it is supposed that the buyer has discharged his debt and that the seller has received payment. This is because written promises are often accepted by banks and money is advanced against them. Otherwise also they can be passed on from person to person. The written promise is either in the form of a bill of exchange or in the form of promissory note.

A bill of exchange comes from an open credit arrangement where the creditor gets the documentary evidence of the amount owing and also the term of payment. The buyer must pay the amount shown on the bill of exchange on the specified date. There cannot be any argument by the buyer about the conditions other than what appear in the document. Therefore, a bill of exchange has been defined as an "instrument in writing containing an unconditional order signed by the maker directing a certain person to pay a certain sum of money only to or to the order of a certain person or to the bearer of the instrument". When such an order is accepted by writing on the face of the order itself, it becomes a valid bill of exchange. Suppose Amar & Co. orders Bimal & Co. to pay Rs. 50,000 three months after date and Bimal accepts this order by signing his name on behalf of Bimal & Co., then it will be a bill of exchange.

The following is a specimen of a properly drawn bill of exchange.

Rs 50,000 **1st July, 2014**

Stamp

90 days after date pay to M/s Amar & Co, or order the sum of Rs Fifty thousand only for the value received ....

To,

M/s Bimal & Co
Bagbazar, Kathmandu

M/s Amar & Co
Jawalakhel, Lalitpur

This is known as draft. This will be sent to M/s. Bimal & Co. and if the order is accepted by them they will write across the order as under:

Rs 50,000 **1st July, 2014**

Stamp

90 days after date pay to M/s Amar & Co, or order the sum of Rs Fifty thousand only for the value received ....

To,	**Accepted**	
	Mr Bimal	
M/s Bimal & Co	**Proprietor**	**M/s Amar & Co**
Bagbazar, Kathmandu	**For Bimal & Co**	**Jawalakhel, Lalitpur**

After acceptance it becomes a proper bill of exchange.

The distinguishing features of a bill of exchange are as follow:

1. It must be in writing.
2. It must be signed by the maker
3. It must be unconditional order to pay.
4. The maker must direct a certain person to pay a certain sum of money.
5. The draft must be accepted for payment by the party on whom the order is made.

3.2 PARTIES TO A BILL OF EXCHANGE

There are three parties to a bill of exchange – the drawer, the drawee and the payee.

Drawer: The maker of bill of exchange is known as the drawer. The signature of the drawer is necessary to complete the instrument; there is, however, no bar in accepting the bill before the drawer signs it. In the above bill of exchange , M/s Amar & Co is the drawer

Drawee: Drawee is the person upon whom the bill of exchange is drawn. Drawee is purchaser of the goods upon whom the bill of exchange is drawn. The dawee has to write the word "accepted" if he accepts to make the payment given in the bill on the due date and has to put his signatures on it. After the drawee of a bill has signed his consent on the face of the bill, he is called the acceptor and this process is called acceptance. A bill of exchange becomes a legal document after acceptance and binds the drawee to honour the bill on the due date. Acceptance however may be general or qualified. The general acceptance requires signatures of the acceptor only without stating any conditions, thereto. However, mention of a bank or a specified place of payment or part payment thereof, makes the acceptance qualified. A qualified acceptance varies the express terms of the bill as originally drawn and thereby the drawer can refuse to consider the bill as accepted. Sometimes the bill of exchange may be accepted by another person on behalf of the drawee. In the above bill of exchange , M/s Bimal & Co is the drawee

Payee: The payee is defined as the person named in the instrument to whom or to whose order the amount of the instrument is directed to be paid. The drawer and the payee may be the same. In the above bill of exchange, M/s Amar & co is the payee

A bill of exchange can be passed on to another person by endorsement. Endorsement on a bill of exchange is made exactly as it is done in the case of a cheque. The primary liability on a bill of exchange is that of the acceptor. If he does not pay, a holder can recover the amount from any of the previous endorsers or the drawee.

3.3 TERMS IN BILLS OF EXCHANGE

a. 'Term of a bill' means the time period for which the bill has been drawn and accepted.
b. ‘Endorsement’ means the act of transferring bills of exchange to creditors/parties as it has equivalent worth of cash/cheque.
c. ‘Due date’ means the date when the term of the bill expires.
d. ‘Grace period’ means the standard time period provided by law i.e. 3 days.
e. ‘Maturity date’ means the date which comes after adding grace period to the due date of a bill.
f. ‘Retire/payment/discharge’ means settlement or payment of liability of the bills by the acceptor.
g. ‘Discounting’ means the act of selling the bills to the bank for consideration.

3.4 CALCULATION OF DUE DATE OF BILLS

The due date of each bill is calculated as follows:

Case	Due Date
a. When the bill is made payable on a specific date	a. That specific date will be the due date
b. When the bill is made payable at stated number of months after date.	b. That date on which the term of the bill shall expire will be the due date. * the term shall expire on that date of the month which corresponds with the date on which the bill is date and if there is no corresponding date on that particular month then last day is considered.
c. When the bill is made payable at stated number of days after date	The date which comes after adding the stated number of days to the date of the bill shall be the due date. * While counting the days, the date of the bill is excluded.

c. When the due date is a public holiday	c. The preceding business day will be the due date
d. When the due date is an emergency/ unforeseen holiday.	d. The next following day will be the due date.

Note: The term of a **Bill after sight** commences from the date of acceptance of the bill whereas the term of a **Bill after date** of drawings a bill commences from the date of drawing of the bill.

3.5 TYPES OF BILL OF EXCHANGE

A bill of exchange can be payable at sight (on presentation) or it can be payable at a time in the future (bill after date). The example of the former type of bill is a cheque – which is drawn on a banker and is payable on demand. A bill that is payable at a time in the future – known as term bill.

3.5.1 Promissory Note

A promissory note is an instrument in writing, not being a bank note or 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. A promissory note has the following characteristics.

1. It must be in writing.
2. It must contain a clear promise to pay. Mere acknowledgement of a debt is not a promissory note.
3. The promise to pay must be unconditional "I promise to pay Rs....... as soon as I can" is not an unconditional promise.
4. The promiser or maker must sign the promissory note.
5. The maker must be a certain person.
6. The payee (the person to whom the payment is promised) must also be certain.
7. The sum payable must be certain. "I promise to pay Rs........ plus all fine" is not certain.
8. Payment must be in legal money of the country.
9. It should not be made payable to the bearer.
10. It should be properly stamped.

Specimen of Promissory Note.

> **Rs 50,000** **1st July, 2014**
>
> **Stamp**
>
> **90 days after date, we promise to pay M/s Charan & co , or order the sum of Fifty thousand with interest at 12 % p.a for the valued received.**
>
> **Rajesh & Co**

M/s. Rajesh & Co. is the promisor while M/s Charan & Co is the payee.

3.5.2 Record of Bills of Exchange and Promissory Notes

A party which receives a promissory note or receives an accepted bill of exchange will treat it as a asset under the head of Bills Receivable. A party which issues a promissory note or accepts a bill of exchange will treat it as a liability under the head of Bills payable

The person who receives the bill has four options. These are

(i) **Bill retained by drawer till due date**.

Journal entries passed in the books of drawer and drawee to record the above transaction are as under

S.no	Books of Drawer	Books of Drawee
1	**For Sale of Goods** Customer A/c Dr To sales A/c	**For purchase of Good** Purchase A/c Dr To, Suppliers A/c
2	**On receipt of duly accepted bills** Bills Receivable A/c Dr To Customer A/c	**At the time of Acceptance of Bill** Suppliers A/c Dr To Bills Payable A/c
3	**On receiving Payment on due date**	**At the time of Payment on due date**

	Cash/Bank A/c Dr To Bills Receivable A/c	Bills Payable A/c Dr To Cash/ Bank A/c

(ii) The bill can be endorsed in favor of another party. The holder of the bill endorsing the bill is called 'endorser and the person to whom it is endorsed is called 'endorsee'. On due date, the last endorsee holding the bill presents the bills to the acceptor for the payment. In this case, the entry will be as follow:

S.no	Books of Drawer	Books of Drawee	Books of endorsee
1	**At the time of endorsement** Endorsee A/c Dr To Bills Receivable A/c (for bill endorsed)	**No entry for the endorsement**	**on receiving endorsed bill** Bills receivable A/c Dr To Endorser A/c (For bill received after endorsement)
2	**Payment by acceptor at the time of Payment on due date** No entry because the bill is duly honored by the acceptor	**Payment by acceptor at the time of Payment on due date** Bills payable A/c Dr To Cash/ Bank A/c For payment made on due date	**Payment by acceptor at the time of Payment on due date** Cash/Bank A/c Dr to Bills receivable A/c (For payment received on due date)

(iii) **The bill of exchange can be discounted with bank.** The bank will deduct a small sum of money as discount and pay the rest of the amount. In this case, Cash is received or treated as deposited in Bank Account, the Bills Receivable is given up and in the bargain there is a small loss. The entry will, therefore, be:

S.no	Books of Drawer	Books of Drawee
1	**At the time of cash received from Bank on discounting of bill** Bank/ Cash A/c Dr Discount A/c Dr To Bills Receivable	**Discounting of bills** No Entry

2	**payment of bill by drawee to bank on due date** No entry is passed in the books of drawer because the bill is duly hourned by the drawee	**Payment of bill on due date** Bills Payable A/c To cash/Bank A/c
3	**Transfer of discount to profit/ loss account** Profit & Loss A/c To Discount A/c	No Entry

(iv) **Bill sent for collection by drawer**.

Drawer may send the bills to the bank for its collection on the maturity date in order to make the collection on time and also for the safe custody of the bills. Bank deducts some charges for collection of such bills. Hence, following enteries are passed;

S.no	Books of Drawer	Books of Drawee
1	**For sending the bills for collection to bank** Bill sent for collection A/c Dr To Bills Receivable A/c	<u>*No Entry*</u>
2	**On collection of such bills by bank** Bank A/c Dr Bank Charge A/c Dr To Bill sent for collection A/c	**At the time of payment of Bill** Bills Payable A/c Dr To Cash/Bank A/c

On the date of maturity there will be two possibilities. The first is that the bill will be paid, that is to say, met or honored. The entries for this will depend upon what was done to the bill during the period of maturity. If the bill was kept, the cash will be received by the party which originally received the bill. The entry will be:

Cash Account Dr.

To, Bills Receivable Account

But if bill is already endorsed in favor of third party or bill was discounted with the bank, no entry will be made.

The second possibility is that the bill will be dishonored, that is to say, the bill will not be paid. If the bill is dishonored, the bill become useless and the party from whom the bill was received will be liable to pay the amount (as also the expenses incurred by the party). Therefore, the following entries will be made:

1. If the bill was kept till maturity then:
   Party (giving the bill) Dr.
   To, Bills Receivable Account

2. If the bill was endorsed to another party, the entry will be:
   Party (giving the bill) Dr.
   To, the Creditor

3. If the bill was discounted with bank
   Party (giving the bill) Dr.
   To, the Bank

4. If the bill was sent for collection bank
   Party (giving the bill) Dr.
   To, Bill sent for collection A/c

We have seen that in case of dishonored, the party which gave the bill has to be debited (because he has become liable to pay the amount). The credit entry is in Bills Receivable Account (if it was retained) or the Creditor or the bank (if it was endorsed in their favor)

3.5.3 Noting Charges

Noting is the procedure adopted if a bill of exchange has been dishonored by non-acceptance or by non-payment. As we know, if the holder of the bill presents it to the drawee for payment on the due date but the later does not pay it off, the bill is said to be dishonored. In such a case, the holder of the bill may resort to legal action by getting the fact of dishonor noted (a form of disapproved) by a Notary Public (a legal practicenor, usually a solicitor, who is empowered to note a dishonored bill of exchange). This is done by the holder by referring the matter to the notary public who himself presents the bill for payment to the drawee and testifies that the later declined to pay it off. This is a legally acceptable evidence of dishonor. Therefore, The Notary public records particulars of the bill, its re-presentment, and the reasons for non-payment of the bill in a regular and also on a notarial ticket, which is to be attached to the bill. The notary public charges some fees for doing all these – which is called noting charges. Generally, the loss by way of noting charges is to be borne by the drawee because it can legally be recoverable from him. The journal entries are as under:

(a) When the drawer pays for the noting charges:

S.no	Books of Drawer	Books of Drawee
	Acceptor Dr To Bills Receivable A/c	Bills Payable A/c Dr Noting Charges A/c Dr

	To Cash A/c (Acceptor account is debited with the amount of the bill and the amount of noting charges paid in cash)	To Drawer A/c (Drawer Account is credited with the amount of the bill and the amount of noting charges to be reimburse to the drawer)

(b) When bank pays for the noting charges:

S.no	Books of Drawer	Books of Drawee
	Acceptor Dr To bank A/c (Amount of bill plus the noting charges paid by the bank are debited to acceptor account and credited to bank account)	Bills Payable A/c Dr Noting Charges A/c Dr To Drawer A/c (Drawer Account is credited with the amount of the bill and the amount of noting charges paid by the bank to be reimbursed through the drawer)

(c) When the endorsee pays for the noting charges:

S.no	Books of Drawer (Endorser)	Books of Endorsee
	Acceptor Dr To Endorsee A/c (Amount of bill plus the noting charges paid by the endorsee)	Endorser or Drawer A/c Dr To Bills receivable A/c To Cash A/c(Noting Charges) (With the amount of bill and noting charges paid in cash

3.5.4 Renewal of Bill

Sometimes the acceptor is unable to pay the amount and request for the extension of time. In such a case a new bill will be drawn and the old bill will be cancelled. If this happens entries should be passed for cancellation of the old bill.

Journal entries for cancellation and renewal of bill are as under

S.no	Books of Drawer (Endorser)	Books of Drawee
1	**At the time of cancellation of old bill retained by the drawer** Drawee A/c To Bill Receivable A/c	**At the time of cancellation of old bill retained by the drawer** Bill Payable A/c Dr To Drawer A/c
2	**For the part payment received**	**For the part payment made**

	Cash/ Bank A/c To Drawee A/c	Drawer A/c Dr To cash/bank
3	**For interest receivable on renewal paid in cash** Cash A/c To Interest Income A/c	**For interest payable on renewal paid in cash** Interest Expense A/c Dr To cash A/c
4	**For interest receivable on renewal include in new bill** Drawee A/c Dr To Interest Income A/c	**For interest payable on renewal include in new bill** Interest expense A/c Dr To Drawer A/c
5	**For New Bill received after acceptence** Bill receivable A/c Dr to Drawee A/c (Amount of the new bill includes interest if it is not received in cash)	**For New Bill received after acceptance** Drawer A/c Dr To Bill Payable A/c (amount of new bill includes interest , if it is not paid in cash)

Illustration 1

Gaurav sold goods to Ganesh on 1st July 2013 for Rs. 25,000. Ganesh immediately accepted a three months' bill. On due date, Ganesh requests that the bill be renewed for a fresh period of two months. Guarav agrees provided interest at 15% was paid immediately for fresh period of two months. To this Ganesh was agreeable. The second bill was duly met on due date. Give journal entries and ledger account in the books of Gaurav.

Solution

JOURNAL ENTRIES

IN THE BOOKS OF GAURAV

Date	Particulars	Debit	Credit
2013			
1-Jul	Ganesh A/c Dr.	25,000	
	To, Sales Account		25,000

	(Sales of goods to Ganesh as per invoice No....)		
	Bills Receivable Account Dr. To, Ganesh Account (Three months acceptance received from Ganesh for the amount due from him)	25,000	 25,000
4- Oct	Ganesh Account Dr. To, Bills Receivable Account (Ganesh's acceptance cancelled because of renewal)	25,000	 25,000
	Ganesh Account Dr. To, Interest income (Interest @ 15% on Rs. 25,000 due from Ganesh for 2 months because of renewal)	625	 625
	Bills Receivable Account Dr. Cash Account Dr. To, Ganesh Account [New acceptance for 2 months for Rs. 25,000 and cash (for interest) received]	25,000 625	 25,625
2013 7- Dec	Cash Account Dr. To, Bills Receivable Account (Cash received against Ganesh's second acceptance)	25,000	 25,000

Ledger Account
Ganesh Account

Dr. **Cr.**

Date	Particulars	Rs.	Date	Particulars	Rs.
2013 July 1	To, Sales	25,000	2013 July 1	By, Bills Receivable A/c	25,000

Oct 4	To, Bills Receivable A/c To, Interest A/c	25,000 625	Oct 4	By, Cash A/c By, Bills Receivable A/c	625 25,000
		50,625			**50,625**

Bills Receivable Account

Dr. **Cr.**

Date	Particulars	Rs.	Date	Particulars	Rs.
2013 July 1	To, Ganesh A/c	25,000	2013 July 1	By, Ganesh A/c	25,000
Oct 4	To, Ganesh A/c	25,000	Oct 4	By, Cash A/c	25,000
		50,000			**50,000**

Sales Account

Dr. **Cr.**

Date	Particulars	Rs.	Date	Particulars	Rs.
			2013 July 1	By, Ganesh A/c	25,000

Interest Income Account

Dr. **Cr.**

Date	Particulars	Rs.	Date	Particulars	Rs.
			2013 Oct 4	By, Ganesh A/c	625

Cash Account

Dr. **Cr.**

Date	Particulars	Rs.	Date	Particulars	Rs.
2013 Oct 4	To, Ganesh A/c	625			
2014 Dec 7	To, Bills Receivable A/c	25,000			

Illustration 2

Journalize the following transactions in Keshav K.C's Books

(i) K.C.'s acceptance to Bhuvan for Rs. 25,000 discharged by cash payment of Rs. 10,000 and a new bill for the balance plus 500 for interest.

(ii) Gagan's acceptance for Rs. 14,000 which was endorsed by K.C to Mahesh was dishonored. Mahesh paid Rs. 550 noting charges.

(iii) Dahal retires bill for Rs, 20,000 drawn on him by K.C. at Rs 500 discount.

(iv) K.C.'s acceptance to Pradhan for Rs. 50,000 discharged by Manandhar acceptance to K.C. for similar amount.

(v) K.C.'s acceptance to Sharma for Rs. 24,000 was discharged by a cash payment of Rs. 12,400 and a new bill for 12,000.

Solution

IN THE BOOKS OF KESHAV K.C

JOURNAL ENTRIES

Date	Particular		Dr.(Rs.)	Cr. (Rs.)
	(i) Bills Payable A/c	Dr.	25,000	
	Interest Account	Dr.	500	
	To, Cash			10,000
	To, Bills Payable Account			15,500
	(Bills Payable to Bhuvan discharged by cash payment of cash of Rs. 10,000 and new bill for Rs. 15,500 including Rs. 500 as interest.)			
	(ii)(a) Gagan's Account	Dr.	14,550	
	To, Mahesh Account			14,550
	(Gagan's acceptance for Rs. 14,000 endorsed to Mahesh dishonored, Rs. 550 paid by Mahesh as noting charges)			
	(iii)Bank Account Dr.		19,500	
	Rebate Account	Dr.	500	
	To, Bills Receivable Account			20,000

	(Payment received from Dahal against acceptance for Rs. 20,000, allowed him a discount of Rs. 500.)		
	(iv)Bills Payable Account Dr.	50,000	
	To, Bills Receivable A/c		50,000
	(Bills Receivable from Manandhar endorsed to Pradhan in settlement of bills payable issued to him earlier)		
	(v)Bills Payable Account Dr.	24,000	
	Interest Account Dr.	400	
	To, Cash Account		12,400
	To, Bills Payable Account		12,000
	(Settlement of Bills Payable issued to Sharma for Rs. 24,000 by payment of Rs. 12,400 including Rs. 400 interest, and issue a fresh bill for Rs. 12,000)		

Illustration 3

Journalizing the following in the books of Deena:

(i) Boby informs Deena that Rahul's acceptance for Rs, 30,000 has been dishonored and noting charges are Rs. 400. Boby accepts Rs. 10,000 cash and the balance as bill at three months at interest of 10% p.a.

Deena accepts from Rahul his acceptance at two months plus interest @ 12% p.a.

(ii) James owes Deena Rs. 32,000, he sends Deena's acceptance in favor of Ralph for Rs. 31,600 in full settlement.

(iii) Deena meets her acceptance in favor of Singh for Rs. 45,000 by endorsing John's acceptance for Rs. 44,500 in full settlement.

(iv) Rahul's acceptance in favor of Deena retired one month before due date, interest is taken at the rate of 6% p.a.

Solution

IN THE BOOKS OF DEENA

JOURNAL ENTRIES

Date	Particular		Dr.(Rs.)	Cr. (Rs.)
i) (a)	Rahul's Account	Dr.	30,400	
	To, Boby's Account			30,400
	(Rahul's acceptance endorsed to Boby dishonored on due date noting charges paid by Bob Rs. 400)			
(b)	Boby's Account	Dr.	30,400	
	Interest A/c	Dr.	510	
	To, Cash A/c			10,000
	To, Bills Payable Account			20,910
	(Amount payable to Boby Rs. 30,400 settled by cash payment Rs. 10,000 and issue of new bill for Rs. 20,910 including interest Rs. 510 for three months on Rs. 20,400 @ 10% p.a.)			
(c)	Bills Receivable Account	Dr.	31,008	
	To, Rahul's A/c			30400
	To, Interest A/c			608
	(Bill received from Rahul for Rs. 30,400 due against earlier acceptance dishonored plus Rs. 608 interest for two months @ 12% p.a.)			
ii)	Bills Payable A/c	Dr.	31,600	
	Discount A/c	Dr.	400	
	To, James A/c			32,000
	(Cancellation of bills payable to Ralph for Rs. 31,600 in			

	Settlement of Rs. 32,000 due from James)			
iii)	Bills Payable A/c	Dr.	45,000	
	To, Bills Receivable A/c			44,500
	To, Discount A/c			500
	(Settlement of acceptance issued to Mr. Singh by endorsement of John's acceptance for Rs. 44,500)			
iv)	Bank Account	Dr.	30,853	
	Discount Account	Dr.	155	
	To, Bills Receivable Account			31,008
	(Amount received from Rahul in settlement of Bill Payable, retired one month before due date)			

3.5.5 Accommodation Bills

Bills of exchange are usually drawn to facilitate trade transmission, that is, bills are meant to finance actual purchase and sale of goods. But the mechanism of bill can be utilized to raise finance also. An Accommodation Bill is a bill of exchange signed by a party as drawer, drawee, endorsed to accommodate another party whose credit is not strong enough to enable him to borrow on his single name. It is drawn for the purpose of arranging temporary finance. Therefore, an Accommodation Bill is a bill of exchange which has been drawn on and accepted by a reputable party for the purpose of giving value to the bill so that it can be discounted.

Suppose Ram needs, finance for three months. In that case he may persuade his friend Sita to accept his draft. The bill of exchange may then be taken by Ram to his bank and get it discounted there. Thus Ram will be able to made use of funds. When the three months period expires Ram will send the requisite amount to Sita and Sita will meet the bill. If both Ram and Sita need money, the same device can be used. Either Ram accepts a bill of exchange or Sita does. In either case, the bill will be discounted with the bank and the proceeds divided between the two parties accounting to mutual agreement. The discounting charges must also be borne by the two parties in the same ratio in which the proceeds are divided. On the due date the acceptor will receive from the other party his share. The bill will then be met. When bills are used for such a purpose, they are known as accommodation bills.

Entries are passed in the books of both parties exactly in the way already pointed out for ordinary bills (trade bills). The only additional entry to be passed is for sending the remittance to the other party and also debiting the other party with the requisite amount of discount. Following is the difference between trade bill and accommodation bill.

Trade Bills	Accommodation Bills
1. These bills are prepared to settle business transactions. 2. These bills are accepted for a consideration. 3. On discounting of these bills, proceeds remain with the holder. 4. Maker can file a case against acceptor in case of dishonored	1. These bills are prepared to meet short-term financial needs. 2. These bills are accepted without any consideration. 3. On discounting of these bills, proceeds may be shared by the parties. 4. Maker cannot file a case against acceptor, in case of dishonored.

3.5.6 Insolvency of Parties

Insolvency is the inability to pay one's debts when they fall due. Insolvency arises due to bankruptcy. This means that bills accepted by him will be dishonored. A person is said to be insolvent, may have valuable assets that are not immediately realizable. Therefore, when it is known that a person has become insolvent, entry for dishonor of his acceptance must be passed. When a person becomes insolvent, his properties are sold by the liquidator or by the official receiver (which is generally less than the amount due) is termed as "Dividend" and is generally expressed as "**so many paisa in the rupee**". When and if an amount is received cash account will be debited and the personal account of the debtor will be credited. The remaining amount will be irrecoverable and, therefore, should be written off as bad debts. In the books of drawee of the bill, the amount not ultimately paid by him due to insolvency, should be credited to deficiency account.

Illustration 4

Beena and Barsha were in need of funds. On 1st January, 2013, Beena accepted Barsha's draft for Rs. 60,000 at 3 months Barsha got it discounted at 6% and remitted 1/3 of the proceeds to Beena. On the due date Barsha was not able to send to amount instead she accepted Beena's bill for Rs. 45,000 at two months. Beena got it discounted for Rs. 44,200. Out of this Rs. 2,800 were sent to Barsha. Early in May Barsha became insolvent. Her estate paid 40% only. Give journal entries in the books of both the parties and give Barsha's account in the books of Beena.

Solution

BOOKS OF BEENA

JOURNAL ENTRIES

Date	Particular	Dr.(Rs.)	Cr. (Rs.)
2013			
1-Jan	Barsha's A/c Dr.	60,000	
	To, Bills Payable Account		60,000
	(Barsha's draft for Rs. 60,000 accepted for mutual accommodation)		

	Bank Account	Dr.	19,700	
	Discount Account	Dr.	300	
	To, Barsha's Account			20,000
	(One third of the proceeds of bill after discounting received from Barsha)			
4-Apr	Bills Receivable Account	Dr.	45,000	
	To, Barsha's A/c			45,000
	(Acceptance received from Barsha to cover the amount due from him)			
	Bank Account	Dr.	44,200	
	Discount Account	Dr.	800	
	To, Bills Receivable Account			45,000
	(Barsha's acceptance discounted for Rs. 44,200)			
	Bills Payable Account	Dr.	60,000	
	To, Bank Account			60,000
	(Own acceptance due on this date met)			
	Barsha's Account	Dr.	3,575	
	To, Bank			2,800
	To, Discount Account*			775
	(Amount remitted to Barsha after discounting the bill)			
7-May	Barsha's Account	Dr.	45,000	
	To, Bank Account			45,000
	(Dishonored of Barsha's acceptance because of her insolvent)			
	Bank Account A/c	Dr.	17,430	
	Bad Debts A/c	Dr.	26,145	
	To, Barsha's A/c			43,575

	(Amount received and debts written off in respect of amount due from Barsha)		

* Rs. 44,200 is realized by discounting the bill. Barsha gets Rs. 42,800 (Rs. 40,000 due to Beena not remitted and Rs. 2,800 now). So Barsha should bear the discount of Rs. 775 [Rs. 800 X Rs.42,800 / Rs. 44,200 = 774.66 = Rs. 775.]

Barsha's A/c

Date	Particular	Rs.	Date	Particular	Rs.
2013 Jan 1	To, Bills Payable	60,000	2013 Jan 1	By Bank A/c	19700
4-Apr	To, Bank A/c	2800		By, Discount A/c	300
	To, Discount A/c	775	4-Apr	Bills Receivable A/c	45,000
7-May	To, Bank A/c	45000		By, Bank A/c	17430
				By, Bad Debts	26,145
		108,575			**108,575**

Working Note

1. Calculation of amount realized from Barsha

Total amount due	43,575
40% of Rs. 43,575	17,430
Bad debts written (Rs. 43,575-Rs.17,430)	26,145

IN THE BOOKS OF BARSHA

JOURNAL ENTRIES

Date	Particular		Dr.(Rs.)	Cr. (Rs.)
2013				
1-Jan	Bills Receivable Account	Dr.	60,000	
	To, Beena's A/c			60,000
	(Acceptance received from Beena)			
`	Bank Account	Dr.	59,100	
	Discount Account	Dr.	900	
	To, Bills Receivable Account			60,000
	(Beena's acceptance discounted at bank at 6%)			
	Beena' A/c	Dr.	20,000	
	To, Bank A/c			19,700
	To, Discount Account			300
	(One-third of proceeds remitted to Beena)			

4-Apr	Beena Account	Dr.	45,000	
	To, Bills Payable Account			45,000
	(Acceptance forwarded to Beena on account of amount due to her)			
	Bank Account	Dr.	2,800	
	Discount Account	Dr.	775	
	To, Beena's A/c			3,575
	(Amount received form Beena and discount credited to her)			
	Bills Payable Account	Dr.	45,000	
	To, Beena's A/c			45,000
	(Acceptance to Beena dishonored because of insolvency)			
	Beena Account	Dr.	43,575	
	To, Bank's A/c			17,430
	To, Deficiency Account			26,145
	[Amount paid (40%) and balance credited to Deficiency Account as being unable to pay]			

3.5.7 Bills for Collection

When a person receives a bill of exchange he may decide to receive the total amount by keeping it till the date of maturity. But in order to ensure safety, he may send it to bank with instructions that the bill should be retained till maturity and should be realized on that date. This does not mean discounting because the bank will not credit the client until the amount is actually realized. If the bill is sent to the bank for collection it is known as "Bill sent for Collection". In that case following entry will be made:

1. When Bills sent for collection
   Bills for Collection Account Dr.
   To, Bills Receivable Account
2. When the amount is realized the entry will be
   Bank Account Dr.
   To, Bills for Collection Account

3. When the amount is not honored, the entry will be
Party A/c Dr.
To, Bills for Collection A/c

3.5.8 Retirement of Bill of Exchange

Retiring a bill is the act of withdrawing a bill of exchange from circulation when it has been paid before the due date. When the drawee of the bill desires to make payment before the due date of the bill and the drawer agrees it, it is called retirement of bill. In such a case the acceptor gets a certain rebate or interest or discount for premature payment. The interest becomes the income of the acceptor and expenses of the payee. It is consideration of premature payment.

Illustration 5

On 1st January 2013, Bishal draws a bill of exchange for Rs. 10,000 due for payment after 3 months on Kalpana and accepted by Kalpana. On 4th March 2013 Kalpana retires the bill at a discount of 12%. You are required to show the journal entries in the books of both parties.

JOURNAL ENTRIES
IN THE BOOKS OF KALPANA

Date	Particulars		Debit	Credit
2013	Bishal A/c	Dr.	10,000	
1-Jan	To, Bills Payable A/c			10,000
	(Being the bill drawn by him accepted)			
4-Mar	Bills Payable A/c	Dr.	10,000	
	To, Bank Account			9,900
	To, Discount A/c			100
	(Being retirement of acceptance 1 month before maturity, interest allowed at 12% p.a.)			

JOURNAL ENTRIES
IN THE BOOKS OF BISHAL

Date	Particulars		Debit	Credit
2013	Bills Receivable A/c	Dr.	10,000	
1-Jan	To, Kalpana's A/c			10,000
	(Being bill of exchange drawn on Kalpana due for payment on 4th April 2013)			
4-Mar	Bank A/c	Dr.	9,900	

	Interest (Discount) A/c Dr.	100	
	To, Bills Receivable A/c		10,000
	(Being bill of exchange has been retired 1 month prior to maturity, the rebate being given to him at 12% p.a.)		

Illustration 6

X draws a three month's bill of exchange for Rs. 15,000 on his debtor Y, who accepts it on 1.1.2013, discounted the bill on 4th January with his bank, the discount are being 10% p.a. On the due date, the bill is dishonored by Y, noting charges being Rs. 50. On 4.4.2013, Y makes an offer to X to pay him Rs. 5,000 cash on account and to settle the balance by agreeing to accept one bill for Rs. 6,000 at one month, and other for the balance at three months-the later including interest @ 12% p.a. for both the bills. X accepts the arrangements. The first bill is met on the due date. But before the maturity of the second bill Y becomes insolvent and a dividend of 50 paisa in the rupee is realized from his estate on 4.7.2013. Show the journal entries in the books of X and Y.

Solution

JOURNAL ENTRIES
IN THE BOOKS OF X

Date	Particulars	Debit	Credit
2013 1-Jan	Bills Receivable A/c Dr. To, Y A/c (For bill drawn on Y accepted)	15,000	 15,000
4-Jan	Bank A/c Dr. Discount A/c Dr. To, Bills Receivable A/c (For discounting bill with banker @ 10% p.a.)	14,625 375	 15,000
4-Apr	Y's A/c Dr. To, Bank A/c (For the bill dishonored at maturity and noting charges Rs. 50)	15,050	 15,050
"	Cash A/c Dr. To, Y's A/c (For cash received from Y as partial payment)	5,000	 5,000

"	Y's A/c Dr. To, Interest A/c (Note 1) (For interest charged for renewing bill)		182	 182
"	Bills Receivable A/c Dr. To, Y's A/c (For a fresh bill drawn on Y for 1 month)		6,000	 6,000
"	Bills Receivable A/c Dr. To, Y's A/c (For another bill drawn on Y for balance along with interest for the both the bills)		4,232	 4,232
7-May	Bank A/c Dr. To, Y's A/c (For discharge of 1st bill on maturity date)		6,000	 6,000
	Y's A/c Dr. To, Bills Receivable (For dishonored of 2nd bill on maturity)		4,232	 4,232
4-Jul	Bank A/c Dr. Bad debts A/c Dr. To, Y's A/c (For 50% of the amount due from Y received on full settlement)		2,116 2,116	 4,232

Working Note

1. Interest on Rs. 6,000 @ 12% p.a. for 1 month and on Rs. 4,050 @ 12% for 3 months = Rs. (60+121.50) = 181.50 (say) 182.

2. Rs. 15,000 – Rs.(5,000+6,000) + Rs. 182 =Rs. 4,232.

JOURNAL ENTRIES
IN THE BOOKS OF Y

Date	Particulars		Debit	Credit
2013	X's A/c	Dr.	15,000	
1-Jan	To, Bills Payable Account			15,000
	(For acceptance of bill from X)			
4-Jan	Bills Payable A/c	Dr.	15,000	
	Noting Charges A/c	Dr.	50	
	To, X's A/c			15,050
	(For bill dishonored by us at maturity and noting charges)			
4-Apr	X's A/c	Dr.	5,000	
	To, Cash A/c			5,000
	(For partial payment made)			
	Interest A/c	Dr.	182	
	To, X's A/c			182
	(For interest charged on renewing bill)			
	X's A/c	Dr.	6,000	
	To, Bills Payable A/c			6,000
	(For acceptance of fresh bill drawn by X for 1 month)			
	X's A/c	Dr.	4,232	
	To, Bills Payable A/c			4,232
	(For acceptance of another bill for balance along with interest for the both the bills)			
7-May	Bills Payable A/c	Dr.	6,000	
	To, Bank A/c			6,000
	(For discharge of 1st bill on maturity date)			

	Bills Payable A/c Dr. To, X's (For dishonored of 2nd bill on maturity)	4,232	 4,232
4-Jul	X's A/c Dr. To, Bank A/c To, Deficiency A/c (For 50% of the amount due to X paid on full settlement)	4,232	 2,116 2,116

Illustration 7

Surendra draws on Rajendra a bill for Rs 45,000 on 1st June 2011 for 3 months. Rajendra accepts the bill and sends it to Surendra who gets it discounted for Rs. 44,100. Surendra immediately remits Rs 14,700 to Rajendra. On the due date Surendra being unable to remit the amount due, accepts a bill for Rs. 63,000 for 3 months which is discounted by Rajendra for Rs. 61,650. Rajendra sends Rs. 11,100 to Surendra. On the due date, Surendra becomes insolvent, his estate paying 40 paise in the rupee. Give Journal entries in the books of Surendra.

Solution

Journal Entries in books of Surendra

Date	Particulars	Debit (Rs.)	Credi(Rs.)
2011 June 1	Bills Receivable A/c To Rajendra (Being acceptance received from Rajendra)	45,000	 45,000
June 4	Bank A/c Discount A/c To Bills Receivable A/c (Being bill discounted with bank)	44,100 900	 45,000
June 4	Rajendra To Bank A/c To Discount A/c (Being 1/3rd proceeds of the discounted bill remitted to Rajendra)	15,000	 14,700 300
Sept 4	Rajendra A/c To Bills Payable A/c (Being acceptance given to Rajendra)	63,000	 63,000

Sept 4	Bank A/c Discount A/c To Rajendra (Being amount received from Rajendra)	11,100 900	 12,000
Dec 7	Bills Payable A/c To Rajendra (Being bill dishonored due to insolvency)	63,000	 63,000
Dec 7	Rajendra To Bank A/c To Deficiency (Being 40% share paid to Rajendra from our estate)	42,000	 16,800 25,200

Working Note: Calculation of discount to be borne by Surendra
Amount due by Surendra but not remitted to Rajendra(45,000-15,000) 30,000
Add: Amount received by Surendra from Rajendra 11,100
Total amount due to Rajendra 41,100
Discount to be borne = Rs. 1,350 *41,110/61,650 = Rs 900

3.6 BILLS RECEIVABLE AND BILLS PAYABLE BOOKS

Bills Receivable and Bills Payable books are journals (Day books) to record in a chronological order the details of bills receivable and bills payable. When large numbers of bill transactions take place in an organization, it is convenient to maintain these books. Wherein any bill transaction takes place, the same is entered in the first instance. Posting to individual debtors or creditors accounts are made from the Day books. Also total of Bills Receivable Account and Bills Payable Account respectively. These books are very useful for following up the status of outstanding bills. When there is large number of bills and these bills fall due on different dates, some of these bills may not be honored on maturity due to some reason or the other. It is possible from these Day Books to trace the details of the outstanding bills and to identify the reasons for not honoring the bills. Given bellow are forms of Day Books for both bills receivable and bills payable:

BILL RECEIVABLE BOOK

S.NO	DATE OF RECEIPT	FROM WHOM RECEIVED	NAME OF DRAWER	NAME OF ACCEPTOR	DATE OF BILL DRAWN	TERM OF BILL	DATE OF MATURITY	WHERE RECEIVABLE	L.F	AMOUNT

BILL PAYABLE BOOK

S.NO	DATE OF RECEIPT	FROM WHOM RECEIVED	NAME OF DRAWER	NAME OF PAYEE	DATE OF BILL DRAWN	TERM OF BILL	DATE OF MATURITY	WHERE PAYABLE	L.F	AMOUNT

Summary

Bills of exchange are exchangeable documents used as substitute of mode of payment. Bills of exchange and promissory notes are used as a means of discharging creditors as well as raising finance. Generally three parties, maker, acceptor and payee are involved in bills of exchange. Noting charge arise when bills are dishonored due to any cause. Acceptor can discharge his liability before due date at rebate or discount. We should have carefully understood the accounting treatments require to issue, acceptance, endorsement, discounting, maturity and insolvency of the parties relating to these. Sometimes two or more parties may make accommodation bills to fulfill their short term financial needs. Accommodation Bill is a bill of exchange which has been drawn on and accepted by a reputable party for the purpose of giving value to the bill so that it can be discounted.

Self-Examination Questions

I. Multiple Choice Questions (MCQs)

1. Under which circumstances drawer and payee is same person
   (a) When drawer discounted the bill with banker
   (b) When drawer held the bill till maturity

(c) When drawer endorse the bill to the third party
(d) When drawer rejects to accept the bill

2. If the due date is a public holiday, what will be the due date of the bill
(a) Following day (b) Preceding day
(c) The same day only (d) One month later

3. Mr. A sold goods to Mr. B
(a) B can draw bill to A (b) A can accept the bill
(c) A can draw bill to B (d) A can draw bill to C

4. When the bills are to be produced to notary public
(a) At the time of drawing the bill (b) At the time of acceptance of the bill
(c) At the time of dishonored of the bill (d) At the time of collection of the bill

5. The promissory note should be signed by
(a) Drawer (b) Drawee
(c) Payee (d) Promisor

6. Ultimately noting charge should be recorded as expense by
(a) Drawer (b) Acceptor
(c) Endorsee (d) Promisor

7. Which of the following instrument is not a negotiable instrument
(a) Bearer cheque (b) Promissory Note
(c) Crossed cheque (d) Bills of Exchange

8. The purpose of accommodation bill is
(a) To finance actual purchase or sale of goods
(b) To facilitate trade transactions
(c) To meet short term financial need of the parties
(d) None of the above

9. On 1.1.2013, A draws a bill on B for Rs. 15,000 for 3 months. At maturity B request A to accept Rs. 5,000 in cash and for balance to draw a fresh bill for 2 months together with 12% p.a. interest, amount of interest will be
(a) Rs. 200 (b) Rs. 300
(c) Rs. 240 (d) Rs. 380

10. For mutual accommodation of X and Y, Y accepted a bill drawn on him by X for 2 months for Rs. 6,000. The said bill is discounted at 12% p.a. and remitted 1/3rd of the proceeds to Y. The amount remitted by X to Y will be
(a) Rs. 2,000 (b) Rs. 1,960
(c) Rs. 1,920 (d) Rs. 1,900

11. Sweta draws a bill on Malina for Rs. 50,000 for 3 months. At maturity, the bill returned dishonored, noting charge Rs. 500. Malina's estate realized only 40 paisa in a rupee. The amount of deficiency to be recorded on insolvency in the books of Malina will be
(a) Rs. 20,200 (b) Rs. 30,300
(c) Rs. 19,800 (d) Rs. 19,000

12. Nepalese currency is a
(a) Bill of Exchange (b) Promissory Note
(c) Hundi (d) Cheque

II. Short Descriptive Questions (SDQs)

1. What is bill of exchange? What are its features?
2. Differentiate between
   (a) Promissory Note and Bills of Exchange
   (b) Trade Bill and Accommodation Bill
3. Write Short Note
   (a) Noting Charge
   (b) Dishonored of the bill
   (c) Insolvency of the parties
   (d) Bills receivable and payable books

III. Practical Questions (PQs)

1. On 1st January 2005, X sold goods worth Rs. 20,000 to Y and drew a bill on Y at three months for the amount. Y accepted the bill and returned it to X. The bill is duly honored at maturity. Pass the necessary journal entries in the books of X and Y.
   i. If X retained the bill till the due date.
   ii. If X discounted the bill with a bank on 1st February at 15% p.a.
   iii. If X endorsed the bill on 1.3.2005 to Z for full settlement of Rs. 20,500.

2. Bikulal received from one of his customer a bill at three months for Rs. 20,000. He discounted it on the same day for Rs. 19,500 with his banker. On the date of maturity the bill was dishonored. The bank incurred noting charges of Rs. 100. However, the customer paid him Rs. 10,000 plus noting charges plus interest for three months amounting to Rs. 250 in cash and accepted a fresh bill at three months for Rs. 10,000, being the balance amount due from him. The second bill was duly honored on due date. Pass journal entries in the books of Bikulal.

3. Journalize the following in the books of King:
   a. King's acceptance to Prince for Rs. 2,500 discharged by a cash payment of Rs. 1,000 and a new bill for the balance plus Rs. 50 for interest.
   b. N. Niraula's acceptance for Rs. 4,000 which was endorsed by King to D. Basnet, was dishonored. Basnet paid Rs. 20 noting charges.
   c. B. Dahal retires a bill for Rs. 2,000 drawn on him by King for Rs. 10 discount.

d. King's acceptance to P. Pradhan for Rs. 5,000 discharged by P. Shrestha's acceptance to King for a similar amount.
e. King's acceptance to S. Sunar for Rs. 4,000 was discharged by a cash payment of Rs. 2,020 and new bill for Rs. 2,000.

4. Mr. D draws two bills on 1st Jan. 2008 for Rs. 6,000 and Rs. 10,000. The bill for Rs. 6,000 is for two months and the bill for 10,000 is for three months. These bills are accepted by Mr. T. On 4th March 2008, Mr. T requests Mr. D to renew the first bill with interest at 18%p.a. for a period of two months. Mr. D agrees to this proposal. On 20th March, Mr. T retires the acceptance for Rs. 10,000 the interest rebate being Rs. 100. Before the due date of renewed bill, Mr. T becomes insolvent and only 45% was realized from his properties. You are asked to pass necessary entries in the books of Mr. D.

5. Bikram draws three bills of exchange on 1st January, 2008 for Rs. 8,000, Rs. 9,000 and Rs. 13,000 respectively. The bill of exchange for Rs. 13,000 is for 2 months, while others are for 3 months. These bills are accepted by Kuber. The second bill was discounted by Bikram on the same date with his bank at 95% of the value. The third bill was transferred on 16th February 2008 to Kranti as full settlement of Rs. 13,450. On 4th March, 2008 Kuber requests Bikram to renew the first bill with interest at 15%p.a. for a period of 3 months. Bikram agrees to this proposal. On the due date Kuber retires the acceptance for Rs. 13,000 and Rs. 8,000.
However, before the due date of the renewal bill Kuber becomes insolvent and only 55 paisa in a rupee can be recovered from his estate. You are asked to show the journal entries in the books of Bikram and Kuber.

6. Shobha draws 2 bills of exchange on 1st January, 2012 for Rs. 3,000 and Rs. 5,000 respectively. The bill of exchange for Rs. 3,000 is for 2 months, while the bill of exchange for Rs. 5,000 is for 3 months. These bills are accepted by Kriti. On 4th March, 2012 Kriti requests Shobha to renew the first bill with interest at 18%p.a. for a period of 2 months. Shobha agrees to this proposal. On 20th March, 2012 Kriti retires the acceptance for Rs. 5,000 the interest rebate i.e. discount being Rs. 50.
Before the due date of the renewal bill Kriti becomes insolvent and only 60 paisa in a rupee can be recovered from her estate. You are asked to show the journal entries in the books of Shobh and Kriti.

7. On 1st January 2007, Pukar draws a bill of Rs. 50,000 on Queen who accepts the same and returns it to Pukar. Draw up the necessary Journal entries in the books of Pukar in the following cases when the bill is dishonored on the due date (4.4.2007):
   a. Bill has been retained till the due date and noting charges paid are Rs. 500.
   b. On 4.2.2007, Pukar discounted the bill with the bank at 15% p.a.
   c. Pukar endorses the bill on 1.2.2007 in favor of his creditor Raghu in full settlement of his dues of Rs. 51,000. Raghu paid noting charges of Rs. 550.
   d. Pukar had sent the bill to the bank for collection on due date and bank paid noting charges of Rs. 400

8. On 1.1.2004, Mohan for the temporary and mutual accommodation of himself and Sohan, draws upon the latter a bill of exchange at 3 months for Rs. 2,000. On 4th Jan, Mohan discounted the bill @ 6%p.a. and hands half the proceeds to Sohan. At maturity Mohan remits the remaining amount due to Sohan who meets the bill. Pass Journal entries in the books of both the parties.

9. Shubha draws on Rajendra a bill for Rs. 45,000 on 1st June 2001 for three months. Rajendra accepts the bill and sends it to Shubha who gets it discounted for Rs. 44,100. She immediately remits Rs. 14,700 to Rajendra. On the due date Shubha, being unable to pay the amount due to Rajendra, accepts a bill for Rs. 63,000 for three months which is discounted by Rajendra for Rs. 61,650. Rajendra sends Rs. 11,100 to Shubha. On the due date Shubha becomes insolvent and only 55% was recovered from her personal properties.
You are asked to pass necessary entries in the books of both the parties.

10. On 1st July, 2012 G drew a bill for Rs. 80,000 for 3 months on H for mutual accommodation. H accepted the bill of exchange.
G had purchased goods worth Rs. 81,000 from J on the same date. G endorsed H's acceptance to J full settlement.
On 1st September, J purchased goods worth Rs. 90,000 from H. J endorsed the bill of exchange received from G to H and paid Rs. 9,000 in full settlement of the amount due to H.
On 1st October 2012 H purchased goods worth Rs. 100,000 from G. He paid the amount due to G by cheque.
Give the necessary Journal Entries in the books of H.

ANSWER

Multiple Choice Questions (MCQs)

1	b	6	b	11	b
2	b	7	c	12	b
3	c	8	c		
4	c	9	a		
5	d	10	b		

CHAPTER- 5

Accounting for Special Transactions

UNIT 4:

Accounting for Royalty

Learning Objectives

1. *To understand the parties related to royalty agreement.*
2. *To familiarize with technique of calculation of Royalty amount.*
3. *To understand the calculation of short working, accounting treatment of short working and recovery of short working from surplus;*
4. *To understand the accounting system of recording royalty related transaction in the books of owner of asset and user of assets.*

4.1 INDTRODUCTION

Royalty is a periodical payment based on output or sale for the use of a certain asset to its owner against the obtaining rights to use in their business. So, we can say that the royalty is the amount of consideration paid by one party to the owner of the asset in return for the right to use that asset. For example, when a publisher publishes a book, he makes a payment – royalty to the author which is based on the number of copies sold or published.

A royalty is generally, paid to the owner of the right, under the following cases:

1. Where the owner of a mine allows another the right to extract minerals from land.
2. Where right such as patents or copyrights are licensed in favor of another,
3. Where an author, artist or designer gives exclusive rights to another to copy the work.

The generic term 'Landlord; has been used to include lessors, authors and patent owners and the term 'lessee' to include publishers, licensee etc.

4.2 MINIMUM RENT/DEAD RENT

A contract is entered into between the landlord and the lessee for payment of royalty, usually calculated upon the quantum of production or sale at a certain stipulated rate. This means that if there were little or no production or sale, the landlord would receive little or no royalty at all, thus undermining the monetary interest of the landlord as well as the lessee. For some reasons or other, the lessee may not take that much effort and enthusiasm in the execution of the work to which royalty relates. To avoid such a situation, the landlord and the lessee agree upon a 'minimum periodical amount that the landlord will receive from the lessee, even if the actual royalty as calculated on the basis of actual production or sale is less than such minimum amount. This assured and mutually agreed periodical minimum amount is known as "Minimum Rent". Generally, royalty agreements are usually associated with a clause that the lessor or landlord must receive a minimum amount whatever be the production or sales in a particular period.

Example:

Suppose royalty per ton of production is Rs.100 and the minimum (annual) rent is Rs. 500,000. Now if the actual production is 3,000 tons, then actual royalty would become Rs. 300,000. In this case the minimum rent of Rs. 500,000 will have to be paid by the lessee. On the other hand, if the actual production is 6,000 tons, then the actual royalty would become Rs. 600,000. In this case Rs. 600,000 will have to be paid by the lessee. Thus, as there is a stipulation for minimum rent, then either the minimum rent or the actual royalty whichever is more shall have to be paid by the lessee.

4.3. SHORT WORKINGS

The excess of minimum rent over actual royalty calculated on the basis of output or sales is termed as ‘shortworkings’. In other words, it refers to the amount by which the actual royalty falls short of the minimum rent. In the above example, the shortworkings is Rs. 200,000 (Rs. 500,000 – Rs. 300,000). Where there is shortworkings in any period the lessee is liable to pay the minimum rent and, in effect, shortworkings becomes the part of the minimum rent not represented by the use of rights. The question of shortworkings will arise only when there is a stipulation for minimum rent in the agreement.

4.4 EXCESS WORKINGS/SURPLUS

It refers to the amount by which the actual royalty exceeds the minimum rent. In the above example, the excess workings is Rs. 100,000 (Rs. 600,000 – Rs. 500,000) if the production is 6,000 tons.

4.5 RECOUPING OF SHORT WORKINGS

In simple, recoupment means adjustment. Usually in the first few years of the royalty agreement, the work does not gather the required momentum because of the time taken in the preparation for starting the production or pushing up the sales, so shortworkings arising in the first few years may not be due to inefficiency of the lessee. Keeping this in view, royalty agreements may contain a clause that shortworkings (i.e. excess amount paid in earlier years) are recoverable by the lessee in subsequent years when royalties are in excess of the minimum rent. The right of getting back the excess payment made by the lessee in earlier years is called the right of recoupment of shortworkings. A time is usually set upon the number of years for which such shortworkings can be recouped. This time limit for recoupment of shortworkings may be fixed or fluctuating. If the shortworkings (partly of wholly) cannot be recouped within the specified time, they lapse and are charged to Profit and Loss Account in the period when such specified time limit for recoupment expires. Therefore, shortworkings are the losses of the lessee, not in the year of their occurrence, but in the year they lapse.

Fixed Right:

When the lessee can recoup shortworkings within a certain period from the date of the lease, it is termed as fixed right. For example, shortworking can be recouped within four years from the date of lease. The shortworking of subsequent years cannot be recouped.

Fluctuating Right:

When the lessee can recoup shortworking of any year during the next following year(s) as per agreement, it is termed as fluctuating right. For example, shortworking can be recouped in the next two years subsequent to the year of shortworkings.

Any shortworkings which cannot be recouped within the specified period becomes irrecoverable and it should be charged to Profit and Loss Account in the year in which it becomes so. However, the recoverable shortworkings should be carried forward and they are shown in the Statement Of Financial Position as a current asset.

The question of shortworking or its recoupment does not arise if the royalty agreement does not contain a clause of minimum rent. In such a case, the payment of royalty is simply based on output or sales.

4.6. ACCOUNTING ENTRIES

4.6.1 Accounting Entries in the Books of Lessee

a. Where a Minimum Rent Exist With Right to Recoup Shortworkings

(i) <u>Where the actual royalty is less than the minimum rent</u>

S.no	Particular	Remarks
1	Royalties Account Dr. Shortworking Account Dr. To, Landlord Account	[Actual royalties for the period] Amount by which the royalties fall short [Minimum rent]
2	Landlord Account Dr. To, Bank Account To, Tax Payable A/c	[Minimum rent] [Net amount paid] [Tax Deducted at Source]
3	Manufacturing/P&L A/c Dr. To, Royalty A/c	[Transfer] [Actual royalty for the period]

	Alternatively, when a separate Minimum Rent Account is maintained, the accounting entries will be as follows:	
1	Minimum Rent Account Dr. To, Landlord Account	[Minimum Rent]
2	Royalty A/c Dr. Shortworking Account Dr. To, Minimum Rent A/c	[Actual royalty for the period] Amount by which the royalties fall short
3	Landlord Account Dr. To, Bank Account To, Tax Payable A/c	[Minimum Rent] [Net amount paid] [Tax Deducted at Source]
4	Manufacturing/P&L A/c Dr. To, Royalty A/c	[Transfer] [Actual royalty for the period]

(ii) When actual royalty is more than minimum rent

S.no	Particular		Remarks
1	Royalty A/c To, Landlord A/c	Dr.	[Actual royalty for the period]
2	Landlord Account To, Bank A/c To, Tax Payable A/c	Dr.	
3	Landlord Account To Shortworking A/c To Bank A/c	Dr	[Recoupment of Shortworking]
4	P & L A/c To, Shortworkings A/c	Dr.	[Shortworking which cannot be recouped]
5	Manufacturing/P&L A/c To, Royalty A/c	Dr.	[Transfer]

Illustration 1

M/s. Koilapani Co. Ltd. took from Mr. Rameshwor a lease of coal field for a period of 25 years from January 1, 2009 on royalty of Rs. 1 per ton of coal raised, with a minimum rent of Rs. 60,000 per year and power to recoup shortworkings during the first three years of the lease. The annual output was as follows (in ton)

2009 – 10,000, 2010 – 70,000, 2011 – 80,000, and 2012 – 120,000

You are required to pass necessary Journal entries in the books of M/s. Koilapani Co. Ltd. when (a) no separate Minimum Rent A/c is maintained. (b) Separate Minimum Rent A/c is maintained. Ignore taxation.

Solution

Statement of Royalty

Year	Output	Actual Royalties	Minimum Rent	Surplus	Shortworking				Amount Payable
					Suffered	Recouped	Written Off	C/F	
2009	10,000	10,000	60,000	-	50,000	-	-	50,000	60,000
2010	70,000	70,000	60,000	10,000	-	10,000	-	40,000	60,000
2011	80,000	80,000	60,000	20,000	-	20,000	20,000	-	60,000
2012	120,000	120,000	60,000	60,000	-	-	-	-	120,000

Explanations:

(i) In the year 2009 the actual royalty is Rs. 10,000 but the minimum rent is Ra. 60,000. Therefore, shortworking is Rs. 50,000 (Rs. 60,000 – Rs. 10,000)

(ii) In the year 2010 the actual royalty is Rs. 70,000. Therefore, the surplus is Rs. 10,000. Only Rs. 10,000 of the 2009's shortworking can be recouped. The balance shortworking of Rs. 40,000 to be carried forwarded to next year.

(iii) In the year 2011 the actual royalty is Rs. 80,000. Therefore, the excess of Rs. 20,000 can be used to recoup previous years' shortworking. The balance Rs. 20,000 to be written off to P/L A/c as an expense because 2011 is the last year for recoupment of shortworking.

In the books of M/s. Koilapani Co. Ltd.

Journal Entries

Date	Particulars		Dr. Rs.	Cr. Rs.
2009	Royalty A/c	Dr.	10,000	
Dec 31	Shortworking A/c	Dr.	50,000	
	To, Rameshwor A/c			60,000
	(Being royalties @ Rs.1 per ton on 10,000 tons subject to a minimum rent of Rs. 60,000)			
	Rameshwor A/c	Dr.	60,000	
	To, Bank A/c			60,000
	(Being amount paid in respect of royalties)			
	Profit and Loss A/c	Dr.	10,000	
	To, Royalty A/c			10,000
	(Being transfer of actual royalties to P/L A/c)			
2010	Royalty A/c	Dr.	70,000	
Dec 31	To, Rameshwor A/c			70,000
	(Being royalties @ Rs.1 per ton on 70,000 tons)			
	Rameshwor A/c	Dr.	70,000	
	To, Shortworking A/c			10,000
	To, Bank A/c			60,000
	(Being amount paid in respect of royalties after recoupment of shortworking Rs. 10,000)			
	Profit and Loss A/c	Dr.	70,000	
	To, Royalty A/c			70,000
	(Being transfer of actual royalties to P/L A/c)			
2011	Royalty A/c	Dr.	80,000	
Dec 31	To, Rameshwor A/c			80,000
	(Being royalties @ Rs.1 per ton on 80,000 tons)			
	Ram A/c	Dr.	80,000	
	To, Shortworking A/c			20,000

	To, Bank A/c		60,000
	(Being amount paid in respect of royalties after recoupment of shortworking Rs. 20,000)		
	Profit and Loss A/c Dr.	80,000	
	To, Royalty A/c		80,000
	(Being transfer of actual royalties to P/L A/c)		
	Profit and Loss A/c Dr.	20,000	
	To, Shortworking A/c		20,000
	(Being shortworking irrecoverable transferred to P/L A/c)		
2012	Royalty A/c Dr.	120,000	
Dec 31	To, Rameshwor A/c		120,000
	(Being royalties @ Re.1 per ton on 120,000 tons		
	Rameshwor A/c Dr.	120,000	
	To, Bank A/c		120,000
	(Being amount paid in respect of royalties)		
	Profit and Loss A/c Dr.	120,000	
	To, Royalty A/c		120,000
	(Being transfer of actual royalties to P/L A/c)		

(b) **Journal Entries**

Date	Particulars	Dr. Rs.	Cr. Rs.
2009	Minimum Rent A/c Dr.	60,000	
Dec 31	To, Rameshwor A/c		60,000
	(Being amount payable as minimum rent)		
	Royalty A/c Dr.	10,000	
	Shortworking A/c Dr.	50,000	
	To, Minimum Rent A/c		60,000
	(Being royalties @ Re. 1 per ton on 10,000 tons – balance is transferred to Shortworking Account.)		
	Rameshwor A/c Dr.	60,000	
	To, Bank A/c		60,000
	(Being amount paid in respect of royalties)		
	Profit and Loss A/c Dr.	10,000	
	To, Royalty A/c		10,000
	(Being transfer of actual royalties to P/L A/c)		

Entries for 2010, 2011 and 2012 are same as in solution (a) above because there is no shortworking in these years and thus "Minimum Rent A/c" need not be prepared.

Illustration 2

The PD Brick Company holds a lease of land to produce bricks for a period of ten years, commending from 1st January, 2004. According to lease, the company is to pay Rs. 250 per thousand units of bricks with a minimum rent of Rs. 250,000 per year. Shortworking can, however, be recouped out of the royalty in excess of the minimum rent of next two years only.

For the year of strike the minimum rent is to be reduced to 60%. The output in number of bricks in thousand for the 6 years is as under. 2004 – 400, 2005 – 800, 2006 – 1,200, 2007 – 1,600, 2008 – 2000, and 2009 – 1,000 (Strike).

Solution

Analysis of Royalties Payable

Year	Output no. of bricks in '000	Actual Royalties @ Rs. 250 per thousand	Minimum Rent	Surplus	Shortworking				Amount Payable
					Suffered	Recouped	Written Off	C/F	
2004	400	100,000	250,000	-	150,000	-	-	150,000	250,000
2005	800	200,000	250,000	-	50,000	-	-	200,000	250,000
2006	1,200	300,000	250,000	50,000	-	50,000	100,000	50,000	250,000
2007	1,600	400,000	250,000	150,000	-	50,000	-	-	350,000
2008	2,000	500,000	250,000	250,000	-	-	-	-	500,000
2009 (Strike)	1,000	250,000	150,000	100,000	-	-	-	-	250,000

In the books of PD Bricks Company

Dr. Royalties Account Cr.

Date	Particulars	Rs.	Date	Particulars	Rs.
2004	To, Landlord A/c	100,000	2004	By, Profit and Loss A/c	100,000
2005	To, Landlord A/c	200,000	2005	By, Profit and Loss A/c	200,000
2006	To, Landlord A/c	300,000	2006	By, Profit and Loss A/c	300,000
2007	To, Landlord A/c	400,000	2007	By, Profit and Loss A/c	400,000
2008	To, Landlord A/c	500,000	2008	By, Profit and Loss A/c	500,000
2009	To, Landlord A/c	250,000	2009	By, Profit and Loss A/c	250,000

Note: It assumed that the Company does not prepared a Manufacturing A/c or a Trading A/c. It prepares only Profit and Loss A/c. Therefore, all actual royalties are transferred to Profit and Loss Account.

Dr. Shortworking Account Cr.

Date	Particulars	Rs.	Date	Particulars	Rs.
2004	To, Landlord A/c	150,000	2004	By, Balance c/d	150,000
2005	To, Balance b/d	150,000	2005	By, Balance c/d	200,000
	To, Landlord A/c	50,000			
		200,000			200,000
2006	To, Balance b/d	200,000	2006	By, Landlord A/c	50,000
				By, Profit and Loss A/c	100,000
				By, Balance c/d	50,000

		200,000			200,000
2007	To, Balance b/d	50,000	2007	By, Landlord A/c	50,000

Dr. Landlord Account Cr.

Date	Particulars	Rs.	Date	Particulars	Rs.
2004	To, Bank A/c	250,000	2004	By, Royalties A/c	100,000
				By, Shortworking A/c	150,000
		250,000			250,000
2005	To, Bank A/c	250,000	2005	By, Royalties A/c	200,000
				By, Shortworking A/c	50,000
		250,000			250,000
2006	To, Bank A/c	250,000	2006	By, Royalties A/c	300,000
	To, Shortworking A/c	50,000			
		300,000			300,000
2007	To, Bank A/c	350,000	2007	By, Royalties A/c	400,000
	To, Shortworking A/c	50,000			
		400,000			400,000
2008	To, Bank A/c	500,000	2008	By, Royalties A/c	500,000
2009	To, Bank A/c	250,000	2009	By, Royalties A/c	250,000

Illustration 3

ABC Company obtained from B & Co. Ltd. a lease of some coal bearing land, the terms being a royalty of Rs. 15 per ton of coal raised subject to minimum rent of Rs. 75,000 per annum with a right of recoupment of shortworkings over the first four years of the lease. From the following details show (i) Royalties Account; (ii) Shortworkings Account; and (iii) B & Co. Ltd.

Year	2003	2004	2005	2006	2007
Sale (tons)	2,000	3,500	4,800	5,600	8,000
Closing Stocks	300	400	600	500	800

Solution

Working Notes

1. Calculation of production and royalties

Year	Sales (1)	Closing Stock (2)	Opening Stock (3)	Production (tons) (4)=(1)+(2)-(3)	Royalties (Rs.) (5)
2003	2,000	300	-	2,300	34,500
2004	3,500	400	300	3,600	54,000
2005	4,800	600	400	5,000	75,000
2006	5,600	500	600	5,500	82,500
2007	8,000	800	500	8,300	124,500

2. Analysis of Royalties Payable

Year	Output Tons	Actual Royalties @ Rs. 15 per ton	Minimum Rent	Surplus	Shortworking				Amount Payable
					Suffered	Recouped	Written Off	C/F	
2003	2,300	34,500	75,000	-	40,500	-	-	40,500	75,000
2004	3,600	54,000	75,000	-	21,000			61,500	75,000
2005	5,000	75,000	75,000	-	-	-	-	61,500	75,000
2006	5,500	82,500	75,000	7,500	-	7,500	54,000	-	75,000
2007	8,300	124,500	75,000	49,500	-	-	-	-	124,500

In the books of ABC Company

Dr. Royalties Account Cr.

Date	Particulars	Rs.	Date	Particulars	Rs.
2003	To, B & Co. Ltd. A/c	34,500	2003	By, Manufacturing A/c	34,500
2004	To, B & Co. Ltd. A/c	54,000	2004	By, Manufacturing A/c	54,000
2005	To, B & Co. Ltd. A/c	75,000	2005	By, Manufacturing A/c	75,000
2006	To, B & Co. Ltd. A/c	82,500	2006	By, Manufacturing A/c	82,500
2007	To, B & Co. Ltd. A/c	124,500	2007	By, Manufacturing A/c	124,500

Dr. Shortworking Account Cr.

Date	Particulars	Rs.	Date	Particulars	Rs.
2003	To, B & Co. Ltd. A/c	40,500	2003	By, Balance c/d	40,500
2004	To, Balance b/d	40,500	2004	By, Balance c/d	61,500
	To, B & Co. Ltd. A/c	21,000			
		61,500			61,500
2005	To, Balance b/d	61,500	2005	By, Balance c/d	61,500
2006	To, Balance b/d	61,500	2006	By, B & Co. Ltd. A/c	7,500
				By, Profit & Loss A/c	54,000
		61,500			61,500

Dr. B & Co. Ltd. Account Cr.

Date	Particulars	Rs.	Date	Particulars	Rs.
2003	To, Bank A/c	75,000	2003	By, Royalties A/c	34,500
				By, Shortworking A/c	40,500
		75,000			75,000
2004	To, Bank A/c	75,000	2004	By, Royalties A/c	54,000
				By, Shortworking A/c	21,000
		75,000			75,000
2005	To, Bank A/c	75,000	2005	By, Royalties A/c	75,000
2006	To, Bank A/c	75,000	2006	By, Royalties A/c	82,500

2007	To, Shortworking A/c To, Bank A/c	7,500 82,500 124,500	2007	By, Royalties A/c	82,500 124,500

b. Where No Minimum Rent Exists

In certain cases, the lease agreement may not contain any clause for minimum rent. Therefore, the question of shortworking does not arise. The landlord is entitled to get only the actual royalties. In this situation, the accounting entries are very simple and are as under.

S. No	Particular	Remarks
1	Royalty A/c Dr. To, Landlord A/c	[Actual royalty for the period]
2	Landlord Account Dr. To, Bank A/c To, Tax Payable A/c	
4	Manufacturing/P&L A/c Dr. To, Royalty A/c	[Transfer]

4.6.2 Accounting Entries in the Books of Lessor

(a) Where the royalty is less than the minimum rent

S. No	Particular	Remarks
	Lessee Account Dr To, Royalties Income A/c To, Royalty Suspense/ Shortworking Allowable A/c	[Minimum rent] [Actual royalties for the period]
2	Bank Account Dr. Tax deduction at source A/c Dr. To, Lessee A/c	[Net amount received] [TDS] [Minimum rent]
3	Royalties Income Account Dr. To, Profit and Loss Account	

(b) Where the royalty is more than the minimum rent

S. No	Particular	Remarks
1	Lessee Account Dr. To, Royalties Income Account	[Actual royalties for the period]
2	Bank Account Dr. Tax deduction at source A/c Dr. To, Lessee A/c	[Net amount received] [TDS] [Actual royalties for the period]
3	Royalties Income Account Dr. To, Profit and Loss Account	
4	Royalty Suspense/ Shortworking Allowable A/c Dr. To, Profit and Loss Account	[Shortworking which cannot be recouped]

Illustration 4

The facts are the same as in the illustration 1. You are required to pass necessary journal entries in the books of Ram and also post and balance the appropriate accounts in the ledgers.

Solution

Working Note

Analysis of Royalties Receivable

Year	Output	Actual Royalties	Minimum Rent	Surplus	Shortworking				Amount Payable
					Suffered	Recouped	Written Off	C/F	
2009	10,000	10,000	60,000	-	50,000	-	-	50,000	60,000
2010	70,000	70,000	60,000	10,000	-	10,000	-	40,000	60,000
2011	80,000	80,000	60,000	20,000	-	20,000	20,000	-	60,000
2012	120,000	120,000	60,000	60,000	-	-	-	-	120,000

In the books of Mr. Rameshwor
Journal

Date	Particulars	Dr. Rs.	Cr. Rs.
2009 Dec 31	Koilapani Co. Ltd. A/c Dr. To, Royalties Income A/c To, Royalty Suspense A/c	60,000	 10,000 50,000

	(Being royalties @ Rs.1 per ton on 10,000 tons subject to a minimum rent of Rs. 60,000)		
	Bank A/c Dr.	60,000	
	To, Koilapani Co. Ltd. A/c		60,000
	(Being amount received in respect of royalties)		
	Royalties Income A/c Dr.	10,000	
	To, Profit and Loss A/c		10,000
	(Being transfer of actual royalties income to P/L A/c)		
2010	Koilapani Co. Ltd. A/c Dr.	70,000	
Dec 31	To, Royalties Income A/c		70,000
	(Being royalties (receivable) @ Re.1 per ton on 70,000 tons)		
	Bank A/c Dr.	60,000	
	Royalty Suspense A/c Dr.	10,000	
	To, Koilapani Co. Ltd. A/c		70,000
	(Being amount received in respect of royalties after recoupment of shortworking Rs. 10,000)		
	Royalties Income A/c Dr.	70,000	
	To, Profit and Loss A/c		70,000
	(Being transfer of actual royalties income to P/L A/c)		
2011	Koilapani Co. Ltd. A/c Dr.	80,000	
Dec 31	To, Royalties Income A/c		80,000
	(Being royalties (receivable) @ Rs.1 per ton on 80,000 tons)		
	Bank A/c Dr.	60,000	
	Royalty Suspense A/c Dr.	20,000	
	To, Koilapani Co. Ltd. A/c		80,000
	(Being amount received in respect of royalties after recoupment of shortworking Rs. 20,000)		
	Royalties Income A/c Dr.	80,000	
	To, Profit and Loss A/c		80,000
	(Being transfer of actual royalties income to P/L A/c)		
	Royalty Suspense A/c Dr.		
	To, Profit and Loss A/c	20,000	
	(Being shortworking irrecoverable transferred to P/L A/c)		20,000
2012	Koilapani Co. Ltd. A/c	120,000	
Dec 31	To, Royalties Income A/c		120,000
	(Being royalties @ Rs.1 per ton on 120,000 tons)		
	Bank A/c Dr.	120,000	
	To, Koilapani Co. Ltd. A/c		120,000
	(Being amount received in respect of royalties)		
	Royalties Income A/c Dr.	120,000	
	To, Profit and Loss A/c		120,000
	(Being transfer of actual royalties (receivable) to P/L A/c)		

Ledger

Koilapani Co. Ltd. Account

Date	Particulars	Rs.	Date	Particulars	Rs.
2004	To, Royalties Income A/c	10,000	2004	By, Bank A/c	60,000
	To, Royalty Suspense A/c	50,000			
		60,000			60,000
2005	To, Royalties Income A/c	70,000	2005	By, Bank A/c	60,000
				By, Royalty Suspense A/c	10,000
		70,000			70,000
2006	To, Royalties Income A/c	80,000	2006	By, Bank A/c	60,000
				By, Royalty Suspense A/c	20,000
		80,000			80,000
2007	To, Royalties (receivable) A/c	120,000	2007	By, Bank A/c	120,000

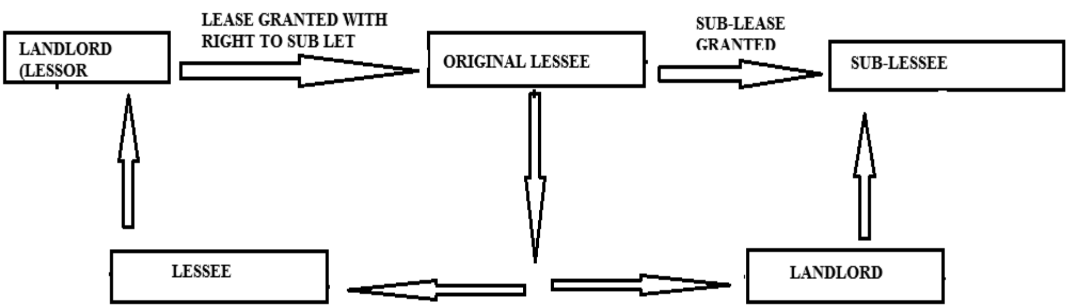
Dr. Royalty Suspense Account Cr.

Date	Particulars	Rs.	Date	Particulars	Rs.
2004	To, Balance c/d	50,000	2004	By, Raniganj Coal Co. A/c	50,000
2005	To, Raniganj Coal Co. A/c	10,000	2005	By, Balance b/d	50,000
	To, Balance c/d.	40,000		By, Raniganj Coal Co. A/c	
		50,000			50,000
2006	To, Raniganj Coal Co. A/c	20,000	2006	By, Balance b/d	40,000
	To, Profit and Loss b/d	20,000			
		40,000			40,000

Dr. Royalties Income Account Cr.

Date	Particulars	Rs.	Date	Particulars	Rs.
2004	To, Profit & Loss A/c	10,000	2004	Koilapani Co. Ltd.	10,000
2005	To, Profit & Loss A/c	70,000	2005	Koilapani Co. Ltd.	70,000
2006	To, Profit & Loss A/c	80,000	2006	Koilapani Co. Ltd.	80,000
2007	To, Profit & Loss A/c	120,000	2007	Koilapani Co. Ltd.	120,000

4.7 SUB-LEASE



If the royalty agreement contains a provision for sub-lease, the original lease may sub-lease to another person either of the whole or a part of the property right (or any other right), generally at an increase royalty. In the sub-lease, the original lessee takes the place of the landlord. Thus a third party becomes involved. In this case, the original lessee is liable to the landlord for the agreed royalty on the total output/sale (own + sub-lease) irrespective of the terms and conditions of the agreement made between the original lessee and the sub-lessee. The original lessee has two sets of relationship.

(a) he is a lessee of the original landlord, and
(b) he is a landlord of the sub-lessee.

4.7.1 Accounting Arrangement

(a) In the books of the original lessee

a. Journal entries where the actual royalty is less than the minimum rent

S.no	Particular		Remarks
1	Royalties Account Shortworking Account To, Landlord Account (being royalties payable to landlord on total production subject to minimum rent)	Dr. Dr.	[Actual royalties for the period] (Own + Sub lease) Amount by which the royalties fall short [Minimum rent]
2	Landlord Account To, Bank Account To, Tax Payable A/c (Being the amount paid to landlord after deducting tax)	Dr.	[Minimum rent] [Net amount paid] [Tax Deducted at Source]
3	Sub-leasee Account To Royalties Income A/c To Royalties Suspense A/c (Being royalties receivable from sub lessee subject to minimum rent)	Dr.	Minimum rent applicable for sub lessee Actual royalties from sub lessee Minimum rent - Actual royalties
4	Bank Account Tax deduction at source A/c To, Sub-Lessee A/c	Dr. Dr.	Actual amount received TDS deducted by the sub lessee

	(Being the amount received from sub lessee after tax deducted at source	
5	Royalities Income A/c Dr. To Royalties Payable A/c To Profit and Loss A/c (Being Royalties on the production of the sub lessee adjusted against royalties payable account and profit on sub lease credited to P/L A/c)	Royalties received from sub-lessee Royalties on production/sales of the sub-lessee payable to Origninal lessor as per royalty agreement with him/her. Profit on sub-lease
6	Manufacturing/P&L A/c To, Royalty A/c (Being royalties on own production transferred to Manufacturing / P&L A/c	Royalties Payable on own production/ Sales

b. Journal entries where the actual royalty is more than the minimum rent

S.no	Particular	Remarks
1	Royalties payable Account Dr. To, Landlord Account (being royalties payable to landlord on total production subject to minimum rent)	[Actual royalties for the period] (Own+ sub Lease) [Minimum rent]
2	Landlord A/c Dr. To, shortworking Recoupable A/c (being shortworkings recouped during the year)	Shortworking recouped during the year
3	Landlord Account Dr. To, Bank Account To, Tax Payable A/c (Being the amount paid to landlord after deducting tax)	[Minimum rent] [Net amount paid] [Tax Deducted at Source]

4	Profit and Loss Account Dr To shortworking Recoupable Account (Being shortworking lapsed and debited to Profit and loss A/c)	Shortworkings could not be recouped
5	Sub-leasee Account Dr. To Royalties Income A/c (Being royalties receivable from sub lessee subject to minimum rent)	Actual Royalties receivable from sub lease
6	Royalties suspense Account To Sub lessee Account To Profit and loss account (Being amount adjusted by the sub lessee in respect of previous shortworking . Amount could not be adjusted by the sub lessee, credited to profit and loss account	Recoupment of shortworking by the sub lease Shortworking could not be recouped by the sub lessee
7	Bank Account Dr. Tax deduction at source A/c Dr. To, Sub-Lessee A/c (Being the amount received from sub lessee after tax deducted at source	Actual amount received TDS deducted by the sub lessee
8	Royalties Income A/c Dr. To Royalties Payable A/c To Profit and Loss A/c	Royalties received from sub-lessee Royalties on production/sales of the sub-lessee payable to Origninal lessor as per royalty agreement with him/her. Profit on sub-lease

	(Being adjustment of royalties receivable against royalties payable in respect of sub lessee production. Profit on sub lease credited to profit and loss account	

Illustration 5

M/s. Bagamati Company Ltd. obtained on 1.1.2004 from Local Authority a lease of sand field, the terms being a royalty of Rs. 50 per ton of sand extract subject to a minimum rent of Rs. 200,000 p.a. with a right of recoupment of shortworking over the first four years of the lease.

On the same date M/s. Bagamati granted a sub-lease of part of the land to M/s. Bhandari Suppliers on a royalty of Rs. 75 per ton merging into minimum rent of Rs. 100,000 per annum with a right of recoupment of shortworking during the next two years following.

Years	2004	2005	2006	2007	2008
Bagamati	2,200	2,320	2,600	2,800	3,600
Bhandari	800	1,080	1,400	1,800	2,400
Total	**3,000**	**3,400**	**4,000**	**4,600**	**6,000**

Show ledgers accounts in the books of Bagamati.

Solution

1. Analysis of Royalties payable

Year	Output	Actual Royalties	Minimum Rent	Surplus	Shortworking				Amount Payable
					Suffered	Recouped	Written Off	C/F	
2004	3,000	150,000	200,000	-	50,000	-	-	50,000	200,000
2005	3,400	170,000	200,000		30,000	-	-	80,000	200,000
2006	4,000	200,000	200,000	-	-	-	-	80,000	200,000
2007	4,600	230,000	200,000	30,000	-	30,000	50,000	-	200,000
2008	6,000	300,000	200,000	100,000					300,000

2. Analysis of Royalties Receivable

Year	Output	Actual Royalties	Minimum Rent	Surplus	Shortworking				Amount Payable
					Suffered	**Recouped**	**Written Off**	**C/F**	
2004	800	60,000	100,000	-	40,000	-	-	40,000	100,000
2005	1,080	81,000	100,000		19,000	-	-	59,000	100,000
2006	1,400	105,000	100,000	5,000	-	5,000	35,000	19,000	100,000
2007	1,800	135,000	100,000	35,000	-	19,000		-	116,000
2008	2,400	180,000	100,000	100,000					180,000

In the books of M/s. Bagmati Company
Royalty Payable Account

Date	Particulars	Rs.	Date	Particulars	Rs.
2004	To, Landlord A/c	150,000	2004	By, Manufacturing A/c	110,000
				By, Royalty Receivable A/c (800 X Rs. 50)	40,000
		150,000			150,000
2005	To, Landlord A/c	170,000	2005	By, Manufacturing A/c	116,000
				By, Royalty Receivable A/c(1080X Rs. 50)	54,000
		170,000			170,000
2006	To, Landlord A/c	200,000	2006	By, Manufacturing A/c	130,000
				By, Royalty Receivable A/c(1400X Rs. 50)	70,000
		200,000			200,000
2007	To, Landlord A/c	230,000	2007	By, Manufacturing A/c	140,000
				By, Royalty Receivable A/c(1800X Rs. 50)	90,000
		230,000			230,000
2008	To, Landlord A/c	300,000	2008	By, Manufacturing A/c	180,000
				By, Royalty Receivable A/c(2400X Rs. 50)	120,000
		300,000			300,000

Dr. Shortworking Account Cr.

Date	Particulars	Rs.	Date	Particulars	Rs.
2004	To, Landlord A/c	50,000	2004	By, Balance c/d	50,000
2005	To, Balance b/d	50,000	2005	By, Balance c/d	80,000
	To, Landlord A/c	30,000			
		80,000			80,000
2006	To, Balance b/d	80,000	2006	By, Balance c/d	80,000
2007	To, Balance b/d	80,000	2007	By, Landlord A/c	30,000
				By, Profit & Loss A/c	50,000
		80,000			80,000

Dr. Landlord Account Cr.

Date	Particulars	Rs.	Date	Particulars	Rs.
2004	To, Bank A/c	200,000	2004	By, Royalty Payable A/c	150,000
				By, Shortworking A/c	50,000
		200,000			200,000
2005	To, Bank A/c	200,000	2005	By, Royalty Payable A/c	170,000
				By, Shortworking A/c	30,000
		200,000			200,000
2006	To, Bank A/c	200,000	2006	By, Royalty Payable A/c	200,000
2007	To, Bank A/c	200,000	2007	By, Royalty Payable A/c	230,000
	To, Shortworking A/c	30,000			
		230,000			230,000
2008	To, Bank A/c	300,000	2008	By, Royalty Payable A/c	300,000

Dr. Royalties (Receivable) Account Cr.

Date	Particulars	Rs.	Date	Particulars	Rs.
2004	To, Royalty Payable A/c(800x50)	40,000	2004	By, Bhandari Suppliers A/c.	60,000
	To, Profit & Loss A/c	20,000			
		60,000			60,000
2005	To, Royalty Payable A/c(1080x50)	54,000	2005	By, Bhandari Suppliers A/c.	81,000
	To, Profit & Loss A/c	27,000			
		81,000			81,000
2006	To, Royalty Payable A/c(1400x50)	70,000	2006	By, Bhandari Suppliers A/c	105,000
	To, Profit & Loss A/c	35,000			
		105,000			**105,000**
2007	To, Royalty Payable A/c(1800x50)	90,000	2007	By, Bhandari Suppliers A/c	135,000
	To, Profit & Loss A/c	45,000			
		135,000			**135,000**
2008	To, Royalty Payable A/c(2400x50)	120,000	2008	By, Bhandari Suppliers A/c	180,000
	To, Profit & Loss A/c	60,000			
		180,000			**180,000**

Dr. M/s. Bhandari Suppliers A/c Cr.

Date	Particulars	Rs.	Date	Particulars	Rs.
2004	To, Royalty Receivable A/c	60,000	2004	By, Bank A/c.	100,000
	To, Royalty Suspense A/c	40,000			
		100,000			100,000
2005	To, Royalty Receivable A/c	81,000	2005	By, Bank A/c.	100,000
	To, Royalty Suspense A/c	19,000			
		100,000			100,000
2006	To, Royalty Receivable A/c	105,000	2006	By, Bank A/c	100,000
				By, Royalty Suspense A/c	5,000
		105,000			**105,000**
2007	To, Royalty Receivable A/c	135,000	2007	By, Bank A/c	116,000
				BY, Royalty Suspense A/c	19,000
		135,000			**135,000**
2008	To, Royalty Receivable A/c	180,000	2008	By, Bank A/c	180,000

Dr. Royalty Suspense A/c Cr.

Date	Particulars	Rs.	Date	Particulars	Rs.
2004	To, Balance c/d	40,000	2004	By, Bhandari Suppliers A/c	40,000
2005	To, Balance c/d	59,000	2005	By, Balance b/d	40,000
				By, Bhandari Suppliers A/c	19,000
		59,000			59,000
2006	To, Bhandari Suppliers A/c	5,000	2006	By, By, Balance b/d	59,000
	To, Profit & Loss A/c	35,000			
	To, Balance c/d	19,000		By, Balance b/d	
		59,000			59,000
2007	To, Bhandari Suppliers A/c	19,000	2007		19,000

Summary

Royalty is the periodical payment based on output of sale for the use of certain assets which ownership is lays with third party according to agreement between owner and user. The party who makes a payment to the owner of the asset in exchange for the right of use his asset is known as lessee and the owner of asset to whom payment is made is known as lessor or landlord. The lessee making payment of royalty treats it as ordinary business expense. Royalty agreements are usually associated with a clause that the lessor or landlord must receive a minimum amount whatever is the production or sales in a particular period. Such amount is known as minimum rent or dead rent. The excess of minimum rent over actual royalty calculated on the basis of output or sales is termed as shortworking. Usually initial period of lease the work does not gather the required momentum because of the time taken in the preparation for starting the production and arising of shortworking may not be due to inefficiency of lessee. Keeping this in view, royalty agreement may contain a clause that shortworkings are recoverable by the lessee in subsequent years when royalties are in excess of the minimum rent. The right of recouping shortworking may be restricted i.e. fixed period or unrestricted i.e. fluctuating. The lessee of the original lease agreement may also sub-lease to other party. In that case the lessee of the original lease will become a landlord or lessor of the sub-lease. However, the lessee of the original lease has responsibility of paying royalties to landlord on basis of output or sale either made by lessee or sub-lessee.

Self-Examination Questions

I. Multiple Choice Questions (MCQs)

1. The parties involved in royalty are called
   (a) Consignee and Consignor (b) Co-Venturers
   (c) Partners (d) Lessee and Lessor

2. Excess of minimum rent over actual royalty is termed as
   (a) Dead Rent (b) House Rent
   (c) Shortworkings (d) Longworkings

3. Mr. A obtains a lease of mine from ABC Co. Ltd. He subsequently sub-lease the right to Mr. Y. What is the position of Mr. A towards Mr. Y?
   (a) Lessee (b) Lessor
   (c) Partner (d) None of the above

4. In the books of lessee at the time of recoupment, the shortworking account should be credited against
   (a) Profit & Loss Account (b) Payable to Landlord
   (c) Bank Account (d) Tax Payable Account

5. In the books of lessor, if the recoupment period of shortworkings expires, then such shortworking should be transferred to
   (a) Manufacturing Account (b) Profit & Loss Account
   (c) Minimum Rent Account (d) None of the above

II. Short Descriptive Questions (SDQs)

1. Explain 'Fixed and Fluctuating Right' for recoupment of shortworkings.
2. Define royalty and state the importance of minimum rent in the royalty agreement.
3. Write Short Note
   (a) Dead Rent
   (b) Sub-lease Agreement
   (c) Recoupment of shortworkings

III. Practical Questions (PQs)

1. A mine was leased for 10 years and output in tonnes was as under:

Year	Output	Year	Output
1	2,000	6	6,500
2	2,500	7	6,800
3	2,800	8	2,600
4	4,000	9	5,000
5	5,200	10	5,500

The royalty was fixed at Rs. 25 per tonne with a minimum rent of Rs. 100,000 per annum. Prepare the statement of the shortworking allowable if shortworking may be recouped;

a. Throughout the term of lease
b. Only within the three years following the year in which the shortworking occur

2. Uniliver Co. Ltd. obtained on 1st January 2002 the use of patent from Universal Ltd on the following condition;
   a. A royalty of 10% on sales subject to a minimum of Rs. 110,000 p.a. will be payable
   b. The royalty will be payable on 15th January following the year to which it related
   c. Uniliver Co. Ltd. will have the right of recouping any shortworkings the first three year of the agreement

Sales affected by Uniliver Co. Ltd, were as follows;

Year	Amount (Rs.)
2002	840,000
2003	1,200,000
2004	1,680,000
2005	2,250,000

Prepare necessary accounts in the books of Uniliver Co. Ltd. for the years 2002 to 2005

3. M/s. AQUA Ltd. took from M/s Boonta Ltd. a lease for a period of 30 years from 1st January 2003 subject to a royalty of Rs. 2.50 per tonne got with a dead rent of Rs. 22,000 a year and power to recoup short workings during the first 4 years of the lease.

Year	**Output (Tonnes)**
2003	2,000
2004	3,600
2005	9,000
2006	15,000
2007	25,000

Give journal entries for each of the five years in the books of the M/s. AQUA Ltd. and M/s. Boonta Ltd.

4. Mr. Pandey wrote a book on Accountancy and got it published from Manakamana Publishers Pvt. Ltd. on the terms that royalty would be 20% on the published price of the copies sold with a minimum payment of Rs. 80,000 every year. Mr. Pandey agreed to revise the book at the end of 3rd year, within 6 months of request made by publisher. In the event of delay, the condition of minimum payment was not applied.

Year	**1**	**2**	**3**	**4**
Copies sold	1,100	2,000	2,200	800
Unit price	200	220	250	250

The revision of the book took 9 months. Pass journal entries in the books of both the parties. The publisher has the right to recoup shortworkings in the first 3 years.

5. LG Industries owned the patent of new type of cell phone, they granted CG Ltd. a license for five years as on 1 January 2008. The license provided for the payment of royalty of Rs. 200 for each cell phone produced subject to a minimum annual payment of Rs. 600,000 for 2008 and increasing by Rs. 40,000 a year. If in any year the royalties, calculated on the cell phones manufactured, is less than the minimum payment, the deficiency could be set off against royalties in excess of the minimum during the following two years, no afterwards. The accounts were to be settled annually on December 31. The number of cell phones manufactured for the five years were as follows:

2008 – 800, 2009 – 1,600, 2010 – 5,400, 2011 – 3,600 and 2012 – 4,200.

You are required to show the (a) Royalties; (b) Shortworking; and (c) LG Industries Account in the books of CG Ltd. which are closed annually on December 31.

6. The Nepal Coal Ltd. holds a lease of a coal mine for a period of ten years commencing from 1.1.2007. According to the lease, the company is to pay 75 paisa as royalty per ton with a minimum rent of Rs. 15,000 per year. Short working can however be recovered out of the royalty in excess of the minimum rent of the next two years only. In the year of strike, the minimum rent is to be reduced to 60%. The output for the six years has been as under.

1st Year	10,000 tons.	4th Year	25,000 tons.
2nd Year	12,000 tons.	5th Year	50,000 tons.
3rd Year	28,000 tons.	6th Year	15,000 tons. (strike)

Write up necessary ledger accounts in books of Nepal Coal Ltd.

ANSWER			
Multiple Choice Questions (MCQs)			
1	d	4	b
2	c	5	b
3	b		

CHAPTER- 6

PREPARATION OF FINANCIAL STATEMENT

UNIT 1:

Preparation of Financial Statement

Learning Objectives

1. *Make out the various accounts which are the part of the financial statements.*
2. *Understand the relationship between Statement of Profit or Loss and Statement of Financial Position.*
3. *Be familiar with the matching principle.*
4. *Go through the Trading Account items.*
5. *Go through the Statement of Profit or Loss items.*
6. *Learn how the adjustment entries incorporate in financial statements.*
7. *Understand the purpose of Profit and Loss Appropriation Account.*
8. *Go through the Statement of Financial Position items.*
9. *Try to understand the purpose of preparing Manufacturing Account etc.*

6.1 INTRODUCTION

Preparation of Financial Statement is the last stage of the accounting cycle. The basic objective of every concern maintaining the books of accounts is to find out the profit or loss in their business at the end of the year. Every businessman wishes to ascertain the financial position of his business firm as a whole during the particular period. Financial statements are prepared to throw light on the financial results of operation of business during the period under consideration and the financial position at the end of the period. The Financial statement consist of following statements

i. Manufacturing and Trading Account
ii. Profit and Loss Account
iii. Statement of Financial Position

The primary function of accounting is to accumulate accounting data in a manner that the financial performance during a period can be determined. The manner in which the amount of profit or loss has been arrived at is disclosed in the financial statement is known as the Revenue Account or Statement of Profit or Loss, prepared at the end of the period. The various items of income and expenditure which arose during the accounting period are grouped under significant heads. The primary objective of the Revenue Account is to present the details of various items of income or expenditure, which have contributed to the making of the profit or loss.. Trading and Manufacturing are added only if the account has been prepared in two or more section to disclose the amount of profit or loss made at different levels of the trading or manufacturing activity.

Although the amount of profit or loss has been ascertained, the next step will be appropriation of profit or distribution of profit among the different parties. This information is contained in Profit and Loss Appropriation Account. The last stage of financial statement except preparation of Cash flow is preparation of Statement of Financial Position. The purpose of preparation of Statement of Financial Position is to know the financial soundness of a concern as a whole during the particular period.

Financial statement portrays the financial effects of transactions and other events by grouping them into broad classes according to their economic characteristic. These broad classes are termed the elements of financial statements. The elements directly related to the measurement of financial position in the Statement of Financial Position are asset, liabilities and equity. The elements directly related to the measurement of performance in the Statement of Profit or Loss are income & gains and expenses & losses.

6.2 PREPARATION OF FINANCIAL STATMENTS

The principal function of financial statement of account is to exhibit truly and fairly the profitability and financial position of the business to which they relate. In order that financial statements are properly drawn up, it is essential that a proper record of transactions are entered into by the business during the period of account. The basic principles in regard to accumulation of accounting information are:

(i) a distinction should be made between capital and revenue, both income and expenditure.

(ii) According to Matching Principle, the revenue and the relevant expenses incurred should be correlated and matched so that a complete picture is available. Incomes and expenses relating to a period of account should be separated from those of another period. The different items of income and expenditure should be accumulated under significant heads so as to disclose the sources from which capital has been procured and the nature of liabilities which are outstanding for payment.

The various items of income and expenditure should be accumulated on the following basis:

(a) Since the final statements of account are intended to show the profitability of the business and not that of its proprietors, it is essential that all personal income and expenditures should be separated form business income and expenditure.

(b) Different types of income and expenditure should be classified under separate heads. Assets should be included in the Statement of Financial Position at a valuation arrived at on the basis at which these are valued in the preceding year. Likewise, a provision for income and expenses which have accrued but not paid, should be made by estimation or otherwise on the same basis as in the previous year.

(c) Every information considered material for judging the profitability of the business or its financial position should be disclosed. For example, when labor charges have increased on account of bonus having been paid to workmen, the amount of bonus paid should be disclosed. Similarly, if some of the items of stock are not readily saleable, these should be valued at their approximate sale price and the basis of valuation and value of such stocks shown separately.

(d) It should be seen that only the effect of transactions which were concluded before the closure of the books of accounts has been adjusted in the accounts of the year. For example, when a sale of goods is to take place only after the goods have been inspected by the purchaser and the inspection had not been made before the close of the year, it would be incorrect to treat the goods as a sale in the accounts of the year.

6.2.1 Inter-relationship of the Revenue Statement and Statement of Financial Positions

One of the points to be remembered is that of total expenditure incurred. Some appears in the Statement of Profit or Loss and some in the Statement of Financial Position. Consider a few examples, out of the total amount spent on manufacturing goods that part which is attributable to finished goods in stock is shown in the Statement of Financial Position as **"closing stock "** and the amount debited to the Trading (or the Profit and Loss) Account is thereby reduced.

When a machine is purchased, that part of the expenditure which is attributable to the year concerned, as "**depreciation",** is debited to the Statement of Profit or Loss and the balance is shown in the Statement of Financial Position as an "**asset**". Next year again, part of the cost will be debited to the Statement of Profit or Loss and the remaining cost will be as an asset in the Statement of Financial Position.

These facts show that the two statements, the Statement of Profit or Loss and the Statement of Financial Position, are thoroughly inter-related. The assets shown in the Statement of Financial Position are mostly only the remainder of the expenditure incurred after a suitable amount has been charged to the Statement of Profit or Loss.

6.2.2 Matching Principle

Expenses related to earning revenue must be matched so that income can be determined. Issued arises in matching the expenses with the revenue of a period due to the following reasons:

- The income is recognized with reference to a period selected, say a year. Certain fixed expenses called period costs which are related to period and not to products, may give rise to appropriate adjustments for un-expiration.
- The adjustment on account of the above will be required to reflect the correct income measurement. However, the accountant may afford to ignore it in cases where the impact on account of non-adjustment in income may not be material.
- There are certain capital expenditures like expenditure on acquisition of Property, Plant & Machinerys which are useful for earning revenue over a period of time extending beyond an accounting period, This may require appropriate allocation of the expenditure to the period on a systematic basis.
- All the expenses relating to revenue which have been recognized as income in particular year should be charged by debiting Statement of Profit or Loss whether or not payment has been actually made.
- The expenses that will generate the future benefit should not be debited to current year's Statement of Profit or Loss but should be carried forwarded as an asset and shown in the Statement of Financial Position and debited to Statement of Profit or Loss when the relevant income will be credited.
- When any income or revenue is received in the current year but the work against it has still to be done and the cost in respect of it has to be incurred next year, the income or the revenue is treated as the income of the next year. It should be shown in the Statement of Financial Position on the liabilities side as "**income received in advance”** and should be credited to the Statement of Profit or Loss of the next year.

6.3 TRADING ACCOUNT

Trading account is the important part of the Statement of Profit or Loss. It is the first stage in the final account which is prepared to know the trading result of gross profit or loss during a particular period. In other word, it is the summary of the purchase and sales of a business or production cost of goods sold and value of sales, the difference between the elements establishes the gross profit or loss which is then carried forward to the Statement of Profit or Loss for calculation of net profit and loss. Accordingly, if the sales revenue is higher than the cost of good sold, the difference is known as “Gross Profit”. Similarly, if the sales revenue is less than the cost of goods sold the difference is known as “ Gross Loss”.

The main objective of preparing Trading Account is to ascertain gross profit or gross loss of a business during the accounting year. Another important function of the trading account is that it enables the owner of the business to compare the gross profit of a current period with the results attained in the previous periods. It is pertinent that, the component in the trading account do not vary in any material effect from previous and subsequent account. This therefore mean that the trading account should be standardized so that same item should appear in similar form in the successive final account so that effective comparision may be made of one trading period with other.

The actual item in the trading account of different classes of enterprises or business will necessarily vary depending on the nature of the nominal account in the respective business for example custom duty, licenses fee, freight and insurance on inward of raw material will be essential items in the trading account of manufacture company but these particular item would not appear in the trading account of a retail or trading company

Specimen Profoma of Trading Account

TRADING AND MANUFACTURING ACCOUNT

FOR THE YEAR ENDED …………………………….

PARTICULARS	Rs	PARTICULARS	Rs
To, Opening stock To, Purchase Less: Purchase Return To Direct Expense Carried Inward Wages Freight Charges Excise and Other Duty Fuel and Power Factory Rent and Rates Factory Lighting To, Gross Profit C/d (Transferred to P & L A/c)		By, Sales Less: Sales Return By, Closing stock By, Gross Loss C/d(Transferred to P & L A/c)	
TOTAL		**TOTAL**	

Trading Accounts Items

a. Cost of Goods Sold

As has been stated earlier, gross profit of a trading firm is the difference between the sale value of the goods and its cost. Naturally, the cost is exclusive of administrative and selling and distribution overheads. In this respect, therefore, understanding the concept of "cost of goods sold" is important. The Cost of Goods Sold principally includes opening stock, purchase price, and other direct expenses incurred on the goods which was sold during the period. .

Other expenses included in the cost of goods sold are the expense incurred on transportation of material to the selling place. Transportation charges paid is termed as "carriage inward" expenses which also include loading and unloading charges.

Another factor to be considered is the discount received in purchase price. Such discount allowed amount has to be excluded from the cost of goods. However, in accounting practice, discount received is accounted separately as revenue (i.e. not credited to purchase account). The principle behind such practice is that a discount is received only due to compliance of certain conditions e.g., bulk purchase, cash payment etc. Similarly, sometimes owning to certain damages or otherwise, purchased goods is returned to the seller. In such a case also the amount of goods returned (at invoice value) is accounted separately under Purchase Return head. The credit balance in this account (debit being suppliers account) is shown by deducting in purchase account in the Trading Account.

Another important aspect is the closing stock of goods. Those are the goods being unsold at a particular date (Balance Sheet Date). Since the "purchase account" includes the price of unsold stock, the same has to be deducted to arrive at the actual purchase price of the goods against actual sales. Goods that are not sold yet are the asset of the firm (available for selling later).

The closing stock is one period’s stock in hand to be offered for selling next year. Therefore, it would appear as 'opening stock' at the beginning of the next year and this has to be considered while calculating total goods available for selling. So far, we have considered only the opening and closing stock of goods while calculating the cost of goods sold. Below is given an illustration which takes into account the carriage inward expenses, purchase discount and purchase return:

b. Opening Stock.

The closing stock (i.e. balance of unsold goods) of the previous year becomes opening stock in the following year because; the stock is available for sale at the start of the next financial year. The unsold goods stock of previous year will be transferred as “**opening stock”** . The Opening stock is placed at the top of Trading Account's debit side. In the first year of a business there will be no opening stock.

c. Purchase and Purchase returns

Purchasing of goods is a normal business transaction. All those purchases made for the purpose of selling shall be debited to purchases account. For Trading Account purpose; only net purchases amount has to be considered. Net purchases amount is the amount of total purchase made during the year minus goods returned (purchases returned) to the suppliers due to defective supplies or inferior quality or any other reasons.

It will be noted that goods purchases and purchase returns are accounted separately under separate accounting heads. Although all returns may be credited directly to the purchase account this practice would conceal the quantum of purchases returned during the year. Since, purchase account has always debit balance, purchase return account being reversal of the same, has always credit balance. This credit balance may be shown in the credit side of the trial balance. But since it is related to the purchases, this is shown by deducting against the purchases (debit) figure.

d. Carriage inward

Cost of goods is not only the price paid for the material purchased. Under the accounting principles, cost of goods includes the price paid for and all the expenditure incurred to bring the goods into present condition and location. Therefore, carriage inward expenses such as transportation, portage, octroi, customs, and insurance etc. form part of the cost of goods. Hence, these expenses, being debited to the carriage inward expenses account will appear in the Trading Account. However, if any freight or charges is paid on any capital asset, like machinery, it should be added to the cost of the asses and not to the Trading Account.

e. Manufacturing Wages

Wages paid to workers in the factory, including stores, should be debited to the Trading Account. If any amount is outstanding, it must be brought into books so that full wages for the period concerned are charged to the Trading Account. However, if wages are paid for installation of an asset, it should be added to the cost of the asset.

f Power and Fuel

Fuel used for the boiler or electricity consumed to run the machines will be included under this item. The full amount for the period concerned should be debited to the Trading Account.

g Factory Lighting

Electricity consumed for providing light in the factory or to run fans should also be debited to the Trading Account. If there is a common lighting system for the general administrative office and the factory, the total bill should be suitably apportioned between the two and only the portion relating to the factory will be debited to the Trading Account. The other portion will be debited to the Statement of Profit or Loss.

h. Factory Rent and Rates

The rent paid for factory premises and local taxes paid on such premises or charges etc. should be debited to Trading Account. If the office and factory are in the same premises in that case expenses should be apportioned on a rational basis and debited to Trading Account and Statement of Profit or Loss respectively.

i. Sales and Sales Return

Sales amount also has to be shown in the Trading Account. In line with treatment of purchases, sales figure will also appear after deducting the sales returns, if any. It has to be borne in mind that sales orders received, but not yet supplied do not constitute a sale.

Sales returns are that merchandise being returned by customers due to some defects or any other reasons. In such a case, the customer has to be refunded (or credited to his personal account) a full sum of the rate which has been billed previously. In other words, sales refund accounting is just a reversal of sales accounting. Both sales and sales return are accounted under separate accounting heads and will appear in the credit side of trading account as follows:

j. Closing Stock

Closing stock is the goods remained unsold at the end of the accounting period and therefore, this is an asset. All the goods purchased during the year are debited to the purchases account. If the ledger balance of purchases account is to be debited to the Trading Account without considering the stock of such purchases, the cost of goods sold would be higher and at the same time there will be no recording of the stock value.

Therefore, valuation of the stock at the year ending is an important aspect to arrive at the gross profit earned by the firm. As per Nepal Accounting Standard on Inventory, the stock has to be valued on the basis of market price or cost price, whichever is lower. Usually market price is always higher than cost price. Hence stock is normally valued at cost price. However, to correctly ascertain the gross profit, the closing stock must be properly taken and valued.

The entry will be:

Stock Account Dr.
    To, Trading Account

It is also possible to pass the entry as follows:

Stock Account Dr.
    To Purchase A/c

To ascertain value of the closing stock, it is necessary to make a complete inventory or list of all the items in the go-down together with quantities. Damaged or obsolete items are separately listed. Also the list should be separate for finished goods, semi-finished goods (work in progress), raw materials and stores. To the list of finished goods, one should also add the goods lying with agents sent to them on consignment basis and also the goods sent on approval to customers.

k. Excise other duties:

Any duties levied on goods produced or purchased that should be included in cost of goods sold. Any duties refunded later shall be deducted from previously paid amount.

6.4 PREPARATION OF TRADING ACCOUNT

The particulars of sales, sales return and sales discount etc. are obtainable separately from respective ledger accounts, which will appear in the trial balance. The trading account is in ledger format consisting debit and credit side. Therefore, the account heads that will appear in this account have to be placed accordingly as per their balances shown in the trial balance.

Sales account has always credit balance and therefore, it will appear in the credit side of the Trading Account. As regards closing and opening balances of inventory stock, they are placed in credit side and the debit side respectively. Opening stock represents stock of inventory brought forward from previous year, which increases the stock available for selling. Therefore, it is debit.

Similarly, the closing stock is the balance remaining from purchases and therefore, to arrive at actual amount of goods sold, this is credited.

Likewise, purchases, carriage expenses etc. have debit balance and hence will appear in the debit side of the Trading Account. The difference between debit side total and credit side total of the Trading Account represent gross profit or loss.

6.4.1 Steps on Preparation of Trading Account

Following steps have to be followed while preparing a Trading Account:

a) From the trial balance, determine the respective account heads that are to be shown in the Trading Account.

b) Determine the account heads that require further adjustments. For instance, purchase returns, and sales returns amount have to be shown by deducting in the purchases and sales accounts respectively.

6.4.2 Closure of Accounts

Since Trading Account is also an account. Therefore, all the accounts that are to be shown in this have to be transferred by passing following closing entries:

a) **<u>Accounts with debit balance</u>**

Trading A/C	Dr.	
To, Opening Stock A/C		Cr.
To, Purchases A/C		Cr.
To, Carriage Inwards A/C		Cr.
To, Sales Return A/C		Cr.

b) **<u>Accounts with credit balance</u>**

Sales A/C	Dr.	
Purchases Return A/C	Dr.	
To, Trading A/C		Cr.

By posting of the above vouchers in respective ledger ,the balance of opening stock, purchases, carriage in, sales return, sales and purchases return account will be nill. At the same time, a new Trading Account will be appeared. At this stage Trading Account will reveal the gross profit, if the credit side is higher or gross loss if the credit side is lower. The gross profit or loss has to be, then, transferred to the Statement of Profit or Loss. This will close the Trading Account also, thus:

In case of credit balance (gross profit)

Trading A/C	Dr.	
To, Profit & Loss A/C		Cr.

In case of debit balance (gross loss)

Profit & Loss A/C	Dr.	
To, Trading A/C	Cr.	

Illustration 1

From the particular given below, prepare a trading account of M/s. Romio Enterprises for the year ended 31.12.2071.

Particular	Dr.(Rs)	Cr. (Rs.)
Opening Stock (1.1.2071)	2,25,000	
Purchases	7,25,000	
Purchase Returns		15,000
Sales Return	30,000	
Sales		8,50,000
Carriage Inward	55,000	
Wages	75,000	
Factory Lighting	10,000	

Note: *Closing Stock as on 32.12.2071 amounted to Rs.3,20,000.*

Solution

M/s Romio Enterprises
Trading Account
For the year ended 32.12.2071

Dr. Cr.

Particular		Rs.	Particular		Rs.
To, Opening Stock		2,25,000	By, Sales	8,50,000	
To, Purchases	7,25,000		Less: return	30,000	8,20,000
Less: return	15,000	7,10,000	Closing Stock		3,20,000
To, Carriage inward		55,000			
To, Wages		75,000			
To, Factory Lighting		10,000			
Gross Profit transferred to profit & loss A/C		65,000			
		11,40,000			**11,40,000**

6.5 STATEMENT OF PROFIT OR LOSS

After preparing Trading Account, the next step is to prepare Statement of Profit or Loss with view to determine the operating result of the business transactions up to a period i.e. accounting year. The Trading Account gave us the cost of goods sold and gross profit earned on sale of goods. Statement of Profit or Loss, in turn, is drawn to determine the net profit which is arrived at after deducting other expenses from the gross profit. The Statement of Profit or Loss can be defined as a report that summarizes the revenues and expenses of an accounting period to reflect the changes in various critical areas of firm's operations. The Trading Account is a sub-section of Profit & Loss Account. Therefore, both accounts are the statement of nominal accounts. Profitability Statement is divided between Trading Account and Profit & Loss Account to obtain information on the gross profit & loss and other administrative and financial costs. Therefore, there is no basic difference between the Trading Account and Profit & Loss Account and there is no need to draw these two different statements as per the prevailing laws and accounting standard. Statement of Profit or Loss alone can also be accommodated all those nominal accounts giving us the net profit/loss amount. However, a separate Trading Account is prepared where gross profit figure is to be shown distinctively. If a single Profit & Loss Account is to be prepared, it also contains all those accounting heads which are supposed to be included in the Trading Account. Where a separate Trading Account is prepared, the resultant gross profit or loss is transferred to the Profit & Loss Account and other administrative and selling expenses and general other income (which have not entered into the Trading Account) are entered to derive the net profit or loss amount. Though two separate accounts are not prepared but it should be necessary to prepare income statement in such a way that by which gross profit or loss can be derived or income statement or Statement of Profit or Loss should report the gross profit or loss of business entity.

As per the NAS – 1, at least following items shall have to be presented on the face of the Statement of Profit or Loss:

a. Revenues;
b. The result of operating activities;
c. Finance costs;
d. Share of the profit or loss of associates;
e. Tax expenses;
f. Profit or loss from or ordinary activities;
g. Net profit or loss for the period.

Additional line items, heading and subtotals shall be presented on the face of the Statement of Profit or Loss when required by a NAS, or when such presentation is necessary to present fairly the entity's financial performance.

An entity shall present, either on the face of the Statement of Profit or Loss or in the notes to the Statement of Profit or Loss, an analysis of expenses using a classification based on either the nature of expenses or their function within the entity. The information is provided in one of two ways.

i. Analysis on the basis of nature of Expense:

The first analysis is referred to as the nature of expense method. Expenses are aggregated in the Statement of Profit or Loss according to their nature and are not reallocated amongst various functions within the entry.

Specimen Profoma of Statement of Profit or Loss based on the nature of expense method

Particular	**Rs.**	**Rs.**
Revenue		X
Other operating income		X
Changes in inventories of finished goods and work in progress		X
Raw Materials and consumables used	X	
Staff costs	X	
Depreciation and amortization expense	X	
Other operating expenses	X	

Total operating expenses		**(X)**
Profit from operating activities		**X**

ii. Analysis on the basis of Operating activities:

The second analysis is referred to as the function of expenses or 'cost of sales' method and classifies expenses according to their function as part of cost of sales or, distribution or administrative activities. This presentation often provides more relevant information to users than the classification of expenses by nature, but the allocation of cost to functions can be arbitrary and involves considerable judgment. An example of a classification using the function of expenses method is as follows:

Specimen Profoma of Statement of Profit or Loss based on the Operating Activities

Particular	**Rs.**
Revenue	X
Cost of sales	(X)
Gross profit	**X**
Other Income	X
Selling and Distribution cost	(X)
General Administrative Cost	(X)
Other expenses	(X)
Profit	**X**

6.5.1 Preparation of Statement of Profit or Loss

The starting point of preparation of Statement of Profit or Loss is the transfer of gross profit or loss reported by Trading Account. Before a final Profit & Loss Account is drawn, attention has to be paid toward matching principle which has been already discussed and adjustments are done accordingly. The major adjustments that a Profit & Loss Account requires are;

a) Valuation of the closing stock (if Trading A/C is not prepared),
b) Depreciation of Property, Plant & Machineries,
c) Provision for doubtful debts,
d) Prepaid expenses,
e) Outstanding expenses,
f) Accrued income (i.e. interest, rental etc.)
g) Revenue collected in advance (e.g. unearned rent)

The ledger balance of accounts arrived after above adjustments make the final preparation of Statement of Profit or Loss easier. The nominal accounts will be closed by transferring to the Profit & Loss Account.

Nominal Account with Debit Balances

Profit & Loss A/C Dr.
To, All Expense Accounts.

Nominal Accounts with Credit Balances

All Income Accounts Dr.
To, Profit & Loss A/C

Nominal account heads are to be closed at the end of every accounting period by transfer to the Profit & Loss Account as shown above. By this act, these accounts will have nil balance and fresh entries are made at the start of the next accounting period. No nominal account shall be carried forward to subsequent accounting period.

When individual nominal accounts are transferred to Profit & Loss Account, this means that those accounts get closed, but a new Statement of Profit or Loss is opened (in ledger book). The balance (net profit or loss) in this account is closed by transferring the same to Profit Appropriation Account or Proprietors (or partner's) capital account.

6.5.2 Format of Statement of Profit or Loss

Since the format of Statement of Profit or Loss or Income Statement is not prescribed either by Nepalese Accounting Standard or Laws. Therefore, we have given below the example of a standard Profit & Loss Account format generally used by an enterprise.

STATEMENT OF PROFIT OR LOSS

FOR THE PERIOD…………………………..

Particular	Rs.	Particular	Rs.
To, Gross Loss		By, Gross Profit	
To, Office Salary		By, Interest income	
To, Rent and Rates		By, Discount Income	
To, Insurance		By, Commission Income	
To, Traveling		By, Profit on Sale of Asset	
To, Stationery & Printing		By, Miscellaneous Income	
To, Repair & Maintenance		By, Net Loss	
To, Telephone, Telex, etc.			
To, Electricity, Water			
To, Audit Fee			
To, Legal Charges			

To, Postage and Telex and Telephone Charges To, Depreciation To, Carriage Out To, Advertisement and Sales Promotion To, Provision for doubtful debts To, Bad debts To, Discount Allowed To, Interest on Loan To, Loss on Sale of Asset To, Miscellaneous Expenses To, Staff Bonus To, Income Tax To, Net Profit			
TOTAL		**TOTAL**	

The account heads mentioned above are only for illustration purpose. Those may be extended or changed according to the nature of the business. Assuming that a separate Trading Account has been prepared the Gross Profit figure has been given in the above Profit & Loss Account format. If the Trading Account is not to be prepared, then all those accounts that are accommodated under the Trading Account e.g. Opening stock, closing stock, purchases, sales, carriage inward expenses (and also W-I-P, if the concern is manufacturing one), will have to be shown in the Statement of Profit or Loss itself.

6.5.4 Other Formats

All nominal accounts form part of the Statement of Profit or Loss. As per the nature of business and requirement for detailed information, the expenses and income account heads may be expanded. But, accommodating all those accounts individually in the control ledger may not be required. In order to contain the same, the expenses and income heads may be grouped under an appropriate control head, the details of which are maintained separately under a subsidiary ledger. This practice will help shorten the control ledger accounts and thus drawing of Statement of Profit or Loss is made easier. For example:

STATEMENT OF PROFIT OR LOSS

FOR THE PERIOD…………………………..

Particular	Schedule	Rs.	Particular	Schedule	Rs.
Cost of Goods manufactured	4		Net Sales	1	

Administrative Expenses	5		Profit on Sale of Assets	2	
Selling & Distribution Expenses	6		Miscellaneous Income	3	
Net Profit					
Total			**Total**		

The number given in schedule indicates the attached schedules wherein details of the concerned accounts (i.e. subsidiary details) are given.

NET SALES **SCHEDULE :1**

PARTICULAR	RS.
Gross Sales Less: Sales return Sales Discount	
Net Sales	

PROFIT ON SALE OF ASSETS **SCHEDULE :2**

PARTICULAR	RS.
A) Sales proceed from sale of Plant A Less: Cost of Assets after accumulated depreciation on Plant A B) Sales Proceed from sale of Plant B Less: Cost of Assets after accumulated depreciation on Plant B C) Sales Proceed from sale of Old Furniture Less: Cost of Assets after accumulated depreciation on Old Furniture	
Profit on sale of assets	

MISCELLENOUS INCOME **SCHEDULE :3**

PARTICULAR	RS.
Income from sales of Old News Papar	

Other Income	
Miscellaneous Income	

COST OF GOOD MANUFACTURED **SCHEDULE :4**

PARTICULAR	RS.
Opening stock	
Purchase during the year	
Carriage inward	
Total Purchase	
Less: Purchase Trade Discount	
Purchase return	
Cost of total goods available	
Less: Closing stock	
Cost of Good Manufactured	

ADMINISTRATIVE EXPENSE **SCHEDULE :5**

PARTICULAR	RS.
Office salary	
Rent expense	
Printing and Stationary	
Repair and Maintenance	
Depreciation	
Miscellaneous Expense	
Administrative Expense	

SELLING AND DISTRIBUTION EXPENSE **SCHEDULE :6**

PARTICULAR	RS.
Advertisement	
Sales Promotion	
Samples	

Carriage Outward Other Selling expense	
Selling and Distribution Expense	

6.5.5 Vertical Statement

Statement of Profit or Loss is usually prepared in "T" form as above**.** However, it has been now customary to prepare the same in vertical form which will be more understandable and meaningful. There is basically no difference in preparation of it either in T form or in vertical form but only in style of presentation.

STATEMENT OF PROFIT OR LOSS

FOR THE PERIOD…………………………..

PARTICULAR	RS.	RS.
Net Sales		
Opening Stock		
<u>Add:</u> Net Purchase during the year		
Carriage inwards		
Total value of net purchase		
<u>Less:</u> Free samples as Advertisement		
Net value of purchase used in production		
Add: Production cost-wages	-	
Goods available for sale		
<u>Less:</u> Closing Stock	-	
Cost of goods sold		-
Gross Profit		
<u>Less: Operational Expenses</u>		
Administrative Expenses:		
Selling And Distribution Expenses		
Net Operating Profit		
<u>Non-Operating Income</u>		
Commission Income		
Discount Received		
Provision For D/D Write Back	-	

Less Non-Operational Expenses: Interest On Loan	-	-
Net Profit		-

Profit and Loss Item:

(i) Drawing:

Drawings are not expenses for the entity and should therefore not be debited to the Statement of Profit or Loss. If proprietor has enjoyed some benefit personally, like use of the entity's car, a suitable amount should be treated as drawing and to that extent the charge to the Statement of Profit or Loss will be reduced. Drawings are debited to the proprietor's Capital Account.

(ii) Income Tax:

In case of corporate entity, the income tax payable is treated like other expenses. But in the case of sole proprietorship, income tax is treated as a personal expense. It is debited to the Capital Account and not to the Statement of Profit or Loss. This is because the amount of the tax will depend on the total income of the partners or proprietor besides the profit of the firm. In case of partnership business, firm's tax liability is to be debited to Statement of Profit or Loss of the firm but partners' tax liability are not to be borne by the firm. Therefore, if the firm pays income tax on behalf of partners, such payment of personal income tax should be treated as drawings

iii. Discount Received and Allowed:

We have already seen that discount is of two types. Trade discount and cash discount. Trade discount is allowed when the order for goods is not below a certain figure. It is deducted from the invoice. Only the net amount of invoice is entered in books. There is no further treatment of the trade discount. Cash discount is allowed to a customer if he makes the payment before a certain date. It is allowance made to him for prompt payment. Discount received is really in the nature of interest received and similarly, discount allowed really means interest paid. Discount received is a gain and is credited to the Statement of Profit or Loss. Discount allowed is debited to this account.

6.5.3 Adjustments

Before the finalization of Statement of Profit or Loss, all required adjustments (e.g. closing entries in respect of expenses to be paid, income to be received, depreciation, closing stock, doubtful debt provisions etc.) should have been completed. The fundamental principle of accounting is that the period to which various items of income and expenditure pertain should be co-extensive with the period of accounts. As such before the Final Accounts are drawn up, it must be ensured that the accounts which require adjustment have been adjusted properly, by providing for the accrued expenses, including income outstanding and excluding prepaid expenses and prepaid income. The entries that will have to be passed for adjusting various accounts of income and expenditure have already been discussed in previous chapter though we have given some entries here for recall of previous entries.

1. Expenses accrued and accruing, e.g. Rent, Interest, Local Taxes, Wages etc.

Expenses Account Dr

To, Liabilities for Expenses

2. Income accrued and accruing, e.g. interest on Government Loans, Discounts on Bill, Professional fees, Rent and Premises on leases, etc.

Income Receivable/ Accrued Income A/c Dr.

To, Income Account

Illustration 2

From the following Trial Balance you are required to prepare

a. Statement of Profit or Loss for the year ended 31.12.2012.on T format
b. Statement of Profit or Loss for the year ended 31.12.2012 on vertical Format

Particulars	**Dr. (Rs.)**	**Cr. (Rs.)**	**Particulars**	**Dr. (Rs.)**	**Cr. (Rs.)**
Opening Stock	46,000		Electricity expenses	9,400	
Purchase and Sales	442,000	820,000	Telephone Charges	4,400	
Sales Return and Purchase Returns	8,000	12,000	Cash at Bank	18,000	
Discount Received		2,200	Printing and Stationery	11,200	
Wages	43,500		Postage	1,090	
Salaries	66,000		Furniture	200,000	
Carriage Inwards	39,100		Cash in hand	210	
Advertising expenses	10,200		Prepaid Printings	1,200	
Bills Receivable and Payable	9,000	10,000	Insurance Premium	3,000	
12% Bank Loan (Taken on Nov.1)		150,000	Carriage Outwards	12,000	
Office Equipments	199,700		Bad debts	800	
Land and Buildings	336,000		Interest on Bank Loan	1,500	
Provision for Doubtful debts		3,200	Capital Account		475,200
Sundry Debtors and Creditors	45,000	40,000	Rates and Rates	5,300	
			Total	**15,12,600**	**15,12,600**

You are required to year end adjustment of following particulars:

1. Closing stock valued at Rs. 38,000 on 31st December.
2. Goods worth Rs. 2,500 were distributed as free samples.
3. Depreciate furniture @ 7.5% and Office equipment @ 10%
4. Provision for doubtful debts to be maintained at 5% on debtors
5. Commission of Rs. 1,300 was earned but not yet received.
6. Rates and taxes of Rs. 800 was paid in advance for 2013.

Solutions:

a. Statement of Profit or Loss for the year ended 31.12.2012.on T format

STATEMENT OF PROFIT OR LOSS

FOR THE YEAR ENDED 31ST DECEMBER 2012

Particular	**Rs.**	**Rs.**	**Particular**	**Rs.**	**Rs.**

Opening Stock		46,000	Sales	820,000	
Purchase during the period	442,000		Less: Sales Returns	8,000	812,000
Less: Purchase Returns	12,000		Closing Stock		38,000
Free samples	2,500	427,500			
Wages		43,500			
Carriage Inwards		39,100			
Gross Profit carried forward to P/L A/c		293,900			
		850,000			**850,000**
Salaries		66,000	Gross Profit b/d		293,900
Office electricity expenses		9,400	Provision for D/D write back		950
Telephone Charges		4,400	Discount Received		2,200
Printing and Stationery		11,200	Commission Income		1,300
Postage		1,090			
Insurance Premium		3,000			
Depreciation:					
On furniture	15,000				
On Equipment	19,970	34,970			
Advertising expenses	10,200				
Add: Free samples	2,500	12,700			
Carriage Outwards		12,000			
Bad debts		800			
Interest on Bank Loan	1,500				
Add: Outstanding Interest for December	1,500	3,000			
Rent and Rates	5,300				
Less: Prepaid	800	4,500			
Net Profit		135,290			
		298,350			**298,350**

b. Statement of Profit or Loss for the year ended 31.12.2012 on vertical Format

STATEMENT OF PROFIT AND LOSS

FOR THE PERIOD 31.12.2012

Net Sales			812,000
Opening Stock		46,000	
Add: Net Purchase during the year	430,000		

Carriage inwards	39,100		
Total value of net purchase	469,100		
Less: Free samples as Advertisement	2,500		
Net value of purchase used in production	4,66,600		
Add: Production cost-wages	43,500	510,100	
Goods available for sale		556,100	
Less: Closing Stock		38,000	
Cost of goods sold			5,18,100
GROSS PROFIT			2,93,900
Less: Operational Expenses			
Administrative Expenses:			
Salary	66,000		
Office Electricity Exp.	9,400		
Insurance	3,000		
Stationery & Printing	11,200		
Rent & Rates	4,500		
Telephone charges	4,400		
Postage	1,090		
Depreciation on Furniture	15,000		
Depreciation on Equipment	19,970	134,560	
Selling and distribution Expenses			
Bad debts	800		
Carriage outwards	12,000		
Advertisement Exp.	12,700	25,500	160,060
NET OPERATING PROFIT			133,840
Non-Operating Income			
Commission Income		1,300	
Discount Received		2,200	
Provision for D/D write back		950	
		4,450	
Less Non-operational Expenses:			
Interest on Loan		(-) 3,000	1,450
NET PROFIT			135,290

6.6 PROFIT AND LOSS APPROPRIATION ACCOUNT

In this account, in addition to the balance brought forward from the previous period, the balance of the Statement of Profit or Loss is also brought in whether it is debit or credit. Appropriation of profits which may take the form of transfer of reserves, interests on capital, salaries of partners or for payment of dividends in case of a company etc. are shown herein. In the case of proprietorship or a partnership, un-appropriated balance is usually left at the end of the year. But in the case company, there is always some balance brought down from the previous year, and carried forward to the following year.

Net profit of a business is derived by deducting total expenses from total income. For the purpose, a Statement of Profit or Loss statement is prepared. Such net profit is then available for distribution or appropriation. The business enterprises may appropriate the said net profit in respect of staff bonus, income tax payment, dividend payment or other specific purposes. Theoretically amount spent for earning income is termed as expenses whereas the amount set aside from the profit is known as appropriation. Though appropriated amount is also paid out such payment do not constitute 'expenses'.

Generally, two separate statements are prepared for Profit & Loss A/C and Profit Appropriation A/C. In the accounting terminology, the Profit & Loss Account and Profit & Loss Appropriation Account are respectively known as 'above the line' (Expenses and income which appear in the Profit & Loss Account) and 'below the line' (distribution of profit which appear in the Profit & Loss Appropriation Account).

As we mentioned above, the form or requirement of preparation of appropriation account is depend on types of organization. In the case of sole proprietorship, all the profit earned by the business enterprises is to be credited (added) to the proprietor's capital account, then appropriation of profit need not be shown separately. This is because so long as the amount is not withdrawn by him, it is considered to be retained in the business itself. Similarly, in the case of partnership firm, the amount of profit may also be credited to each partner's capital accounts according to their profit sharing ratio.

Therefore, in case of the proprietorship and partnership firm preparation of separate Profit & Loss Appropriation Account is not necessary. At the same time, in case of a joint stock company, the profit earned may be shown in its Statement of Financial Position under the name "profit & Loss Account" itself and the amount appropriated for dividend may be deducted directly as expense from this account. However, instead of directly adjusting the amount of profit as stated above, if a 'Profit & Loss Appropriation Account' is prepared, it will show the detailed statement of profit appropriation.

6.6.1 Heading of Appropriation

The appropriation of profit earned in the business may be classified into two parts:

a) Distribution
b) Retained Earnings

6.6.1.1 Profit to be disbursed

The first disbursement to be made from profit is in respect of staff bonus and income-tax (though normally treated as above the line item as per prevailing laws). So long as the provision in respect of staff bonus and income-tax payable to the government out of the profit of the business is not made, the amount of distributable profit to owners cannot be ascertained. Therefore, the amount of staff bonus as per the Bonus Act and income-tax payable as per the Income-Tax Act and Rules should be provided for or allocated. While allocating the said amount, following entry will be passed.

Profit & Loss A/C	Dr.
To, Staff Bonus Payable	.

To, Provision for Income Tax

In addition to provision for income-tax, the other aspect of the distribution of net profit is dividend. This is the amount set aside for distribution to the shareholders. The journal entry in this case will be as:

Profit & Loss Account Dr.
To, Proposed Dividend A/C

6.6.1.2 Retained Earning

It is not necessary that the profit earned in the business should be fully distributed. Some portion of the profit as considered appropriate as per future plan, is retained in the business itself under various Reserve Funds which may be utilized for expansion of business, payment of any liabilities, replacement of Property, Plant & Machineries and also for specific reserve as may be prescribed by law.

Free reserve refers to the reserve which is not committed for any specific purpose and this reserve may also be utilized for distribution of dividend in the year of low profit. This is also known as General Reserve.

6.7.2 Specific Reserves

They refer to the reserves which are set up for defined purpose and the amount so set up in such reserve shall be spent only for the said specific purpose. Reserves set up as required by law are intended for the purpose of strengthening the capital base of the business. For instance, Bank and financial institutions in Nepal are required to transfer 20% of their net profit after tax to the Statutory General Reserve till the amount in such reserve become double the paid-up share capital.

Besides that entity may require to set up a reserve due to contractual obligations like as per loan agreement which would require a specific amount to be transferred to a separate reserve from the profit for a specific period. The objective of such reserve is to restrict dividend distribution and to ensure timely repayment of the loan without facing any difficulty. Similarly, while issuing the debentures or bonds by any company, they also set up a separate reserve for their redemption (repayment) known as Debenture Redemption Reserve.

In some cases the company may set up of voluntary reserves for the purpose of availing the additional capital as may be required for business expansion, meeting contingencies like payment of compensation, to make cushion for possible losses, and replacement of machinery and equipment being used in the business.

6.6.3 Accounting Procedure

The setting side of amounts from profit for the reserves as stated above is done by way of debiting the Profit & Loss Account itself. For instance,

Profit & Loss A/C Dr.

To, General Reserve
To, Special Reserve
To, Staff Welfare Fund

To, Land Acquisition Fund
To, ...

6.6.4 Format of Profit and Loss Appropriation Account

PROFIT & LOSS APPROPRIATION ACCOUNT

PARTICULAR	DEBIT RS.	PARTICULAR	CREDIT RS.
General Reserve Fund Automation Fund Staff Welfare Fund Proposed Dividend Balance Transferred to Statement of Financial Position		Balance brought forward from last year Net Profit for this year	

An amount left after appropriation of profit earned from business operation has to be shown in Statement of Financial Position as balance of Statement of Profit or Loss and transferred to Appropriation Account of next year as "Balance brought forward from last year". As this amount can also be appropriated, the same is required to be added with the net profit for the year for arriving at the total distributable amount. In the event of accumulated loss in the precious year(s) as appearing in the Statement of Financial Position (debit balance of the Profit & Loss Account), such amount would also be brought to the debit side of the above appropriation account. This amount would reduce the current distributable profit and such deduced amount of profit should only be distributed.

6.7 STATEMENT OF FINANCIAL POSITION

One of the major components of Financial Statements prepared by the accounting system is the Statement of Financial Position, also called the Statement of Financial Position. The Statement of Financial Position shows the financial status of a given company at a particular instant in time. It is essentially a snapshot of the organization at a given date.

In other words, Statement of Financial Position is a statement which shows the affairs (or financial position) of an enterprise at a given date. In case of preparation of a Trail Balance, the total amounts of debit and credit entries would be equal whereas this principle would not be applicable in case of the Statement of Financial Position. It is because the Statement of Financial Position would not tally on direct preparation from the Trial Balance until adjustment for difference arising from the nominal accounts (i.e. for the amount of profit or loss) is made. The reason for this is that the profit or loss of the business would strengthen (in case of profit) or deplete (in case of loss) the financial position of the enterprise, which should also be adjusted in the Statement of Financial Position.

All the accounts appearing in the Statement of Financial Position are the Real Accounts. In other words, assets and capital as well as liabilities that exist in the business on the date of the Statement of Financial Position are its components. In above discussion we learned that all the revenue items shown on trial balance are transferred to either in Trading Account or Statement of Profit or Loss to ascertain the gross profit or loss and net profit or loss respectively. The remaining items are still open or not closed and that will be carried forwarded to next accounting period because these are assets which can be utilized in next accounting year to produce revenue or liabilities that have to be met in due course of time. If all these remaining items of trial balance arrange in a systematic way in accordance with balances along with net result of Statement of Profit or Loss, we will get one statement which is known as Statement of Financial Position. Therefore, Statement of Financial Position is nothing but it is systematic arrangement of balances of real account items.

The Statement of Financial Position may be defined as "a statement which sets out the assets (items having a debit balance) and Liabilities (items having a credit balance) of a firm or an organization as at a certain date." Since even a single transaction will made a difference to some of the assets or liabilities, the Statement of Financial Position is true only at a particular point of time. That is the significance of the word "as at".

The Statement of Financial Position has certain characteristics which should be noted. These are the following:

(i) It is prepared at a particular date, rather the close of a day and not for a period. It is true only on that date and not later or before;

(ii) The Statement of Financial Position is prepared only after the preparation of the Statement of Profit or Loss. This is the reason why the Statement of Profit or Loss (including the Trading Account) and the Statement of Financial Position are together called Financial Statements. Without being accompanied by the Statement of Profit or Loss, the Statement of Financial Position will not be able to throw adequate light on the financial position of the entity.

(iii) Since capital always equals the difference between assets and liabilities and since the capital account will independently arrive at this figure, the two sides of the Statement of Financial Position must have the same total. If it is not so, there is certainly an error somewhere.

Basically, the Statement of Financial Position will answer following questions pertaining to the business.

a) What are the resources (capital and reserves) of the business?
b) What are the liabilities of the business?
c) How are the resources of the business utilized?

6.7.1 Format of Statement of Financial Position

STATEMENT OF FINANCIAL POSITION
AS ON DATE ……………… ……..…..

LIABILITIES/ CAPITAL	RS.	ASSETS	RS.
Capital & Reserve		**Property, Plant & Machinery**	
Share Capital		Land and Building (Net of Depreciation)	
Capital Reserve		Furniture, Fixture (Net of Depreciation)	
Reserves & Surplus		Plant and Machinery(Net of Depreciation)	
Less : Profit & Loss A/c (if loss)			
		Investments	
Loan and Borrowings		Fixed Deposit	
Long-term Loan		Share of other Public companies	
Bank Loan		Debentrue and bond of other companies	
		Current Assets	
Current Liabilities		Cash & Bank	
Bank overdraft		Accounts Receivable	
Interest payable on loan		Less : Provision for Doubtful debt	
Accounts payable		Staff Advance	
Employees provident fund		Prepaid insurance	
Income tax payable		Interest receivable	
Outstanding salaries		Closing Stock	
Outstanding Rent			
TOTAL		**TOTAL**	

6.7.2 Arrangements of Assets and Liabilities(1) Assets:

Assets are basically of two types. Those that are meant to be used by the firm over a long period and not sold and those that are meant to be converted into cash as quickly as possible. Examples of the later are book debts, stocks of finished goods and materials, etc. The former type of assets is called fixed assets. It is desirable that in the Statement of Financial Position the two types of assets should be shown separately and prominently. This would give meaningful and logical information.

Assets may be grouped in one of the following two ways:

(i) Liquidity: Under this approach the asset, which can be converted into cash first, is presented first. Those assets which are most difficult in this respect are presented at the bottom.

(ii) Permanence: Assets which are to be used for long term in the business and are not meant to be sold are presented first. Assets which are most liquid, such as cash in hand are presented at the bottom.

The various assets in two orders will be as follows:

In the order of Liquidity	In the order of Permanence
Cash in Hand	Goodwill
Cash at Bank	Patents
Investments	Furniture
Sundry Debtors	Machinery
Stock or Finished Goods	Stock of Work-in-progress
Stock of Raw Material	Stock of Raw Material
Stock of Work-in-progress	Stock or Finished Goods
Machinery	Sundry Debtors
Furniture	Investments
Patents	Cash at Bank
Goodwill	Cash in Hand

Some of the assets may be capable of being sold easily like investment in government securities or shares or some companies. They should be treated as liquid or permanent according to the intention of the firm.

(2) Liabilities:

The liabilities to outsider will be of two types. Those which must be settled within one year and those which will be paid after one year. The former type of liability is called current or short term liability.

Liabilities may also be shown according to the urgency with which payment has to be made. One way is to first show the capital, then long-term liabilities and last of all short term liabilities like amounts due to suppliers of goods or bills payable. The other way is to start with short term liabilities and then show long term liabilities and last of all capital.

As per the NAS – 1, each enterprise should determine, based on the nature of its operations, whether or not to present current asset, non-current assets ,current liabilities and non-current liabilities as separate classifications on the face of the Statement of Financial Position. This classification will apply when this distinction is made. When an enterprise chooses not to make this classification, assets and liabilities should be presented broadly in or order of their liquidity. Whichever method of presentation is adopted, an enterprise should disclose, for each asset and liability item that combines amounts expected to be recovered or settled both before and after twelve months from the Statement of Financial Position date, the amount expected to be recovered or settled after more than twelve months.

While exhibiting the accounts in the Statement of Financial Position, classification and grouping need to be made but the order of presentation may differ. There is also the practice of presenting the accounts in the order of liquid assets to fixed assets in the assets side and current liabilities to capital & reserves in the liability side.

Example of presenting the Statement of Financial Position in the order of liquidity is given below.

Assets	**Liabilities**
Current Assets	**Current Liabilities**
1. Cash 2. Debtors/Account Receivable 3. Other Receivable 4. Closing Stock 5. Prepaid Expenses 6. Staff Advance	1. Creditors/ Accounts payable 2. Bank overdraft/working capital loan 3. Dividend payable 4. Income tax payable 5. Tax Payable (TDS) 6. Other current liabilities (incl. outstanding expenses)
Investments	**Long-term liabilities**
1. Government Bonds 2. Shares/Debentures 3. Placements	1. Debenture 2. Term Loan
Property, Plant & Machinery	Capital & Reserve
1. Land 2. Building 3. Machinery 4. Furniture, Fixture 5. Equipment	1. Capital 2. Reserves 3. Capital Reserve 4. Profit & Loss Account (undistributed profit)
Other Assets	<u>Notes</u>
1. Patent Rights 2. Goodwill 3. Expenses yet to be written off 4. Profit & Loss A/C (The amount of accumulated loss)	In case of company, the capital may also be in the form of Preference and ordinary shares

Note: Even if the assets headings are stated in order of liquidity in the Statement of Financial Position, same order need not be followed in respect of the liabilities. The practice of presenting the asset headings in the order of liquidity is commonly followed in banks and financial institutions.

Illustration 3

From the information given in illustration 2, prepare the Statement of Financial Position of M/s. Romio Enterprises as on 31.12.2012.

Solution

M/S. ROMIO ENTERPRISES
STATEMENT OF FINANCIAL POSITION
AS ON 31ST DECEMBER, 2012

Liabilities and Capital	Rs.	Rs.	Assets	Rs.	Rs.
			Property, Plant & Machinery:		
Capital Account	475,200				
Net Profit	135,290	610,490	Land and Buildings		336,000
			Furniture	200,000	
12% Bank Loan		150,000	Less: Depreciation	15,000	185,000
			Office Equipment	199700	
			Less: Depreciation	19,970	179,730
Sundry Creditors		40,000	Closing Stock		38000
Bill Payable		10,000	Sundry Debtors	45,000	
Outstanding Interest			Less: Provision D/D	2,250	42,750
on Bank Loan		1,500	Bills Receivable		9,000
			Prepaid Printings		1,200
			Prepaid Rent		800
			Commission Receivable		1,300
			Cash at Bank		18,000
			Cash in Hand		210
		811,990			**811,990**

Illustration 4

The following is the Trial Balance of Mr. A on 31st December 31, 2012

TRIAL BALANCE

Particulars	Debit	Credit
Purchases during the period	15,000	
Debtors	20,000	
Interest Earned		400
Salaries	3,000	
Sales		32,100
Purchase Returns		500
Wages	2,000	
Sales Returns	1,000	
Rent	1,500	
Bad debts written-off	700	
Creditors		12,000
Capital		10,000
Drawings	2,400	
Provision for Bad debts		400

Printing and Stationary	800	
Insurance Premium	1,000	
Opening Stock	1,200	
Office Expenses	5,000	
Furniture and Fittings	2,000	
Provision for Depreciation		200
TOTAL	**55,600**	**55,600**

Prepare a Statement of Profit or Loss for the year ended December 31, 2012 and also the Statement of Financial Position as on that date after making the following adjustments.

a. Depreciate Furniture and fixtures by 10% on original cost.
b. Make a provision for Doubtful Debts equal to 5% of Debtors
c. Salaries for the month of December amounting to Rs. 300 were unpaid which must be provided for. The balance in the account included Rs. 200 paid in advance.
d. Insurance is prepaid to the extent of Rs. 200
e. Provide Rs. 800 for office expenses.
f. Stock valued at Rs. 600 was taken by Mr. A for his personal use, the cost of which has not been adjusted in the books of account.
g. Closing Stock was valued at Rs. 6,000

Solution

STATEMENT OF PROFIT OR LOSS
OF MR. A
FOR THE YEAR ENDED DECEMBER 31, 2012

Particulars	**Rs.**	**Rs.**	**Particulars**	**Rs.**	**Rs.**
Opening Stock		1,200	Sales	32,100	
Purchase	15,000		Less: Returns	1000	31,100
Less: Returns	500		Closing Stock		6,000
Less: Drawing	600	13,900			
Wages		2,000			
Gross Profit carried forward to P/L A/c		20,000			
		37,100			**37,100**
Salaries (3,000 + 300 - 200)		3,100	Gross Profit b/d		20,000
Office expenses (5,000 + 800)		5,800	Interest		400
Rent		1,500			

Printing and Stationery		800			
Insurance Premium (1000-200)		800			
Depreciation:		200			
Bad Debts		700			
Provision for B/D		600			
Net Profit		6,900			
		20,400			**20,400**

STATEMENT OF FINANCIAL POSITION
OF MR. A
AS AT DECEMBER 31, 2012

Liabilities and Capital	Rs.	Rs.	Assets	Rs.	Rs.
			Property, Plant &		
Capital Account			Machinery:		
Opening Balance	10,000		Furniture & Fittings	2,000	
Net Profit	6,900		Less: Depreciation	400	1,600
	16,900				
Less: Drawings	3,000	13,900	Closing Stock		6,000
Sundry Creditors for goods		12,000	Sundry Debtors	20,000	
Outstanding Expenses		1,100	Less: Provision D/D	1,000	19,000
			Advance to Staff		200
			Prepaid Expenses		200
		27,000			**27,000**

Illustration 5

The following are the balances as at 31st December 2012 extracted from the books of Mr. Mahesh

	Rs.		Rs.
Plant and Machinery	40,500	Bad debts	2,200
Furniture and Fittings	15,250	Bad debts Recovered	1,250
Bank Overdraft	160,000	Salaries	32,650
Capital Account	115,000	Outstanding Salaries	5,350
Drawings	15,000	Prepaid Rent	500
Purchases	230,500	Rent	6,500
Opening Stock	132,250	Carriage inward	2,350
Wages	22,325	Carriage outward	3,250
Provision for Doubtful debts	5,700	Sales	290,600
Provision for discount on Debtors	1,375	Advertisement Exp.	6,750
Sundry Debtors	152,500	Printing and Stationery	2,200
Sundry Creditors	77,500	Cash in hand	2,300
Cash at Bank	7,250		

Additional information

1. Difference in the trial balance, if any, can be taken as miscellaneous expenses or miscellaneous income.
2. Bank overdraft is arrived against hypothecation of stock. The bank overdraft outstanding as on 31.12.2012 accounted for 80% of drawing power. Such drawing power is ascertained by deducting 20% as margin from the value of stock as on that date.
3. Purchase includes sales returned of Rs. 5,500 and sales include purchase returns of Rs. 4,750.
4. Goods withdrawn by Mahesh for own consumption Rs. 7,500 were included in purchases.
5. Depreciation is to be provided in plant & machinery @ 15% p.a. on furniture & fitting @ 10% p.a.
6. Wages paid for installation of plant and machinery amounting to Rs. 750 was included in wages account.
7. Create a provision for doubtful debts @ 5% and provision for discount on debtors @ 2.5 percent.
8. A debit balance of Rs. 2,500 in the account of Ram, a Creditor is included in the list of sundry debtors.
9. Free samples distributed for publicity costing Rs. 1,250.

Prepare a Statement of Profit or Loss for the year ended 31st December 2012 and a Statement of Financial Position as on that date.

Solution

STATEMENT OF PROFIT OR LOSS

FOR THE YEAR ENDED 31.12.2012

	Particulars	Rs.	Rs.		Particulars	Rs.	Rs.
To.	Opening Stock		132,250	By,	Sales	285,850	
To.	Purchase	216,250			Less: Returns	5,500	280,350
	Less: Returns	4,750	211,500	By,	Closing Stock		250,000
To.	Wages		21,575		(Rs 160,000x100/80x100/80)		
To,	Carriage Inward		2,350				
To.	Gross Profit carried forward to P/L A/c		162,675				
			530,350				**530,350**
To.	Salaries		32,650	By,	Gross Profit b/d		162,675
To,	Advertisement Exp.		8,000	By,	Bad Debts Recovered		1,250

To,	Rent		6,500	By,	Misc. Income		17,500
To,	Printing and Stationery		2,200				
To,	Bad debts		2,200				
To,	Carriage Outwards		3,250				
To,	Provision for B/D (7,500-5,700)		1,800				
To,	Provision for discount on Debtors (3,563-1,375)		2,188				
To,	Depreciation on:						
	Plant and Machinery @ 15% p.a.		6,188				
	Furniture and Fixture @ 10% p.a.		1,525				
To.	Net Profit to Capital A/c		114,925				
			181,425				**181,425**

STATEMENT OF FINANCIAL POSITION OF MAHESH
AS ON 31.12.2008

Liabilities	Rs.	Rs.	Assets	Rs.	Rs.
Capital Account			Property, Plant & Machinery:		
Opening Balance	115,000		Plant & Machinery	41,250	
Net Profit	114,925		Less: Depreciation	6,187	35,063
	229,915		Furniture & Fittings	15,250	
Less: Drawings	22,500	207,425	Less: Depreciation	1,525	13,725
			Closing Stock		250,000
Bank overdraft		160,000	Sundry Debtors		138,937
Sundry Creditors		77,500	(Note 3)		
Outstanding Salaries		5,350	Advance to Supplier		2,500
			Prepaid Rent		500
			Cash at Bank		7,250
			Cash in Hand		**2,300**
		450,275			**450,275**

Working Notes

1. Rectification entries:

a.	Sales Returns A/c	Dr.	5,500	
	Sales A/c	Dr.	4,750	
	To, Purchase A/c			5,500
	To, Purchase Return A/c			4,750

(Sales returns and purchase returns wrongly included in purchases and sales respectively, now rectified)

b.	Drawings A/c	Dr.	7,500	
	To, Purchase A/c			7,500

(Goods withdrawn for own consumption included in purchases now rectified)

c.	Plan & Machinery A/c	Dr.	750	
	To, Wages A/c			750
d.	Advance to Suppliers A/c	Dr.	2,500	
	To, Sundry Debtors A/c			2,500

(Advance to suppliers wrongly included in the list of debtors, now rectified)

e.	Advertisement expenses A/c	Dr.	1,250	
	To, Purchases A/c			1,250

(Free samples distributed for publicity out of purchases now rectified)

2. Trial Balance of Mahesh (After rectification)
As on 31.12.2012

Accounts Heads	Rs.	Rs.
Plant and Machinery	41,250	
Furniture and Fittings	15,250	
Bank Overdraft		160,000
Capital Account		115,000
Drawings	22,500	
Purchases	216,250	
Opening Stock	132,250	
Wages	21,575	
Provision for Doubtful debts		5,700
Provision for discount on Debtors		1,375
Sundry Debtors	150,000	
Sundry Creditors		77,500
Cash at Bank	7,250	
Bad debts	2,200	
Bad debts Recovered		1,250
Salaries	32,650	
Outstanding Salaries		5,350
Prepaid Rent	500	
Rent	6500	
Carriage inward	2,350	

Carriage outward	3,250	
Sales		285,850
Advertisement Exp.	8,000	
Printing and Stationery	2,200	
Cash in hand	2,300	
Sales Returns	5,500	
Purchase Returns		4750
Advance to Suppliers	2,500	
Misc. Income (balancing figure)		17,500
	674,275	**674,275**

3. Calculation of Provision for doubtful debts and provision for discount on debtors

Sundry Debtors (rectified)	Rs. 150,000
Less: Provision for doubtful debt	7,500
	142,500
Less: Provision for discount on debtors @2.5%	3,563
	Rs. 138,937

Illustration 6

Below is given the Trail Balance of Raja & Ranka Co. as on 31 Dec. 2013. The partners share profit as Raja 2/3 and Ranka 1/3 up to 50% of the distributable profit to the company and the balance equally.

Accounts Heads	Rs.	Rs.
Freehold Premises	150,000	
Plant and Machinery	45,000	
Commission Income		10,000
Raja's Capital Account		50,000
Ranka's Capital Account		30,000
Purchases of Raw Material (net)	75,000	
Opening Stock		
Finished Goods	40,000	
Raw Materials	20,000	
Work-in-Progress	18,000	
Wages	20,000	
Provision for Doubtful debts		1,500
Discount	2,900	
Sundry Debtors	50,000	
Sundry Creditors		25,000
Cash at Bank	8,200	
Bad debts	1,500	

Royalties	1,500	
Salaries for works Manager	12,000	
Discount Received		2,500
Office Rent	4,000	
Factory Rent and Rates	6,500	
Carriage inward	1,500	
Carriage outward	900	
Sales (net)		325,000
Factory Exp.	7,500	
Office Expenses	7,500	
Insurance	2,000	
Ranka's Loan		30,000
	474,000	474,000

The following information is to be taken into consideration

1. Closing Stock: Finished Goods-Rs. 50,000; Raw Materials-Rs. 30,000; Work-in-Progress – Rs. 25,000
2. Outstanding liabilities to be provided for wages Rs. 5,000, Office salaries Rs.6,000 and Office rent-Rs. 2,000
3. Bad debts provision to be adjusted to 2.5% on sundry debtors. Insurance premium paid in advances Rs. 500.
4. Depreciate Freehold Premises by 2.5% and Plant and Machinery by 5%
5. Partners' salary to be allowed to Raja Rs. 6,000 and Ranka Rs. 3,000. The Loan Account of Ranka was raised in the books before the commencement of the year.

You are required to prepare the Statement of Profit or Loss for the year ended 31st Dec 2013.

Solution

Raja & Ranka Co.
Statement of Profit or Loss
For the year ended 31.12.2013

	Particulars	Rs.	Rs.	Particulars	Rs.	Rs.
To.	Raw Material consumed			By, Work-in-Progress		
	Opening Stock	20,000		Closing	25,000	
	Add: Purchase	75,000		Less: Opening	18,000	7,000
	Less: closing Stock	(30,000)	65,000	By, Cost of Production c/d		114,250
To.	Wages	20,000				
	Add: Outstanding	5,000	25,000			
To,	Carriage Inward		1,500			
To,	Factory Expenses		7,500			
To,	Royalties		1,500			

To,	Factory Rent and Rates		6,500			
To,	Salaries of Works Manager		12,000			
To,	Depreciation of P/M		2,250			
			1,21,250			**1,21,250**
To,	Cost of production b/d		114,250	By, Sales		325,000
To,	Opening stock of FG		40,000	By, Closing Stock of F/G		50,000
To,	Gross Profit c/d		220,750			
			375,000			**375,000**
To.	Office Salaries Outstanding		6,000	By, Gross Profit b/d		220,750
To,	Discount		2,900	By, Discount received		2,500
To,	Office Rent	4,000		By, Commission Income		10,000
	Add: Outstanding	2,000	6,000	By, Provision for D/D written back		250
To,	Bad debts		1,500	(Rs. 1,500-Rs. 1,250)		
To,	Carriage Outwards		900			
To,	Insurance	2,000				
	Less: Prepaid	500	1,500			
To,	Office Expenses		7,500			
To,	Depreciation on premises		3,750			
To,	Interest on Ranka's Loan @ 6%		1,800			
To.	Net Profit to Capital A/c		2,01,650			
			2,33,500			**2,33,500**

Profit and Loss Appropriation Account
For the year ended 31.12.2013

			By, Net Profit b/d	2,01,650
To, Salaries to Partners				
Raja	6,000			
Ranka	3,000	9,000		
To, Net divisible profit transferred to:				
Raja's Capital	112,380			
Ranka's Capital	80,270	192,650		
		2,01,650		2,01,650

Statement of Financial Position of Raja & Ranka Company as on 31.12.2013

Liabilities and Capital	Rs.	Rs.	Assets	Rs.	Rs.
Capital Account:			Property, Plant & Machinery:		
Raja	50,000		Freehold Premises	150,000	
Add: Salary	6,000		Less: Depreciation @ 2.5%	3,750	146,250
Add: Net Profit	112,380	168,380	Plant & Machinery	45,000	
Ranka	30,000		Less: Depreciation @ 5%	2,250	42,750
Add: Salary	3,000				
Add: Interest on Loan	1,800		Prepaid insurance		500
Add: Net Profit	80,270	115,070	Sundry Debtors	50,000	
			Less: Provision for Bad Debts	1,250	48,750
Ranka's Loan		30,000	Closing Stock:		
Sundry Creditors		25,000	Finished Goods	50,000	
Outstanding Wages		5,000	Raw Materials	30,000	
Outstanding Office Rent		2,000	Work-In-Progress	25,000	105,000
Outstanding Salaries		6,000	Cash at Bank		8,200
		351,450			**351,450**

Illustration 7

From the following data, prepare a Profit and loss a/c and a Statement of Financial Position as on 31- 3-2014.

Particulars	Rs.	Particulars	Rs.
Drawings	10,000	Capital	30,000
Purchases	30,000	Purchase returns	1,000
Sales Returns	5,000	Sales	60,000

Carriage in	2,000	Wages outstanding	2,000
Carriage out	3,000	Rent received	1,000
Depreciation on Plant	4,000	Reserve for doubtful debts	1,000
Plant account	20,000	Interest (Cr)	5,000
Salaries & wages	3,000	Sundry creditors	6,000
Bad debts	2,000	Loans	38,000
Premises	20,000		
Interest	5,000		
Stock 1.4.95	25,000		
Sundry debtors	15,000		
	1,44,000		**1,44,000**

Adjustment:

(a) Stock on 31-3-14 was Rs.40,000. A fire broke-out in the godown and destroyed stock worth Rs.5,000. Insurance company had accepted the claim in full.

(b) Provide for bad debts @ 10% and provide for discount on debtors @ 5% and on creditors @ 10%
(c) Depreciate buildings at the rate of 15% p.a.
(d) Rent outstanding amounted to Rs.1,000
(e) Closing stock includes samples worth of Rs.2,000.
(f) Provide interest on drawings @ 10% and on capital @ 10%.

Solution:

Statement of Profit or Loss for the year ending 31st March 2014

Particulars	**Rs.**	**Rs.**	**Particulars**	**Rs.**	**Rs.**
To Opening stock	25,000		By Sales	60,000	
To purchases	30,000		Less: Returns	5,000	55,000
Less: purchase returns	1,000		By Closing stock		38,000
	29,000		By Stock destroyed by fire		5,000
Less: Sample	2,000	27,000			
To Carriage inwards		2,000			
To Gross Profit C/d		44,000			
		98,000			**98,000**
To Salaries & Wages		3,000	By Gross profit b/d		44,000
To Rent outstanding		1,000	By Rent received		1,000
To Carriage outwards		3,000	By Interest		5,000
To Bad debts	2,000		By Provision of discount creditors 6,000 x 10%		600

Add: New provision for bad debts (15,000 x10%)	1,500		By Interest on drawings (10,000 x 10%)		1,000
	3,500				
Less: Existing provision for bad bets	1,000	2,500			
To Provision for discount on debtors (15,000-1,500) x 5%		675			
Interest		5,000			
To Depreciation:					
Plant	4,000				
Building (20,000x15%)	3,000	7,000			
To Interest on capital		3,000			
To Net profit, transferred to capital account.		26,425			
		51,600			**51,600**

Note:

(1) Premises include Land and Buildings, So, depreciation on Buildings applies to premises.
(2) Stock destroyed by fire is credited to trading a/c and claim is shown as an asset.
(3) Depreciation on plant given in Trial balance is assumed to be current year's depreciation.
(4) Samples included in closing stock should be separated from stock by reducing from stock. So, effective closing stock is only Rs.38,000.

The samples should be reduced from purchases because they are not meant for sale. Since they are not yet distributed, they appear on assets side of Statement of Financial Position.

Adjustment entry is:

Samples A/c Dr 2,000
To purchases A/c 2000

Statement of Financial Position as on 31.3.2014

Liabilities	**Rs.**	**Rs.**	**Assets**	**Rs.**	**Rs.**
Sundry creditors	6,000		Debtors	15,000	
Less: Provision for discount	600	5,400	Less: Provision for bad debts	1,500	
Loans		38,000	Less: Provision for discount on debtors	675	12,825

Wages outstanding		2,000	Closing stock		38,000
Rent outstanding		1,000	Samples in stock		2,000
Capital	30,000		Insurance claim Receivable		5,000
Add: Net profit	26,425		Plant		20,000
Add: Interest on capital	3,000		Premises	20,000	
	59,425		Less: Depreciation	3,000	17,000
Less: Interest on drawings	1,000				
	58,425				
Less: Drawings	10,000	48,425			
		94,825			**94,825**

Illustration 8

The following is the Trial balance as on 31st December 2014 extracted from the books of Mr. Shanthi

Particulars	**Debit Rs.**	**Credit Rs.**
Freehold Land	35,000	
Mortgage Loan		20,000
Plant and Machinery	45,500	
Loose tools 1.1.14	5,600	
Bills payable		3,400
Book debts	18,200	
Sales		1,21,500
Cash at bank	11,000	
Stock 1.1.2014	10,500	
Insurance	300	
Bad debts	560	
Sundry creditors		15,600
Bills Receivable	5,400	
Purchases	50,000	
Cash on hand	640	
Rent, Rates, etc.	1,300	
Interest	250	
Wages	10,700	
Trade expenses	150	

Salary	1,560	
Repairs to plant	875	
Carriage Inwards	350	
Discount	290	175
Satish's capital		40,000
Drawings	2,500	
	2,00,675	**2,00,675**

Prepare Statement of Profit or Loss and Statement of Financial Position after making the following adjustment: Provision for doubtful debts at 5% on book debts; Interest on capital at 5% unexpired insurance premium Rs.90; Rent outstanding on 31-12-92 Rs. 300; Loose tools revalued at Rs.4,500, Closing stock Rs.30,000.

Solution

Profit and Loss A/c of Mr.Satish
For the year ended 31st December 2014

Dr. Cr.

Particulars	**Rs.**	**Rs.**	**Particulars**	**Rs.**
To Opening stock		10,500	By Sales	1,21,500
To Purchases		50,000	By Closing stock	30,000
To Wages		10,700		
To Carriage inwards		350		
To Gross profit c/d		79,950		
		1,51,500		**1,51,500**
To Insurance	300		By Gross profit b/d	79,950
Less: Unexpired	90	210	By Discount	175
To Bad debts	560			
Add: Provision for doubtful debts	910	1470		
To Rent & Rates	1,300			
Add: Outstanding	300	1,600		
To Interest		250		
To Trade expenses		150		
To Salary		1,560		
To Repairs to plant		875		
To Discount		290		
To Interest on capital (40,00 x 5%)		2,000		
*To Depreciation on Loose tools		1,100		
To Net profit, transferred to capital A/c		70,620		
		80,125		**80,125**

***Note :** Loose tools are generally revalued at the end of accounting year. They are the low value tools and implements like spanners, screw drivers etc. The difference between closing value of loose tools and their opening value is to be treated as depreciation. (Revaluation method of depreciation) i.e Rs. 5,600-4,500 = Rs. 1,100

Statement of Financial Position of Mr. Satish as on 31-12-2014

Liabilities	**Rs**	**Rs.**	**Assets**	**Rs**	**Rs**
Bills payable		3,400	Cash at Bank		11,000
Sundry creditors		15,600	Cash on hand		640
Outstanding rent		300	Book debts	18,200	
Mortgage loan		20,000	Less: Provision for doubtful debts	910	17,290
Capital	40,000		Bills receivable		5,400
Add: Net profit	70,620		Closing stock		30,000
Add: Interest on capital	2,000		Prepaid insurance		90
	1,12,620		Loose tools	5,600	
Less: Drawings	2,500	1,10,120	Less: Depreciation	1,100	4,500
			Plant and machinery		45,500
			Freehold land		35,000
		1,49,420			**1,49,420**

Note : Prepaid Insurance and unexpired insurance are both one and the same.

6.8 MANUFACTURING ACCOUNT

Trading Account is prepared by an enterprise doing trading business i.e. buying and selling of goods manufactured by others. However, where an enterprise is a manufacturing concern, it usually buys one product (raw materials etc.) and by means of labor and machine applied to it, transforms it to another more valuable product which it sells. Moreover, a trading business have only the stock of the finished goods whereas the manufacture will have stock of raw materials, semi-processed goods (WIP) and finished products. Besides, in course of manufacturing, there are other manufacturing overheads too e.g., labor wages, oil & lubricants, rental of factory building, factory supplies, technical staffs' remunerations, electricity & power, depreciation of machinery and equipment etc. which are directly related to the production process. Therefore, a separate Manufacturing Account is usually prepared to gain knowledge of the cost of manufactured goods. The Manufacturing Account is not a substitute for Trading Account. A manufacture also has to sell its product therefore; they also prepare the Trading Account.

A manufacturing account has the following functions:

1. It shows the total cost of manufacturing the finished products and set out in detail with appropriate classifications, the constituent elements of such cost. It is, therefore, debited with the cost of materials, manufacturing wages and expenses incurred directly or indirectly on manufacture.

2. It provides details of factory cost and facilitates reconciliation of financial books with cost records .It serves as a basis of comparison of manufacturing operation from year to year.
3. The Manufacturing Account may also be used for various other purposes. For example, if the output is carried to the Trading Account at market prices, it discloses the profit or loss on manufacture. Similarly, it may also be used to fix the amount of production cost and profit sharing bonus schemes .

Specimen Profoma of Manufacturing Account

Manufacturing account

For the year Ended …………………………..

Particular	Rs.	Particular	Rs.
Opening Stock of Work-in-Progress		Closing Stock of W-I-P	
Material Consumed		Cost of goods manufactured transferred to Trading A/C	
Opening Stock			
Purchase during the year			
Less: Purchase Return			
Less: Closing Stock			
Carriage Inward			
Wages (Labour)			
Electric Power			
Add: Outstanding			
Depreciation on:			
Plant and Machinery			
Land and Building			
Total		**Total**	

6.8.1 Elements of Manufacturing Cost

1. Work-In-Progress:

The stock of Work-in-Progress Account at the end of an accounting period represents the asset value of the partially completed items remaining in the production process. These unfinished goods should be valued comprising the cost of the raw materials used, the labor applied, and a proportionate share of the manufacturing overhead expenses applied so far in the manufacturing process. The value of closing work-in-progress is credited to the Manufacturing Account resulting in reduction of the cost of manufactured goods which, in the next year, is debited to Manufacturing Account as "Opening Work-in-Progress". The accounting treatment is same as that of closing stock in a Trading Account.

2. Materials Used

It is the cost of materials consumed in the process of manufacturing good. This includes not only the basic raw materials but also other materials used in manufacturing the product For example, in the Garment Industries, the prime raw material is cloths. But also equally required materials are stitching threads, buttons, fasteners, other inner material etc. These materials also form part of material costs.

3. Carriage inward

Carriage inward expenses are the expenses incurred during the transportation of materials into the factory site. Such expenses, together with road tax, Octrai, custom duty, etc. form part of material cost and therefore, come under Manufacturing Account.

4. Wages

Wages is the amount paid to workmen directly involve in production activities is form part of manufacturing cost.

5. Salary of foreman and other technical personnel

Salary of foreman, supervisors etc. is indirect labor cost which has direct relationship with production activities. Therefore, these expenses also form part of manufacturing cost. However, if those personnel are also involved in works other than in factory (say, the factory manager allocates his time to administration work), then the proportionate share of his salary may be charged to such appropriate account head under **'Administrative Salary'** Account.

6. Factory Expense

This is generally known as manufacturing overhead, which is also known as factory overhead. Various the factory expenses involves indirect labor, factory supplies (e.g. loose tools) rent of factory building and machineries; lighting, heating and power expenses, oil and lubricants etc.

7. Depreciation

Depreciation is the cost of the Fixed Asset used during the production of goods. As such, depreciation on factory building, machineries, tools & equipment are directly associated with manufacturing activities. Generally, depreciation in charged off to the Profit & Loss Account. However, if Manufacturing Account is prepared, such depreciation has to be charged to it to arrive at a more realistic manufacturing cost.

6.8.2 Closure of the Account

As we discussed in above relating Statement of Profit or Losss all item belonging to Manufacturing Accounts are to be transferred to Manufacturing Account by passing the entries.

<u>Transfer of Expenses Heads</u>

Manufacturing Account Dr.

    To, W-I-P Opening
    To, Opening Stock of Materials

To, Purchases
To, Wages
To, Carriage Inward
To, Factory Wages/Salaries
To, Factory Overhead
To, Depreciation (Machinery & Building etc.)

The respective ledger balances will have nil balance when above entry was passed and at the same time increase debit balance in the Manufacturing Account.

Transfer of Credit Items

There is no sale of goods at this stage. Therefore, the only account heads that will have to be credited to this account are the closing stock of materials and closing work-in-progress. Once the values of closing stocks have been arrived at, the same balances are to be transferred to the Manufacturing Account thus:

Closing Stock (material) Dr.
Work-in-Progress (closing) A/C Dr.
To, Manufacturing A/C

If, there is any balance in Purchase Returns A/c, the same has to be closed by transferring to the Manufacturing A/c.

The Manufacturing Account thus consisting of debit items (expenses) and credit items (stocks in hand) will naturally have excess debit balance which denotes the ‘cost of goods manufactured’ or ‘cost of production’. This cost of goods manufactured is related to the finished products available for selling. Hence it has to be transferred to the Trading Account, thus

Trading Account Dr.
To, Manufacturing A/c

6.8.3 By-Products

In most manufacturing operations, the production of the main product is accompanied by the production of a subsidiary product which has a value on sale. For example, the production of hydrogenated vegetable oil is accompanied by the production of oxygen gas and the production of steel yields scrap. The subsidiary product is termed as a ‘by-product’ because its production is usually very difficult to ascertain the cost of the product. Moreover, its value usually forms a very small percentage of the main product. It is often treated as "Miscellaneous Income", but the correct treatment would be to credit the sale value of the by-product to Manufacturing Account so as to reduce to that extent, the cost of manufacture of main product.

Illustration 9

The following account heads are extracted from the Ledger of M/s. Amar Manufacturer Co. as on 31.12.2069, Prepare Manufacturing and Statement of Profit or Loss and Statement of Financial Position as on that date.

Particulars	Rs.
• Opening W-I-P	10,000
• Opening Stock of Material	6,800
• Material Purchase less returns	16,50,260
• Opening Stock of finished goods	23,400
• Capital Account	200,000
• Drawings	15,000
• Rates and Taxes	2,500
• Salaries	35,240
• Lighting	6,210
• Office Rent	6,000
• Electric Power	25,600
• Traveling Expenses	2,220
• Insurance (Fire)	1,500
• Advertisement Expenses	37,750
• Sales less return	18,35,200
• Bad Debs written-off	9,050
• Discount (Debit Balance)	4,225
• Wages (Labor)	32,212
• General Expenses	11,265
• Postage and Fax expenses	3,200
• Carriage Inwards	5,120
• Factory Land and Building	25,650
• Plant and Machinery	40,000
• Sundry Creditors	37,670
• Furniture and Fixtures	31,200
• Sundry Debtors	65,210
• Cash in Hand	1,218
• Cash at Bank	22,040

Adjustments required

1. Closing Stock (2069.12.31)
   a) Work-in-Progress 12,000
   b) Materials 3,767
   c) Finished Goods 8,333
2. Provide depreciation at 10% on Plan and Machinery, 5% on Furniture and fixtures and 2.5% on Land and Buildings
3. Provide 2.5% for discount on Debtors and Create Provision at 10% for bad debts.
4. Sundry Creditors include an amount of Rs. 2,000 realized from Mr. Shrestha, whose account had been written off two years back.
5. Insurance was paid in advance upto 30 Ashwin 2070.

6. On machine whose value in books as at 01.01.2069 at Rs. 12,000 was disposed of on 30th Poush, 2069 for Rs. 8,750 in part exchange for a new machine costing Rs. 19,000 and an invoice for the net amount of Rs. 10,250 was entered in the books.
7. The following expenditures were outstanding:- Audit fees Rs. 1,200; salaries Rs. 3,000; Electric power
8. A deposit of Rs. 5,000 received from one of the Debtors was credited to his personal account. Ignore fraction of a Rupee in the calculations.

Solution

M/s. Amar Manufacturer CO.
Manufacturing Account
For the year Ended 2069.12.31

Particulars		Rs.	Particulars	Rs.
Opening Stock of Work-in-Progress		10,000	Closing Stock of W-I-P	12,000
Material Consumed			Cost of goods manufactured transferred to Trading A/C	17,20,516
Opening Stock	6,800			
Purchase less return	16,50,260			
	16,57,060			
Less: Closing Stock	3,767	16,53,293		
Carriage Inward		5,120		
Wages (Labour)		32,212		
Electric Power	25,600			
Add: Outstanding	2,500	28,100		
Depreciation on:				
Plant and Machinery	3,150			
Land and Building	641	3,916		
Total		**17,32,516**	**Total**	**17,32,516**

Note:

1. *For understandability, adjustments in respective account heads are shown in the above statement. In actual practice, the adjustment vouchers are passed and ledger balances get changed accordingly.*
2. *Similarly, closing stock of materials may be shown in the credit side instead of deducting in total material purchase value.*

M/s. Amar Manufacturer CO.
Trading Account for the year Ended 2069.12.31

Particulars	Rs.	Particulars	Rs.
Opening Stock of finished goods	23,400	Sales less return	18,35,200
Cost of goods manufactured	17,20,516	Closing Stock of finished goods	8,333
Gross Profit (Transformed) to Profit & Loss A/C	99,617		
Total	**18,43,533**	**Total**	**18,43,533**

M/s. Amar Manufacturer Co.
Statement of Profit or Loss
For the year Ended 2069.12.31

Particulars	Rs.	Particulars	Rs.
Salaries	38,240	Gross Profit b/d	99,617
Rate and Taxes	2,500	Bad debts recovered	2,000
Lighting	6,210	Net loss to be shown in B/S	35,304
Office Rent	6,000		
Traveling Expenses	2,220		
Insurance	750		
Advertisement	39,550		
General Expenses	11,265		
Postage and Fax	3,200		
Audit Fees	1,200		
Bad debts	9050		
Provision of bad debts	7,021		
Discount	4,225		
Provision for discount	1,580		
Depreciation on Furniture	1,560		
Loss on sale of Machinery (WN -1)	2,350		
Total	**1,36,921**	**Total**	**1,36,921**

M/s. Amar Manufacturer Co.
Statement of Financial Position
As at 2069.12.31

Capital and Liabilities		Rs.	Assets		Rs.
Capital	200,000		*Property, Plant & Machinery*		
Less: Drawing	15,000		Land and Building	25,650	
Less: Net Loss	35,304		Less: Depreciation	641	25,009
		1,49,696			
Deposit from debtor		5,000	Plant and Machinery (WN -2)		34,500
Sundry Creditors	37,670				
Less: Bad debt recovered	2,000	35,670	Furniture and Fittings	31,200	
Outstanding Expenses		8,500			
			Less: Depreciation	1,560	29,640
			Current Assets		
			Stock in trade at cost		
			Raw material	3,767	
			Work-in-Progress	12,000	
			Finished Goods	8,333	24,100
			Sundry Debtors	70,210	
			Less: Provision for B/D	7,021	
				63,189	
			Less: Provision for		

		Discount 1,580	61,609
		Cash at Bank	22,040
		Cash in Hand	1,218
		Prepaid Insurance	750
Total	**1,98,866**	**Total**	**1,98,866**

Working Notes:

1. Calculation of profit/loss on sale of Machinery, opening balance of Machinery

Book Value of Machine sold		12,000	
Depreciation (upto 30.09.2069) (12000*0.1*9/12)	9,00		
Book Value on 30.09.2069 (A)		11,100	
Sale proceeds (B)		8,750	
Loss on sale (A-B)		2,350	
Closing balance of Plant & Machinery as per trail		40,000	
Less: net amount of machine entered in books during the year		10,250	
Opening balance of plant & machinery			29,750

2. Machinery A/c

Particular	**Rs.**	**Particular**	**Rs.**
To, Balance b/d	29,750	By, Bank	8,750
		By Depreciation	900
To Bank	19,000	By loss on sale of machine	2,350
		By Depreciation (29750-12000)*10% 1775 (19000*10%*3/12) 475	2,250
		By Balance c/d	34,500
Total	**48,750**	**Total**	**48,750**

Illustration 10

Mr. Shrestha is sole proprietor of a large business. Following balances were extracted from his books as on 31st March, 2013:

Particulars	**Rs.**	**Particulars**	**Rs.**
Shrestha's Capital A/c	54,050	Interest Received	725
Stock as on 1.4.2012	23,400	Cash with Traders Bank Ltd.	4,000
Sales	144,800	Discount Received	1,495
Sales Return	4,30	Investment @ 5% as on 1.4.2012	2,500
Purchase	121,550	Furniture as on 1.4.2012	900
Purchase Return	2,90	Discount Allowed	3,770

Carriage Inward	9,30	General Expenses	1,960
Rent	2,85	Audit Fees	350
Salaries	4,65	Fire insurance Premium	300
Sundry Debtors	12,000	Travelling Expenses	1,165
Sundry Creditors	7,40	Postage and Telegram	435
Loan From Bank @ 12%	10,000	Cash in Hand	190
Interest Paid	45	Deposits at 10 % as on 1.4. 2012	15,000
Printing and Stationary	1,70	Drawings	5,000
Advertisement	5,60		

Adjustments:

a) Purchases include furniture purchased on 1st January, 2013 for Rs. 1,000.
b) Depreciation should be provided on furniture at 10% per annum.
c) Value of stock as on 31st March, 2013 is Rs. 39,300. This includes goods returned by customer on 31st March 2013 to the value of Rs. 1,500 for which no entry has been passed in the books.
d) The loan account from Bank in the books of Mr. Shrestha appears as follows:

Date	Particulars	Amount(Rs.)	Date	Particulars	Amount(Rs.)
31.3.2013	To Balance c/d	10,000	1.4.2012	By Balance b/d	5,000
			31.3.2013	By Bank	5,000
	Total	10,000			10,000

e) Sundry Debtors include Rs. 2,000 due from Robert and Sundry Creditors includes Rs. 1,000 due to him.
f) Interest received represents Rs. 100 from Sundry Debtors and balance on investments and deposits.
g) Interest paid includes Rs. 300 paid to the Bank.
h) Provide for interest payable to the Bank and for interest receivable on investment and deposits.
i) Make provision for doubtful debts @ 5% on the balance under Sundry Debtors. No such provision need to be made for the deposits.

You are required to prepare Trading and Profit and Loss Account for the year ending 31st March, 2013 and Balance Sheet as on that date after taking into consideration the above mentioned adjustments.

Answer

In the book of Shrestha Trading and Profit and Loss Account

For the year ended 31.3.2013

Particulars	Rs.	Rs.	Particular	Rs.	Rs.
To Opening Stock		23,400	By Sales	144,800	139,000
To Purchase	121,550	117,650	Less:Returns (4300+1500)	5,800	
less: Transferred to	1,000		By Closing Stock		39,300
Furniture Less: Return	2900				
To Carriage Inwards		9,300			
To Gross Profit C/d		27,950			
		178,300			**178,300**
To Salaries		4,650			
To Rent		2,850			
To Advertisement		5,600	By Gross Profit b/d		27,950
To Printing and		1,700	By Interest		1,725
To Interest (WN-2)		750	By Discount Received		1,495
To Discount Allowed		3,770			
To General Expenses		1,960			
To Travelling Expenses		1,165			
To Fire Insurance		300			
To Postage and		435			
To Provision for Doubtful debt [WN 1]		475			
To Depreciation on		115			
To Audit Fees		350			
To Net Profit c/d		7,050			
		31,170			**31,170**

Balance Sheet as on 31.3.2013

Liabilities	Rs.	Rs.	Assets	Rs.	Rs.
Capital A/c		56,100	Furniture	900	1,785
Balance as on 1.4.2012	54,050		Add : Additional	1,000	
Add: Net Profit	7,050		Less Depreciation	115	
Less: Drawings	5,000				

Loan from Bank		10,000	Investments		2,500
Interest Outstanding on		300	Deposits		15,000
Sundry Creditors		6,400	Interest accrued on		1,000
			and Deposits[WN 3]		
			Stock in Trade		39,300
			Sundry Debtors	9,500	
			Less: Provision	475	9,025
			Cash with Traders Bank		4,000
			Cash in Hand		190
		72,800			**72,800**

Working Notes

1. **Calculation of Provison for doubtful debts**

Sundry Debtors as per trial Balance	12,000
Less: Sales return not recorded	1,500
	10,500
Less: Cancellation against Sundry Creditors	1,000
Adjusted balance of Sundry Debtors	9,500
Provision for doubtful debts @ 5%	475

2. **Outstanding Interest on Bank Loan**

Annual Interest on Loan @ 12%	600
Less: Interest paid to Bank	300
Outstanding Interest	300

3. **Accrued Interest on Investment and Deposits**

Annual interest on Investment @ 5%	125
Annual interest on Deposits @ 10%	1,500
	1,625
Less: Interest received on Investment and Deposits	625 (725- 100)
Accrued Interest	1,000

Illustration 11 The following are Ledger balances of Shree Rambabu as on 2012.12.31, Prepare Manufacturing and Statement of Profit or Loss and Statement of Financial Position as on that date.

Particulars	Rs.
• Opening Stock of Material (2012.1.1)	51,256
• Material Purchase less returns	165,265

• Opening Stock of finished goods	12,625
• Capital Account	200,000
• Drawings	15,250
• Rates and Taxes	3,756
• Salaries	15,200
• Electricity Charges	2,120
• Electric Power	3,250
• Insurance	1,000
• Advertisement Expenses	17,256
• Sales less return	150,210
• Bad Debs Provision (Cr,)	450
• Discount (Debit Balance)	1,216
• Wages (labor)	18,560
• General Expenses	4,065
• Outstanding Expenses	2,100
• Carriage Inwards	5,210
• Factory land and building	21,200
• Plant and Machinery	22,500
• Sundry Creditors	56,562
• Prepaid Insurance	200
• Sundry Debtors	17,800
• Cash in hand	364
• Cash at Bank	6,756
• Loan taken on mortgage	20,000
• Goodwill	10,000
• Interest on mortgage loan	400
• Dividend Received	3,250
• Bills Payable	11,575
• Investment Reserve as on 1.1.2012 (Cr)	1,250
• Bad debts	450
• Discount Received	2,715
• Investment at cost as on 1.1.2012	36,150
• Bills Receivable	16,263

Additional Information:

(1) Factory Buildings were constructed on land purchased for Rs. 10,000 during the year but this was wrongly posted to the Purchases Account.

(2) Provide depreciation at 10% on Plant and Machinery and at 5% on buildings.

(3) Interest has to be provided on Mortgage Loan at 6% per annum keeping in view the fact that a sum of Rs. 5,000 was repaid on 31st March, 2012.

(4) The market value of the investments as at 31.12.2008 was Rs. 37,000. The investment Reserve Account represents the difference between the cost and market value.

(5) Electricity charge was paid in advance to the extent of Rs.155.

(6) Some investments were sold during the year for Rs. 1,260 realizing a profit of Rs. 125 when compared to their market value on 1st Jan 2012. The sale proceeds were, however, credited to the sales account.

(7) Provision for Bad debts should be maintained at 10%

(8) Out of the Bills Receivable, one bill for Rs. 1,200 matured for payment in the last week of December 2008. However, the Bankers informed that they could not collect the said bill on 31st Dec. 2012. This information was not recorded in the books.

(9) The Closing stock was as follows:

Raw Materials	Rs. 85,263
Finished Goods	Rs. 64,987

You are required to prepare the Manufacturing, Statement of Profit or Loss and the Statement of Financial Position.

Solution

Books of Shree Rambabu
Manufacturing Account
For the year Ended 2012.12.31

Particulars		**Rs.**	**Particulars**	**Rs.**
Material Consumed			Cost of goods manufactured transferred to Trading A/C	151,588
Opening Stock	51,256			
Purchase less return	155,265			
	206,521			
Less: Closing Stock	85,263	121,258		
Carriage Inward		5,210		
Wages (Labor)		18,560		
Electric Power		3,250		
Depreciation on:				
Plant and Machinery	2,250			
Land and Building	1,060	3,310		
Total		**151,588**	**Total**	**151,588**

Books of Shree Rambabu
Trading Account
For the year Ended 2012.12.31

Particulars	**Rs.**	**Particulars**	**Rs.**
Opening Stock of finished goods	**12,625**	**Sales less return**	**148,950**
Cost of goods manufactured	151,588		
Gross Profit (Transfer to Profit & Loss A/C	49,724	Closing Stock of finished goods	64,987
Total	**213,937**	**Total**	**213,937**

Books of Shree Rambabu
Statement of Profit or Loss
For the year Ended 2012.12.31

Particulars	Rs.	Particulars	Rs.
Salaries	15,200	Gross Profit b/d	49,724
Rate and Taxes	3,756	Discount	2,715
Electricity charges	1,965	Dividend Received	3,250
Insurance	1,000	Profit on sale of Investment	125
Advertisement	17,256		
General Expenses	4,065		
Interest on Mortgage	1,275		
Bad debts	450		
Provision of bad debts	1,450		
Discount allowed	1,216		
Net Profit Transferred to Capital A/c	8,181		
Total	**55,814**	**Total**	**55,814**

Books of Shree Rambabu
Statement of Financial Position
As at 2012.12.31

Capital and Liabilities		Rs.	Assets		Rs.
Capital	200,000		*Property, Plant & Machinery*		
Add: Net Profit	8,181		Goodwill		10,000
Less: Drawing	(15,250)	192,931	Land and Building	21,200	
			Add: Additions	10,000	
				31,200	
Investment Reserve A/c		3,235	Less: Depreciation	1,060	30,140
Loan on Mortgage		20,000	Plant and Machinery	22,500	
			Less: Depreciation	2,250	20,250
Sundry Creditors		56,562	Investment at market value		37,000
Bills Payable		11,575	*Current Assets*		
			Stock in trade at cost		
Outstanding Expenses		2,100	Raw material	85,263	
Outstanding Interest			Finished Goods	64,987	150,250
on Mortgage Loan		875	Bills Receivable		15,063
			Sundry Debtors	19,000	
			Less: Provision for B/D	1,900	17,100
			Cash at Bank		6,756
			Cash in Hand		364
			Prepaid Expenses		355
	Total	**2,87,278**		**Total**	**287,278**

Working Notes:

(i) Rs. 10,000 has been deducted from purchases and added to Land and Buildings;

(ii) Rs. 1,200 has been deducted from Bills Receivable and added to Sundry Debtors;

(iii) Rs. 1,260 has been deducted from sales, being sale proceeds of investments the cost Rs. 1,135, has been deducted from investments.

(iv) The cost of investments is Rs. 35,015 i.e. Rs. 36,150 less Rs. 1,135. Since these have to be shown at Rs 37,000, Rs, 1,985 (i.e. Rs. 37,000-Rs.35,015) has been added to investment Reserve which now becomes Rs. 3,235. Strictly, speaking the cost, of the investments sold being less than the market value, the profit should be more than Rs. 125. However, the cost of each investment would be different hence this point has been ignored.

(v) Interest on mortgage loan:

Interest on Rs. 25,000 @ 6% for 3 months	375
Interest on Rs. 20,000@ 6% for 9 months	900
	1,275
Less: Paid	400
Outstanding	**875**

12. Mr. Giriraj is the proprietor of the large business. The following balances were extracted from his book as on 31st March 2005.

Particulars	Amounts	Particulars	Amount
Land and Building	40000	Sales	468100
Purchase	326700	Dividents from investments	960
Return inwards	2500	12% Bank loan secured on fixed assets (no movements during the year)	40000
Travelling Expenses	6900	Girija's Capital Account	80000
Printing Expenses	1600	Bills payables	2600
Cash at bank	30790	Sundry creditors	63130
Discount allowed to debtors	1800	Returns outward	3700
Miscellaneous expenses	18620	Discount received	1200
Sundry debtors	64000	Bills receivables	4800
Postage	800	Stock (01.04.2004)	63680
Furniture	8000	Interest on bank loan	3000
Joint venture suspense account	800	Salaries (including advances NRs. 1500)	22000
Cash in hand	4900	Entertainment expenses	1800
Motor Cash	16000	Carriage inwards	3000
Investments (market value NRs. 14000	12000		
Drawings	10000		
Advertisement expenditure	16000		

Additional Information

a. Sales included a sum of NRs. 32000 received from sales of goods on behalf of Mr. Premraj . The cost of these goods to Premraj was NRs.20000. Mr. Giriraj is entitled to a commission of 5% on sales, for which, effect should be given, and reimbursement of selling expenses. Selling expenses NRs. 1000 were debit to Miscellaneous Expenses Account.
b. On 1st September 2004 Mr. Giriraj entered into a joint venture with Mr. Hari with an agreement to share the profit and losses equally. Hari supplies goods totaling NRs. 33000, which where wrongly passed through the Purchase Book. These goods where sold for cash at a profit 25% on sales and stood credited to sales account. Hari has earlier incurred an amount of NRs 15000 on account of freight and insurance. Joint venture suspense account represent the selling expenses incurred by Giriraj on joint venture.
c. During the year some goods (invoiced at NRs 48000) were sent to sundry customer on 'sale on approval' basis. On 31st March 2005, 20% of those goods remain with customers as the period of approval didn't expire as yet. Proper adjustment should be made in respect of the above. Giriraj makes his invoice at cost 25%.
d. Bills receivable for NRs 2000 endorsed on 1st December 2004 in favour of creditors became subsequently dishonored but no entry for the dishonor has been passed.
e. 3/4th of the advertisement expenses is to be carried forward.
f. Two cheques of NRs 1200 and NRs 1800 issued to parties on 26th March 2005 were lying unpresented on 31st March 2005.
g. Of the debtors a sum of NRs. 1100 is irrecoverable and to be written off. Crete a provision for doubtful debts at 2%.
h. Depreciate fixed assets by 10% except Motorcar, Which is to be depreciate at 20% .
i. Stock on 31st March 2005 was NRs. 4500.

You are required to prepare the Trading and Profit & Loss A/c for the Year ending on 31st March 2005 and Balance Sheet as on that date after taking into consideration the above mentioned information.

Solution

Trading and Profit and Loss Account of Mr. Giriraj
For the year ended on 31.03.2005

Dr. Cr.

Particulars		Amount	Particulars		Amount
To Opening stock		63,680	By Sales (WH-2)	38,200	
To Purchase (WH-1)	2,93,700		Loss :	2,500	
Less: Return	3,700				3,80,000
		2,90,000	By Closing Stock:		

To Carriage Inwards	3,000	At Shop 45,000	
To Gross Profit c/d	76,000	With Customer on approval basic	
		[9600* 100/125] 7680	52,680
	4,32,680		**4,32,680**
To Travelling Expenses	6,900	By Gross Profit b/d	76,000
To Printing & Stationery	1,600	By Discount received	1,200
To Discount Allowed	1,800	By Dividend from investment	960
To Miscellaneous Expenses (WN-5)	17,620	By Commission on goods sold on behalf of Premra (WH-3)	1,600
To postage	800	By Profit on joint venture(WN-4)	4,350
To Advertisement Expenses (WN-6)	4,000		
To Salaries (22,000-15,00)	20,500		
To Entertainment Expenses	1,800		
To Interest on bank loan (WN-7)	4,800		
To Bad debts(WN-8)	1,100		
To Provision for doubtful debts (WN-8)	1,106		
To Depreciation on:			
Building 4000			
Furniture 800			
Motor car 3200	8,000		
To Net profit (Transferred to Capital A/c)	14,084		
	84,110		**84,110**

Balance Sheet
As on 31.03.2005

Capital & Liabilities	**Amount**	**Assets**	**Amount**
Capital Account:		Fixed Assets:	
Opening Balance	80,000	Land & Building	40,000
Add: net profit	14,084	Less: Dep.	4,000
Less: drawings	10,000		36,000
	84,084	Furniture	8,000
Loans:		Less: Dep.	800
			7,200
12% bank loan secured by a charge on fixed assets	40,000		

		Motor car	16,000
Interest due on the loan (WN-7)	1,800	Less: Dep.	3,200
			12,800
Current Liabilities:		Investments (Market value Rs. 14,000)	12,000
Sundry Creditors:		Current Assets:	
for goods	32,130	Stock at shop	45,000
for joint venture (WN-10)	38,850	Stock on approval	7,680
for sale on consignment	29,400		52,680
	1,00,380	Sundry debtors(WN-8)	55,300
Bills payable	2,600	Less: Provision	1,106
			54,194
		Bills receivables	4,800
		Cash in hand	4,900
		Cash at bank	30,790
		Advance against salary	1,500
		Advertisement suspense account	12,000
	2,28,864		**2,28,864**

Working Notes	**Amount(RS)**
1. Net Purchase	
Purchase given in trial balance	3,26,700
Less: Purchase of goods in Joint Venture	33,000
Net Purchase	2,93,700
2.Net Sales	
Sales given in trial balance	4,68,100
Less: sale of consigned goods	32,000
Sales of goods under joint venture(33000*100/75)	44,000
Goods sent on approval(48000*20%)	9,600
Net Sales	3,82,500
3. Commission on consignment	
Consignment sales	32,000

Commission @ 5%	1,600

4. Profit on joint venture

Sale value of goods in joint venture (33000*100/75)	44,000
Less: cost of purchase	33,000
Less: expenses incurred by Hari (co-venturer)	1,500
Less: expenses incurred(joint venture suspense)	800
Profit on joint venture	8,700
Share of profit of Mr. Giriraj(50%)	4,350

5.Miscellaneous Expenses

Expense given in Trial Balance	18,620
Less: expense in relation to consignment	1,000
Miscellaneous Expense(Net)	17,620

6.Advertisement Expenditure

Expenses given in trial balance	16,000
Less: carried forward(16000*3/4)	12,000
Advertisement Expenses(Net)	4,000

7. Interest on bank loan

Bank loan	40,000
Rate of interest(12%)	4,800
Less: already paid	3,000
Outstanding interest	1,800

8. Sundry Debtors, Bad debts & Provisions

Sundry debtors(given)	64,000
Less: debtors on goods sent on approval	9,600
Less: bad debts to be written off	1,100
Add: bill receivable endorsed dishonoured	2,000
	55,300
Provision for doubtful debt @ 2%	1,106

9.Sundry Creditors for goods

Sundry creditors(given)	63,130

Add: bills dishonored	2,000
Less: co-venture A/c	33,000
Sundry creditors for goods	32,130

10

Dr.

Particulars	**Amount**
To Balance c/d	38,850
	38,850

11

Dr.

Particulars	**Amount**
To cash/bank (selling expenses	1,000
To commission	1,600
To balance c/d	29,400
	32,000

Summary

Financial Statement is the final product of the accounting system which will provide information regarding performance and financial position of the entity. It consist basically two statements namely revenue statement and status (real accounts items) statement. The revenue statement can be sub-divided into Manufacturing Account, Statement of Profit or Loss as required. However, preparation of all three types of account may not be required for all types of organizations. It depends on the nature of activities carry out by the entities and their reporting requirement. The Manufacturing Account shows the total cost of production and Statement of Profit or Loss reflect the gross profit or loss and net profit or loss respectively. Similarly, status report i.e. Statement of Financial Position shows the financial position of an organization at a given date.

In this unit we have discussed the techniques of preparing Manufacturing Account, Statement of Profit or Loss, Profit and Loss Appropriation Account and Statement of Financial Position. Items to be covered in each account are discussed at length along with suitable illustration.

Self-Examination Questions

I. Multiple Choice Questions (MCQs)

1. Capital is the difference between
   (a) Income and Expenses (b) Sales and Cost of goods sold
   (c) Assets and Liabilities (d) None of the above

2. Manufacturing account is prepared
   (a) To ascertain the profit or loss on the goods purchased
   (b) To ascertain the cost of the manufactured goods
   (c) To show the sale proceeds from the goods produced during the year
   (d) Both (b) and (c)

3. Over statement of closing work in progress in the period will
   (a) Understate cost of goods manufactured in that period
   (b) Understate current assets
   (c) Understate gross profit from the sales in that period
   (d) Overstate net income in that period

4. Sales is equal to
   (a) Cost of goods sold – Gross Profit (b) Cost of goods sold + Gross Profit
   (c) Gross Profit – Cost of goods sold (d) Cost of goods sold + Net Profit

5. Contingent Liability is
   a) an ascertained liability but its amount and due date are indeterminate
   b) an ascertained liability but its amount and due date are determinate
   c) an unascertained liability but its amount and due date are determinate
   d) an unascertained liability but its amount and due date are indeterminate

6. Sales Rs 100,000, Cost of goods sold Rs 80,000 Closing stock Rs 10,000, Operating expenses Rs 5,000 , fireignt Inward Rs 1000, Freight outward Rs 3,000 . The operating Profit is
   a) Rs 15,000
   b) Rs 25,000
   c) Rs 24,000
   d) None

7. Amount of by product should be shown in
   (a) Debit site of Manufacturing Account (b) Debit site of Trading Account
   (b) Credit site of Manufacturing Account (d) Asset side of Statement of Financial Position

8. Prepaid Rent is shown as:
   (a) Current asset
   (b) Current Liability
   (c) Fixed asset
   (d) Income

9. If closing stock appears in the Trial Balance it appears in:
   (a) Trading account
   (b) Statement of Profit or Loss
   (c) Statement of Financial Position
   (d) Profit and loss appropriation

10. Opening stock rs 100,000 , Sales Rs 500,000 , Gross profit @ 25% on cost . Purchase Rs 600,000 then Closing stock is
   a) Rs 125,000
   b) Rs 225,000
   c) Rs 300,000
   d) Rs 325,000

11. Opening Stock Rs 40,000 , purchases Rs 360,000 , Closing Stock Rs 130,000 but the market value of the closing stock was Rs 120,000 ,Sales Rs 380,000, Carriage inward Rs 6,000 , Fireight inward Rs 4,000, salary expense Rs 50,000, return inward Rs 20,000, return outward Rs 40,000. The Gross Profit for the year is
   a) Rs 60,000
   b) Rs 70,000
   c) Rs 90,000
   d) Rs. 1,10,000

12. Bills receivable discounted but not due till date of final account is shown as:
   (a) Liabilities
   (b) Assets
   (c) Profit & Loss A/c
   (d) Notes to Accounts (contingent liabilities)

13. Only personal and real accounts are shown in:
   (a) Trial balance
   (b) Statement of Financial Position
   (c) Trading A/c
   (d) Profit & Loss A/c

14. Cost of Raw material consumed rs 100,000, Closing stock of Raw material Rs 30,000 Opening Work in progress Rs 60,000, Closing Work in progress Rs 15000. Manufacturing overheads rs 8000 , Sales of scrap Rs 3000 , selling overheads Rs 10,000. The cost of manufactured goods is
   a) Rs 150,000
   b) Rs 160,000
   c) Rs 153,000
   d) None

15. Closing stock of work in progress Rs 30,000 cost of manufactured goods Rs 100,000. Opening stock of finished goods Rs 20,000 closing stock of finished good rs 25000 the manufacturing cost of finished goods sold is
    a) Rs 95000
    b) Rs 105,000
    c) Rs 65,000
    d) None of above

II. Short Descriptive Questions (SDQs)

1. 'Manufacturing Account is prepared to find out cost of goods produced' Explain.
2. Define Statement of Financial Position. What are the objectives of Statement of Financial Position?
3. Differentiate between Trading Account and Profit & Loss Account.

II. Practical Questions (PQs)

1. From the following Trial balance prepare a Statement of Profit or Loss for the year ending 31st Chaitra, 2075 and a Statement of Financial Position as on that date:

Debit Balance:			
Sundry Debtors	1,500	Rent, Rates and Taxes	800
Stock 1.1.2069	5,000	Drawings	2,000
Land & Buildings	10,000	Purchases	10,000
Cash in Hand	1,600	Office Expenses	2,500
Cash at Bank	4,000	Plant & Machinery	5,700
Wages	3,000	Salaries	2,000
Bills Receivables	2,000	*Credit Balance:*	
Interest	200	Capital	25,000
Bad Debts	500	Interest	600
Repairs	300	Sundry Creditors	7,000
Furniture & Fixtures	1,500	Sales	17,000
Depreciation	1,000	Bills Payable	4,000

On 31st Chitra, 2075 the stock was valued at Rs. 10,000

2. The following is the trial balance of Mr. Niroj as on 31.12.2019

Particulars	Debit	Particulars	Credit
Stock on 1.1.2019	75,000	Sales	750,000
Purchases	525,000	Capital	1000,000
Fuel and Power	15,000	Creditors	125,000
Building	360,000	Reserve Fund	45,000
Salaries	75,500	Bank Overdraft	20,000
Plant and Machinery	350,000	12% Bank Loan	150,000
Debtors	145,000	Provision for doubtful debts	10,000
Cash at bank	45,500	Return	12,000
Wages	64,000	Discount Received	23,000

Carriage outward	35,000	Bills payable	25,000
Investment	200,000		
Rent	15,000		
Stationery	5,000		
Goodwill	80,000		
Interest on Loan	10,000		
Drawing	100,000		
Entertainment	40,000		
Prepaid expenses	20,000		
Total	**2,160,000**	**Total**	**2,160,000**

Additional Information:

i. The value of stock at the end was Rs. 126,500
ii. Plant and Machinery included Machinery costing Rs. 50,000 purchased on 1.7.2019
iii. Depreciate Plant and Machinery by 10% and Amortize Goodwill by 20%.
iv. Wages outstanding for two months.
v. Prepaid expenses expired to the extent of Rs. 15,000
vi. Income tax paid Rs. 15,000 during the year but not recorded.
vii. Provision for bad debts is to be maintained @ 10% of debtors after deducting bad debts Rs. 5,000
viii. Credit purchase of Rs. 10,000 made during the year, was not recorded.
ix. Provide interest on capital and drawing @ 5% p.a.

3. From the following Trial Balance of Mr. Sudhir and additional information prepare Statement of Profit or Loss for the year ended 31st March, 2019 and Statement of Financial Position as on that date:

Trial Balance as at 31st March 2019

Particulars	Debit	Particulars	Credit
Furniture	20,000	Capital	100,000
Purchases	150,000	Interest earned	4,000
Debtors	200,000	Sales	321,000
Salaries	30,000	Purchase Return	5,000
Wages	20,000	Creditors	120,000
Rent	15,000	Provision for bad debts	6,000
Sales Return	10,000	Commission received	2,000
Bad Debt Written off	7,000		
Drawings	24,000		
Printing & Stationery	8,000		
Insurance	12,000		
Opening Stock	50,000		
Office Expenses	12,000		
Total	**558,000**	**Total**	**558,000**

Additional Information:

1. Depreciate Furniture by 10%.
2. A provision for doubtful debts is to be created to the extent of 5% on sundry debtors.
3. Salaries for the month of March, 2013 amounting to Rs. 3,000 were unpaid which must be provided for. However salaries included Rs. 2,000 paid in advance.
4. Insurance amounting to Rs. 2,000 is prepaid.
5. Provide for outstanding office expenses Rs. 8,000
6. Stock used for private purpose Rs. 6,000
7. Closing Inventory in Trade Rs. 60,000.

4. The following is the Trial Balance of Miss. Sandipa Gautam as at 31st Ashad 2075:

Debit Balances	Rs.	Credit Balances	Rs.
Stock on 1.4.2069	46,800	Owner's Capital	86,690
Returns inwards	8,600	Sales	389,600
Purchases	321,700	Returns Outward	5,800
Freight & Carriage	18,600	Sundry Creditors	14,800
Rent & Taxes	5,700	Bank Loan @6% p.a.	20,000
Salaries & Wages	9,300	Miscellaneous income	250
Sundry Debtors	24,000	Discount Earned	4,190
Bank Interest	900		
Printing and Stationery	14,600		
Cash at Bank	8,000		
Furniture & Fittings	5,000		
Discount Allowed	1,800		
General Expenses	11,450		
Insurance	1,300		
Postage & Telegrams	2,330		
Cash in Hand	380		
Traveling Expenses	870		
Drawings	40,000		
Total	**521,330**	**Total**	**521,330**

The following adjustments should be made:

(a) Included amongst the Debtors is Rs. 3,000 due from Miss. Rosy and included among the creditors Rs. 1,000 due to her. (b) Provision for doubtful debts be created @ 5% and Reserve for discount @ 2% on sundry debtors. (c) Depreciation on furniture & fittings @ 10% shall be written off. (d) Personal purchases amounting to Rs. 600 had been included in the purchases. (e) Interest on Bank Loan shall be provided for the whole year. (f) A quarter of the amount of printing and stationery is to be carried forward to the next year. (g) Credit purchase invoice amounting to Rs. 400 had been omitted from the books. (h) Stock on 31.3.2075 was Rs. 78,600.

Required: Statement of Profit or Loss for the year ended 31.3.2075 and Statement of Financial Position as on that date.

5. From the following balances and information received from the books of Mr. Sohit on 31.12.2019, you are required to prepare the Statement of Profit or Loss for the year ended 31.12.2019 and the Statement of Financial Position on that date:

Particulars	Debit	Credit
Mr. Sohit's Capital Account		60,000
Plant and Machinery	18,000	
Depreciation on Plant and Machinery	2,000	
Repairs of Plant	1,600	
Wages	28,000	
Salaries	4,000	
Income Tax	500	
Cash in Hand	2,000	
Land	24,000	
Building Depreciation	2,500	
Purchases less Returns	123,500	
Sales		249,000
Bank Overdraft		13,800
Accrued Income	2,000	
Salaries Outstanding		2,000
Bills Receivables	30,000	
Bills Payables		3,000
Provision for Bad Debts		6,000
Bad Debts	1,000	
Discount on Purchases		4,000
Sundry Debtors	35,000	
Sundry Creditors		23,300
Stock on hand on 1.1.2019	37,000	
Buildings	50,000	
Total	361,100	361,100

Additional Information given was:

a. Stock on 31.12.2019 was Rs. 30,000

b. Write off Rs. 3,000 as bad debts and maintain a provision for bad debts at 5% on Sundry Debtors.

c. Goods costing Rs. 5,000 were sent to a customer on sale on approval basis on 30.12.2019. These were recorded as actual sales. The rate of gross profit was 1/6th of Sales.

d. Rs. 1,200 paid as rent on the office was debited to landlord's a/c and was included in sundry debtors.

e. General Manager is to be given a commission at 10 % after charging the commission of works manager and his own on net profit.

f. Works manager is to be given a commission at 5% after charging commission of General Manager and his own commission on net profit. Such commissions shall be calculated to the nearest multiple of a rupee.

6. Ram was carrying on business as a wholesale businessman. He closes his accounts by 31st December every year. Shyam is his manager on a monthly salary of Rs. 1,500 till 30.6.2018 and from 1.7.2019, it was agreed that he will admitted as a partner with 1/3 share in the profit and losses without any salary. The books of the firm yielded the following Trial Balance at the end of the year on 31.12.2019.

Particulars	Rs.	Rs.
Furniture and Fittings	9,000	
Motor Car	15,000	
Ram's Drawing Account	18,000	
Ram's Capital Account		35,000
Purchases (Rs. 100,000 till 30.6.2019)	210,000	
Opening Stock	30,000	
Selling Expenses(10% of sales)	33,000	
Sundry Debtors	14,000	
Sundry Creditors		7,700
Cash at Bank	15,000	
Cash in Hand	900	
Salaries (including Shyam's salary)	15,000	
Office Rent	6,400	
Rent Advance	4,000	
Sales		330,000
Audit Fee	2,400	
	372,700	3,72,700

The following additional information is available.

(i) Furniture and fittings are to be depreciated at 10% and Motor car at 20%.

(ii) Rent which was Rs. 500 p.m. till 31.8.2019 was increased to Rs 600 p.m. from 1.9.2019.

(iii) Sales during the first six months of the year Rs. 110,000. Stock on 30.6.2019 was Rs. 50,000 and on 31.12.2019 was Rs. 20,000.

You are required to prepare the Statement of Profit or Loss in columnar from showing the shares of the partners and the Statement of Financial Position of the firm as at 31.12.2019.

7. From the following trial balance and information, prepare statements of performance and statement of position of Mr. Somesh for the year ended Ashad 32, 2065.

Accounts Heads	Rs.	Rs.
Furniture	8,000	
Somesh's Drawing Account	19,200	
Somesh's Capital Account		160,000
Purchases	128,000	

Trade Expenses	1,280	
Sundry Debtors	29,440	
Sundry Creditors		19,200
Cash at Bank	7.360	
Cash in Hand	2,048	
Salaries and Wages	29,600	
Land and Buildings	144,000	
Return Outward		6,400
Loan taken on Magh 1, 2064 @ 6 % p.a.		48,000
Return Inward	8,000	
Carriage	16,000	
Sundry Expenses	960	
Printing and Stationery	800	
Insurance	1,600	
Provision for bad and doubtful debts		1,600
Provision for discount on debtors		608
Bad debts	640	
Profit of Textile Department		16,000
Stock of general goods on 1.04.2064	34,080	
Stock of Textile goods of 1.04.2064	12,800	
	475,808	475,808

Additional Information:

1, Stock of general goods on Ashadh 32, 2065 valued at Rs. 43,680
2. Fire occurred on 23rd Ashadh 2065 and Rs. 16,000 worth of general goods were destroyed. The Insurance Company accepted claim for Rs. 9,600 only and paid the claim money on 10th Shrawan 2065.
3. Bad debts amounting to Rs. 640 are to be written off. Provision for bad and doubtful debts is to be made at 5% and for discount @ 2% on debtors.
4. Received Rs. 9,600 worth of goods on Jestha 12, 2065 but the invoice of purchase was not recorded in the purchase book.
5. Mr. Somesh took away goods worth Rs. 3,200 for personal use but no record was made thereof.
6. Charge depreciation @ 5% on Land and building, 15% on Plant and machinery and 25% on furniture.
7. Insurance includes prepaid to the extent of Rs. 320.

8. The following information is given to you:

Provision for doubtful debts on 1st January	12,000
Provision for discount on debtors 1st January	5,000
Bad debts written off during the year	14,000

Discount allowed during the year	14,000
Sundry Debtors on 31st December	200,000

The provision for doubtful debts is maintained at 4% of debtors and the provision for discount is maintained @ 2% of the debtors. Give the accounts relating to the two provisions.

ANSWER

Multiple Choice Questions (MCQs)

1	c	6	a	11	d
2	b	7	c	12	d
3	d	8	a	13	b
4	b	9	c	14	a
5	d	10	c	15	a

CHAPTER- 7

NOT FOR PROFIT ORGANISATIONS

UNIT 1:

Not for Profit Organisations

Learning Objectives

1. *Try to understand the meaning of Receipts and Payments Account and Income and Expenditure Account and see the distinct between the two Accounts.*
2. *Learning the technique of preaparing Receipts and Payments Account.*
3. *Identify main sources of income and learn the technique of preparing Income and Expenditure Account from Recepit and Payment Account.*
4. *Learn the technique of preparing Statement of Financial Position.*

7.1 INTRODUCTION

The non-profit organization is a legal and accounting entity that is operated for the benefit of the society as a whole, rather than for the benefit of a sole proprietor or a group of partners or shareholders. In every society, some organization or associations are found which do not have profit making as their objective. Their main objective may be social, educational, religious or charitable cause and they take the form of clubs, societies or college. The organization other than business enterprises such as public hospital, club, community school, voluntary/charitable institutions etc. which do not have profit making objective also have financial transactions. In other words, these organizations involve in the activities of generating revenue, incurring expenditure and similarly also acquiring assets. Therefore, accounting for transactions relating to their activities with respect to income and expenditure, as well as assets and liabilities for these institutions are also to be done

Accounting is always done with respect to an entity. An accounting entity may be an individual or group of persons. On the basis of the objectives to be achieved accounting entities can be divided into two categories. These are: (i) Entities for profit, and (ii) Not-for-profit entities.

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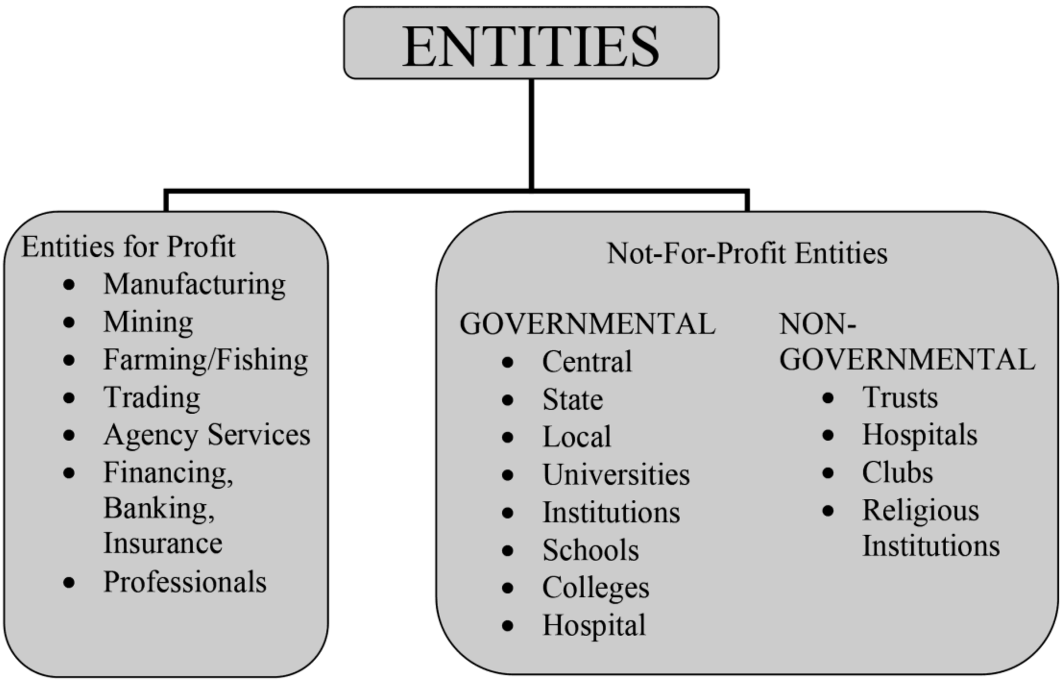

The objective of Profit making entities is to conduct business and earn profit. These entities include manufacturers, wholesalers, retailers, service providers such as transporters, bankers, insurance agencies, and professionals such as doctors, lawyers, engineers, architects, professional advisors, etc.

However, the objective of Not-For-Profit Entities is to provide services to the people without any intentions to seek profit. The main objective of these entities may be promotion of social, educational, religious, cultural or charitable activities. These entities may be in the form of sports club, social or literary club, religious institutions, libraries, hospitals, educational institutions, professional bodies, societies and charitable institutions like orphanage homes, and old age homes. There is no difference in the method of accounting between the business enterprises and the not profit organizations. The same principles and concept of accounting equally apply to both types of organizations. However, following basic difference may be noted:

a) Investment of capital is made in the business organization whereas the non-profit making organizations have the "Capital Fund" instead of the capital whose sources are membership fee, grants received from donors as well as surplus of incomes over expenditures.

b) In case of the business enterprises, they prepare the account called "Profit & Loss Account" for its income and expenses as they have the profit making objective. Whereas the organizations with non-profit making objective prepare the account known as "Income & Expenditure Account". That is why, simply avoid the words 'Profit' and 'Loss'.

c) The non-profit making institutions are being charitable organizations do not distribute the "Excess of Income" among its members.

Generally, the organizations with non-profit making objective have the practice of following cash-basis of accounting for its income and accrual basis of accounting for its expenditure. The main reason for this is that the income receipts being voluntary contribution, the same cannot be considered as 'receivable' simply on the basis of some ones expression of 'willingness' to contribute or donate.

Main Source of Income of non-profit organization are the subscription, ordinary donations, membership fees or entrance fees, recurring grants from local authorities and income from investments etc. Any amount raised for a special activity, e.g. on sale of match tickets, is deducted from the expenditure of that activity and net amount is shown in the income and expenditure account. Any receipt of capital nature shall not be shown as income but will be credited to the **Capital Fund** or **special purpose fund e**.g**. "Building Fund"** or if the receipts is on account of sale of Property, Plant & Machinery, it shall be credited to the assets account. The collected funds are spend for meeting various expenses of the society such as payment of rent, salary, repair and maintenance of the Property, Plant & Machinery, traveling, expenses of the canteen and consumable stores.

7.2 ACCOUNTING HEADS

Though the rules of preparing the final account of the commercial organization and Not-For-Profit-Organizations are same ,but there are some items which are peculiar to the Not-For-Profit organizations. Some of these headings are discussed below:

Capital Fund

It is an item of Statement of Financial Position of a non-profit organization representing the net investment of its contributing members. It is the main resources of these institutions. After its initial setting up from grant, this would either increase or decrease on the basis of excess of income over expenditure or vice versa arising from its activities.

Grants

Activities of the Not-For-Profit organization depends upon the grant received from various entities of the society. These grants can be divided in two categories i) Recurring or General Grants ii) Non-recurring or Special Grants. Recurring grants in the form of maintenance grants is spent in the year of receipt and is trated as revenue receipt and credited to income and expenditure account. Special Grants provided by the donor for specific program or for purchase of assets are treated as capital receipt and transferred to fund account. For example, if grant is received for the construction of building, the receipt of the fund is required to be accounted separately as follows:

Cash Account Dr.
To, Building Construction Grant A/C Cr.

Similarly, if donation or grant is received from any source towards organizing an annual sports program -

Cash Account Dr.
To, Annual Sports Program Grant A/C Cr.

It is not necessary that the amount of grants have to be received in cash only. Donors may provide grants in kind as well. In such situation, the account head concerning the specific group of goods/assets received should be debited instead of debiting the cash.

While expending the cash received for any special program or purpose, the same program operation account should be debited. This is required to maintain the record of the extent of expenditure made under such program or purpose. For example, if building construction is being carried out, the amount spent for such purpose would be recorded as:

Building Construction Account Dr.
To, Cash Account Cr.

The above Building Construction Account being real account should be subsequently transferred to the fixed asset. Therefore, this should come in the assets side of the Statement of Financial Position. After the completion of the construction work, the purpose of the grant is considered achieved as such it is not required to be shown as "Special Grant" in the Statement of Financial Position. Therefore, in such situation, the grant amount should be transferred to the "Capital Fund" by passing following entries:

i. Building Account Dr.
To, Building Construction A/C
(For capitalization of building on completion of construction)

ii. Building construction Grant A/C Dr.
To, Capital Fund
(For transfer of specific purpose fund to capital fund account on completion of construction of building).

Donation

It is amount contributed by the supporters, members and well-wishers of the organization in form of cash or kind. The donation may be general or specific. When the purpose for which the donation is to be utilized is not mentioned, it is called as General Donation and treated as income in the year of receipt. If the amount of general donation is very large, it can be treated as capital receipt and should be recorded on liabilities side of the Statement of Financial Position but the general donation of relatively small amount are credited to the income and expenditure account.

Donation received for the specific purposes are capitalized and recorded on liabilities side of the Statement of Financial Position. On completion of the purpose for which specific donation was received, the amount of specific donation fund should be transferred to capital fund. Similarly, if the books of accounts are closed prior to completion of the special program for which a grant has been received, the balance amount of such grant would appear in the Statement of Financial Position as follows;

Liabilities Side	Rs.
Grant for Annual Sports	50,000
Less: Expenditure till date	20,000
	30,000

Legacy

It is an amount or other item of value received from a deceased person under the terms of a will. When anything is personally given away by a will, it is treated as a gift in the legal term. The gift which is made by a will, out of general fund of an estate. it is described as 'legacy'. A legacy may be 'demonstrative' when it is made out of a particular fund or 'specific' when a particular portion of the assets assigned. Legacy is of non-recurring nature, it is treated as capital receipt and recorded on liabilities side of Statement of Financial Position as addition to capital fund. If the legacy is received for the specific purpose, then it should be capitalized in the name of the 'Fund' for that particular purpose .

Subscription

It is a primary source of income of Not-For-Profit organizations. It is the amount paid by the members at regular intervals to keep his membership alive. It is a revenue item and should be credited to income and expenditure statement of the period in which it was received after being adjusted for outstanding and advance subscription.

Illustration 1

Prepare a Subscription Account from the following items for the year ending on 31st March, 2018

i) Subscription in arrears on 31.3.2017: Rs. 500
ii) Subscription received in advance on 31.3.2017: Rs.1,100
iii) Total Subscription received during 2017-18: Rs. 35,400
This includes Rs. 400 for 2016-17, Rs. 900 for 2018-19 and Rs. 300 for 2019-20. Subscription outstanding for 2017-18: Rs 400

Solution

Subscription Account

Particulars	Rs.	Particulars	Rs.
To Outstanding Subscription A/c	500	By Advance Subscription A/c	1,100
To Income & Expenditure A/c (bal. fig)	35,300	By Bank A/c	35,400
To Advance Subscription A/c For 2018-19 900 For 2019-20 300	1,200	By Outstanding Subscription A/c For 2016-17 100 For 2017-18 400	500
	37,000		**37,000**

Entrance or Admission Fee

Admission fee payable by a member only once, at the time of becoming a member, should be treated as capital receipts and credited to Capital Fund Account. Where the amount is small, just to cover the expenses of admission, it should be treated as revenue receipts and credited to income and Expenditure Account. When a specific direction has been given in the rules and regulations of the organization, it should be treated accordingly.

Life Membership Fees:

Amount received from life membership is a capital receipt and should be credited to a special fund and an amount equal to annual subscription is transferred to the Income and Expenditure Account every year .The balance of this fund is carried forward till it is fully exhausted. Alternatively, the entire amount can be credited to the Capital Fund in the year in which it is received.

Thus, while preparing the final accounts on accrual basis by the charitable institutions, specially in respect of the annual fee and other fee received, differentiation is required to be made between the amounts pertaining to the previous year, amount yet to be received and amount received in advance.

Illustration 2

A club has received in total Rs. 5,00,000 towards annual fees. Of this amount, Rs. 10,500 pertains to the previous year and Rs. 20,000 has been received in advance pertaining to the next year whereas Rs. 11,500 is yet to be received in respect of the current year's fee. Accordingly, the actual fee earned for the year out of the total amount received during to year would be as follows;

Statement showing the Total Life Membership Fee Income for the year

Particular	Amount	Amount
Total amount received		5,00,000

Less: Previous year's fee	10,500	
Less: Next year's fee	20,000	30,500
Cash received for this year		469,500
Add: Amount yet to be received for this year		11,500
Total fee income for the year		481,000

The journal entries for the above adjustment are to be passed as follows: (Only such entries which requires adjustment in the fees account).

a) Adjustment entry for the amount of Rs. 10,500 received during the year in respect of the fee pertaining to the previous year:

Fee Income Account Dr. 10,500
To, Fee Receivable Account 10,500
(Assuming the above amount has been debited to the Fee Receivable Account in the previous year).

b) Adjustment entry for the amount of Rs. 11,500 being this year's fee yet to be received:

Fee Receivable Account Dr. 11,500
To, Fee Income Account 11,500

c) Adjustment entry for the amount of Rs. 20,000 being the fee received in advance pertaining to the next year:

Fee Income Account Dr. 20,000
To, Fee Received in Advance 20,000

(This "Fee Received in Advance" A/C will be transferred to Fee Income A/C in the subsequent year).

After passing and posting of the above entries, the Fee Income Account would appear as follows:

Fee Income Account

Dr. **Cr.**

Particular	**Rs.**	**Particular**	**Rs.**
To, Fee Receivable	10,500	By Cash	5,00,000
To, Fee Received in Advance	20,000	By Fee Receivable	11,500
To, Net fee transferred to Income & Expenditure A/C	481,000		
	511,500		**511,500**

Illustration 3

Subscription received during the year 2018	Rs. 170,000
Subscription outstanding at the beginning of 2018	14,000
Subscription outstanding at the end of 2018	16,000

Calculate the amount of subscription to be credited to Income and Expenditure Account during the year of 2018

Solution:

Subscription Account

Dr. **Cr.**

Particulars	**Rs.**	**Particulars**	**Rs.**
To, Subscription Outstanding at the beginning	14,000	By, Cash A/c	170,000
To, Income and Expenditure A/c	172,000	By, Subscription Outstanding at the end	16,000
	186,000		**186,000**

Illustration 4

Calculate the amount of subscription to be credited to Income and Expenditure Account during the year of 2018 from the following information.

Subscription received during the year 2018	Rs. 82,000
Subscription outstanding at the beginning of 2018	8.900
Subscription outstanding at the end of 2018	3,200
Subscription received in advance for 2019	2,700

Solution

Subscription Account

Dr. **Cr.**

Particulars	**Rs.**	**Particulars**	**Rs.**
To, Subscription Outstanding at the beginning	8,900	By, Cash A/c	82,000
To, Subscription received in advance for coming year	2,700	By, Subscription Outstanding at the end	3,200
To, Income and Expenditure A/c	73,600		
	85,200		**85,200**

7.3 RECEIPTS & PAYMENTS ACCOUNTS

This is basically the statement of cash receipts and payments and therefore, this is known as "Receipt & Payment Account". This is an elementary form of account commonly adopted by non-profit making concern such as hospital, clubs, societies etc., for presenting periodically the result of cash receipts and payments. It consists of a classified summary of cash receipts and payments over a certain period together with cash balances at the beginning and close of the period. Therefore, from this account, information about total cash (and bank) balance in the beginning of the year (or period), the amount received from various sources, the amounts of payments made during the year under various accounts and balance of cash remaining at the end of the year could be ascertained. Charitable institutions may not necessarily maintain proper accounting. But still they will be maintaining a cash-book where all receipts and payments are recorded in chronological order.

For convenience of preparation of the account, the cash-book is usually provided with a sufficient number of analysis columns on each side to record separately the principal items of income and expenditure. A sundry column is also provided for extraordinary items, which are analysed at the end of the year.

Illustration 5

The receipts and payments for the Rotary Club of Kathmandu for the year ended Asadh 31, 2076 were: Entrance fees Rs. 30,000; Membership fees Rs. 300,000; Donation for making parking shade Rs. 100,000, Exhibition sales Rs. 12,00,000, Exhibition expenses Rs. 980,000, Salaries and Wages Rs. 92,000, Construction of parking shade Rs. 125,000; General expenses Rs. 6,000; Rent and taxes Rs, 4,000, Bank charges Rs. 800. Rental income for ground Rs. 30,000.

Cash in hand Shrawan 1, 2075 Rs. 12,500 and Asadh 31, 2076 Rs. 8400

Bank Balances Shrawan 1, 2075 Rs, 225,580.

Prepare the Receipts and Payments Account for the year ended Asadh 31, 2076.

Solution

Rotary Club of Kathmandu
Receipts and Payments Account
For the year ended Asadh 31, 2076

Receipts	Rs.	Payments	Rs.
To, Cash in Hand b/d	12,500	By, Exhibition Expenses	980,000
To, Bank Balances b/d	225,580	By, Salaries and Wages	92,000
To, Entrance Fees	30,000	By, Construction of Parking Shade	125,000
To, Membership Fees	300,000	By, General Expenses	6,000
To, Donation for Parking Shade	100,000	By, Rent and taxes	4,000
To, Exhibition sales	1,200,000	By, Bank Charges	800
To, Rental Income	30,000	By, Balance c/d	
		Cash in Hand	8,400
		Bank Balances	681,880
	1,898,080		**1,898,080**

Limitation of Receipts and Payments Accounts:

From a study of the above account, it will be apparent that the increase in the cash and bank balances at the end of the year, as compared to those in beginning, does not truly represent the surplus for the year since it does not take into account the cost of construction of the parking shade, which is in excess of the donation received, the outstanding subscription or those which were collected in advance, etc.. Since the Receipts and Payments Account includes items relating to all periods or of all types, it does not serve the purpose of ascertaining whether current income is sufficient to meet the current expenses for the year.

7.4 INCOME AND EXPENDITURE ACCOUNT

Income and Expenditure Account is same as the Statement of Profit or Loss of a business enterprises. Both accounts are the nominal accounts and prepared on the basis of accrual principle of accounting. Income and Expenditure Account is prepared by matching the revenues against the expenses for a specific period, usually a year. It is an account which is widely adopted by non-profit making concerns. Since non-profit making organization do not earn profit (or incur loss) they do not prepare Statement of Profit or Loss but to evaluate the financial performance of the concern prepare Income and Expenditure Account at the year end. This will show surplus or deficit of income over expenditure.

The method and technique of the preparation of an Income and Expenditure Account is similar to that which is followed in the preparation of a Statement of Profit or Loss of a profit-seeking organization. All the income irrespective of whether received or not are shown on the right hand side (income side) and all expenditures irrespective of whether paid or not are shown in the left-hand side (expenditure side). No capital expenditure or receipt is taken in the Income and Expenditure Account. The difference of total of income side and expenditure side will be taken as surplus or deficit.

Income and Expenditure A/C and Receipt & Payment Account is not complimentary to each other. The Income and Expenditure A/C is a statement to shown the difference between the Income and Expenses (considering accounts) whereas Receipt and Payment Statement shows only the receipt of cash and payments made. The differences existing between the Income & Expenditure Account and the Receipt & Payments Account are as follows:

	Receipts and Payments Account	**Income and Expenditure Account**
i.	It is a summarized and classified version of both cash and bank transactions. It starts with the opening cash or bank balance and is debited with all sums received and credited with amounts paid out whether or not such receipts and payments relate to the period.	It is drawn up in the same from as the Profit & Loss Account. Expenditure of revenue nature only is shown on the debit side, and income and gains or revenue nature are shown on the credit side.
ii.	The balance of the accounts at the end of year represents the difference between the amount of cash received and paid out. It is always in debit since it is made up of cash in hand and at bank.	It does not start with opening balances. The closing balance represents the amounts by which the income exceeds the expenditure only or vice versa.
iii.	All the receipts and payments whether of a revenue or capital nature are included in the account.	It contains all the items of income and expenditure relevant to the period of account, whether received or paid out as well as that which have fallen due for recovery or paid out as well as that which have fallen due for payment or have accrued for recovery. Capital

		receipts and expenditures are not taken into account. Prepaid expenses and pre-payments of income are excluded.

For easily remembering, summary of differences of Receipts and Payments Account and Income and Expenditure are reproduced as under:

	Difference	Receipt & Payment	Income & Expenditure
a)	Opening balance (Cash & Bank)	Appear	Do not Appear
b)	Capital Income & Expenditure	Appear	Do not Appear
c)	Revenue, Expenditure & Income	Appear	Appear
d)	Income & Expenditure, Receivable & Payable (on accrual basis)	Do not Appear	Appear
e)	Prepaid expenses	Appear	Do not Appear
f)	Incomes received in advance	Appear	Do not Appear
g)	Depreciation, provision for bad and doubtful debts	Do not Appear	Appear
h)	Credit sales & Purchases	Do not Appear	Appear
i)	Closing Cash & Bank Balance	Appear	Do not Appear

Preparation of Income and Expenditure Account and Statement of Financial Position from Receipts and Payments Account along with additional information:

Step 1

Prepare Statement of Financial Position at the beginning of the period after taking into account (i) the opening balances of cash and bank as per Receipts and Payment Account, and (ii) Assets and Liabilities (supplied through additional information) at the beginning. The difference between the Assets and Liabilities represents Accumulated Fund. This accumulated fund is also called General Fund or Capital Fund.

Step 2

Identify, from the payments side of the Receipts and Payments Account, the Capital payments and revenue payments, Now,

(i) Post revenue payments in which no adjustments to be made directly, to the expenditure side of Income and Expenditure Account.

(ii) Prepare statements or open ledger accounts in respect of revenue payments in which adjustment to be made. Post the adjusted amount to the expenditure side of the Income and Expenditure Account.

(iii) Post capital payments to appropriate assets or liabilities for being incorporate in the Statement of Financial Position.

Step 3

Identify, from receipts side of the Receipts and Payments Account, the capital Receipts and Revenue receipts, then

(i) Post revenue receipts in which no adjustment is to be made, directly to the income side of the Income and Expenditure Account.

(ii) Prepare statement or open ledger accounts in respect of revenue receipts in which adjustment is to be made. Post the adjusted amount is to the income side of the Income and Expenditure Account.

(iii) Post capital receipts to appropriate assets and liabilities for being incorporated in the Statement of Financial Position.

Step 4

Analyze the additional information given and make necessary entries in the Income and Expenditure Account for depreciation on Property, Plant & Machinery, loss or profit on sale of assets etc.

(i) Depreciation – post to the expenditure side of the income and Expenditure Account.

(ii) Loss on sale of Assets - post to the expenditure side of the Income and Expenditure Account.

(iii) Profit on sale of Assets – Post to the income side of the Income and Expenditure Account.

Step 5

Calculate surplus or deficit in the Income and Expenditure Account transfer to Accumulated fund Account. Prepare Statement of Financial Position at the end of the period after taking into account opening balance, addition and/or sale during the year and other adjustments like depreciation etc. in respect of assets.

Illustration 6

Kathmandu Golf Club provided you the following Receipts and Payments Account along with additional information for the year ended 31.12.2018. You are required to prepare Income and Expenditure Account for that period.

Kathmandu Golf Club
Receipts and Payments Account
For the year ended 31.12.2018

Receipts		**Rs.**	**Payments**	**Rs.**
To, Bank Balances b/d		3,800	By, Sports Equipment Purchased (on 1.9. 2018)	10,000
To, subscriptions:			By, Salaries and Wages	3,400
2017	2,000		By, Tournament Expenses	4,000
2018	18,500		By, Electricity	500
2019	900	21,400	By, Printing	300
To, Entrance fees		800	By, Expenses for exhibition	2,100

To, Interest on investment	1,500	By, Balance c/d	7,200
	27,500		**27,500**

Additional information: (i) Property, Plant & Machinery of the club on 1.1.2018 includes the following: Sports Equipments – Rs. 15,500; Club ground – Rs. 62,000; Furniture – Rs. 2,000 (ii) Subscription for 2018 collected in 2017 – Rs. 500, (iii) Unpaid subscription for 2018 – Rs. 300 (iv) Depreciation to be provided @ 20% p.a. sport equipment and @ 5% p.a. on furniture.

Prepare an Income and Expenditure Account for the year ended on 31.12.2018.

Solution

Kathmandu Golf Club
Income and Expenditure Account
For the year ended 31.12.2018

Dr. Cr.

Expenditure	Rs.	Income		Rs.
To, Salaries and Wages	3,400	By, Subscriptions	18,500	
To, Tournament Expenses	4,000	Add: Received in 2017	500	
To, Electricity	500		19,000	
		Add: Subscription in arrear	300	
To, Printing	300			19,300
To, Expenses for exhibition	2,100	By, Interest on Investment		1,500
To, Depreciation:	800			
Sport Equipments (Note 1)	3,767			
Furniture	100			
To, Excess of income over expenditure	5,833			
	20,800			**20,800**

Working Note: 1, Depreciation on sports Equipments – 20% on Rs. 15,500 for 1 year + 20% on Rs. 10,000 for 4 months = Rs. 3,100 + Rs. 667 = Rs. 3,767

2. Entrance Fees (or Admission Fees) should be treated as Capital Receipts as the paid by a member only one at the time of becoming a members.

7.5 STATEMENT OF FINANCIAL POSITION

The Statement of Financial Position of non-profit making concern is prepared on the same principles as the Statement of Financial Position of a profit-seeking business. It may be prepared either in the order of liquidity or in the order of permanence. It is classified summary of the ledger balances left over after account of all the revenue items have been closed off by transfer to the Income and Expenditure Account. The Statement of Financial Position includes fixed and floating assets, liabilities and the Capital Fund or the Accumulated Fund. The Capital Fund represents the amount contributed by members. If, however, members have not contributed any amount, the name should be Accumulated Fund. The surplus or deficit, if any, on the year's working as disclosed by the Income and Expenditure Account is shown either as an addition to or deduction from the Capital Accumulated Fund brought forward from the previous period.

Preparation of Statement of Financial Position:

(a) Assets appearing in previous Statement of Financial Position should be adjusted for (i) addition, (ii) sale , and (iii) depreciation during the year.
(b) New assets acquired (for which payment must have been entered on the credit side of the receipts and payments account) will be entered in the Statement of Financial Position. This also applies to the new liabilities incurred e.g. loans taken. The debit side of receipts and payments account will show this.
(c) Outstanding and prepaid expenses, subscriptions, etc, will be shown in the Statement of Financial Position. This also applies to income received in advance.
(d) The closing balance of cash in hand and at Bank (as shown in the Receipts and Payments Account) will be shown in the Statement of Financial Position.
(e) Previous year's liabilities should be adjusted for payments made.
(f) Special capital receipts (as shown by receipts and payments account) will be shown in the Statement of Financial Position.
(g) Capital Fund (as disclosed by the previous Statement of Financial Position. Capital fund at any date can be ascertained by deducting liabilities from assets.

Illustration 7

The following was the Receipts and payments Account of International Club for the year ended Dec 31, 2018

RECEIPT AND PAYMENT ACCOUNT

Receipts	**Rs.**	**Payments**	**Rs.**
Cash in hand	1,000	Groundsman's Fees	7,500
Bank balance:		Mowing Machine	15,000
Deposit Account	22,300	Rent of Ground	2,500
Current Account	6,000	Cost of Teas	2,500
Bank Interest	300	Printing and Office Expenses	2,800
Donation and Subscription	26,000	Repairs to equipment	4,000
Receipts from teas	3,000	Honoraria to Secretary	4,000
Contribution to fares	1,000	Bank Balance:	
Sale of Equipment	800	Deposit Account	30,900
Proceeds from events	7,800	Current Account	1,500
Donation for forthcoming tournaments	10,000	Cash in hand	3,500
		Travelling Expenses	4,000
	78,200		**78,200**

You are given the following additional information:

	Jan 1 Rs.	Dec 31 Rs.
Subscriptions due	1,500	1,000
Amount due for printings etc.	1,000	800
Cheques unpresented being payment for repairs	3,000	2,600
Interest not yet entered in the Pass Book		200
Bonus to Groundsman		3,000
Machinery & Equipment	8000	17500

For the year ended Dec 31, 2018, the honoraria to the secretary are to be increased by a total of Rs. 2,000.

Prepare the Income and Expenditure Account for 2018 and the relevant Statement of Financial Position.

Solution

INCOME AND EXPENDITURE ACCOUNT OF INTERNATIONAL CLUB FOR THE YEAR ENDING 31.12.2018

Expenditures	Rs.	Rs.	Income	Rs.	Rs.
To, Groundsman's fee		7,500	By, Donation and Subscriptions		25,500
To, Rent of Ground		2,500	By, Receipts from teas (fares) less expenses		500
To, Traveling Expenses	4,000		By, Proceeds from events		7,800
Less: Contribution	1,000	3,000	By, Interest		500
To, Printing and Office Exp.		2,600			
To, Depreciation on Machinery:					
Opening Balance	8,000				
Add: Purchase	15,000				
Less: closing balance	17,500				
	5,500				
Less: Sales	800	4,700			
To, Honoraria to Secretary		6,000			
To, Bonus to groundsman		3,000			
To, Repairs to Equipments		4,000			
To, Excess of income over Exp.		1,000			
		34,300			**34,300**

STATEMENT OF FINANCIAL POSITION
OF INTERNATIONAL CLUB AS ON 31.12.2018

Liabilities	**Rs.**	**Rs.**	**Assets**	**Rs.**	**Rs.**
Outstanding Expenses:			Cash in hand		3,500
Groudman's Bonus		3,000	Balance in Deposit Account		30,900
Printing		800	Current Account		1,500
Honoraria		6,000	Subscription Due		1,000
Capital Fund			Interest Due		200
Opening	33,800		Machinery and Equipments		17,500
Add: Surplus for the year	1,000	34,800			
Tournament Fund (Donation)		10,000			
		54,600			**54,600**

Opening Statement of Financial Position

Liabilities	**Rs.**	**Assets**	**Rs.**
Outstanding Expenses &		Cash in hand	1,000
Honoraria	5,000	Balance in Deposit Account	22,300
Capital Fund (Balancing figure)	33,800	Cash in Current Account	6,000
		Subscription Due	1,500
		Machinery	8,000
	35,800		**38,800**

Illustration 8

The Income and Expenditure Account of Women's Club for the year 2018 is as follows.

Expenditures	**Rs.**	**Income**	**Rs.**
To, Salaries	120,000	By, Subscriptions	170,000
To, Printing and Stationery	6,000	By, Entrance Fees	4,000
To, Postage	500	By, Contribution for dinner	36,000
To, Telephone	1,500		

To, General Expenses	12,000		
To, Interest and Bank Charges	5,500		
To, Audit fees	2,500		
To, Annual Dinner Exp.	25,000		
To, Depreciation	7,000		
To, Surplus	30,000		
	210,000		**210,000**

The account has been prepared after the following adjustments:
Subscription outstanding on 31.12.2017 Rs. 16,000
The club owned a building since 2017 Rs. 190,000
Subscription outstanding on 31.12.2018 Rs. 18,000
The club had sport equipment on 31.12.2017 valued at Rs 52,000
Subscription received in advance on 31.12.2017 Rs. 13,000

At the end of the year after depreciation of Rs. 7,000 equipments amounted to Rs. 63,000
Subscription received in advance on 31.12.2018 Rs. 8,400

In 2017 the club had raised a bank loan which is still unpaid Rs. 30,000
Salaries outstanding on 31.12.2017 Rs.6,000
Salaries outstanding on 31.12.2018 Rs. 8,000
Cash in hand on 31.12.2018 Rs. 28,500
Audit fees for 2017 paid during 2018 Rs. 2,000
Audit fees for 2018 not paid Rs. 2,500

Prepare the Receipts and Payments Account of the Club for 2018 and Statement of Financial Position as on 31.12.2018. All workings should be part of your answers.

Solution

WOMEN'S CLUB
RECEIPTS AND PAYMENTS ACCOUNTS

Receipts	**Rs.**	**Payments**	**Rs.**
To, Balance b/d (balancing figure)	13,600	By, Salaries (Note 3)	118,000
To, Subscriptions (Note 2)	163,400	By, Printing & Stationery	6,000
To, Entrance Fees	4,000	By, Postage	500
To, Contribution for dinner	36,000	By, Telephone	1,500
		By, General Expenses	12,000
		By, Audit Fees	2,000
		By, Annual Dinner expenses	25,000
		By, Interest and Bank charges	5,500

		By, Sports Equipment (Note 4)	18,000
		By, Balance c/d	28,500
	217,000		**217,000**

STATEMENT OF FINANCIAL POSITION
OF WOMEN'S CLUB AS ON 31.12.2018

Liabilities	Rs.	Rs.	Assets	Rs.	Rs.
Capital Fund			Property, Plant &		
Opening balance	220,600		Machinery		190,000
Add: Surplus	30,000	250,600	Building		
Bank Loan		30,000	Sports Equipments:	52,000	
Current Liabilities			Opening balance	18,000	
Creditors for Expenses			Addition	70,000	
Salaries	8,000			7,000	63,000
Audit fees	2,500	10,500	Less: Depreciation		
Subscription received in			Current Assets		
advance		8,400	Cash in hand		28,500
			Subscription Due		18,000
		299,500			**299,500**

Working Notes:

1. Opening Statement of Financial Position

Liabilities	Rs.	Assets	Rs.
Bank Loan	30,000	Building	190,000
Creditor for Expenses:		Sports Equipment	52,000
Salaries	6,000	Cash in Hand	13,600
Audit Fees	2,000	Subscription due	16,000
Subscription received in advance	13,000		
Capital Fund (Balancing figure)	220,600		
	271,600		**271,600**

2. Subscription:

As per Income and Expenditure A/c	170,000
Add: Subscription outstanding 2017	16,000
	186,000
Add: Subscription received in advance for 2019	8,400
	194,400
Less: Subscription received in advance on 2017	13,000
	181,400

3. Salaries

As per Income and Expenditure A/c	120,000
Add: Outstanding of 2017	6,000
	126,000
Less: Outstanding of 2018	8,000
	118,000

4. Sports Equipments

Closing balance	63,000
Add: Depreciation	7,000
	70,000

Less:	Subscription outstanding for 2018	18,000	Less: Opening balance	52,000
			Purchases	**18,000**
		163,400		

Illustration 9

The Income and Expenditure Account of the Youth Club for the year 2018 is as follows:

Expenditures	**Rs.**	**Income**	**Rs.**
To, Salaries	4,750	By, Subscriptions	7,500
To, Printing and Stationery	450	By, Entrance Fees	250
To, Secretary's Honorarium	1,000	By, Contribution for dinner	1,000
To, General Expenses	500	By, Profit on Sport meet	750
To, Interest and Bank Charges	150		
To, Audit fees	250		
To, Annual Dinner Exp.	1,500		
To, Depreciation	300		
To, Surplus	600	`	
	9,500		**9,500**

The accounts had been prepared after the following adjustments:

	Rs.
Subscription outstanding at the end of 2017	600
Subscription received in advance on 31.12.2017	450
Subscription received in advance on 31.12.2018	270
Subscription outstanding on 31.12.2018	750

Salaries outstanding at the beginning and the end of 2018 were respectively Rs, 400 and Rs. 450. General expenses include insurance prepaid to the extent of Rs. 60. Audit fees for 2018 is as yet unpaid. During the 2018 audit fees for 2017 paid amounting to Rs. 200.

The club owned a freehold lease of ground valued at Rs. 10,000. The Club had sport equipments on 1st January 2018 valued at Rs. 2,600. At the end of the year, after depreciation, this equipments amounted Rs, 2,700. In 2017, the club has raised a bank loan of Rs. 2,000. This was outstanding throughout 2018, On 31st December 2018 cash in hand amounted to Rs. 1,600. Prepare the Receipts and Payments Account for 2018 and Statement of Financial Position end of the year.

Solution

THE YOUTH CLUB
RECEIPTS AND LOSS ACCOUNTS
FOR THE YEAR ENDING 2018

Receipts	Rs.	Payments	Rs.
To, Balance b/d (balancing figure)	1,390	By, Salaries (Note 3)	4,700
To, Subscriptions (Note 2)	7,170	By, Printing & Stationery	450
To, Entrance Fees	250	By, Secy. Honorarium	1,000
To, Contribution for dinner	1,000	By, General Expenses	500
To, Profit on Sport meet	750	Add: Paid for 2017	60
		By, Audit Fees (2017)	200
		By, Annual Dinner expenses	1,500
		By, Interest and Bank charges	150
		By, Sports Equipment (Note 4)	400
		By, Balance c/d	1,600
	10,560		**10,560**

STATEMENT OF FINANCIAL POSITION
OF YOUTH CLUB AS ON 31.12.2018

Liabilities	Rs.	Rs.	Assets	Rs.	Rs.
Capital Fund			Property, Plant & Machinery		
Opening balance	11,540		Freehold ground		10,000
Add: Surplus	600	12,140	Sports Equipments:		
Bank Loan		2,000	Opening balance	2,600	
Current Liabilities			Addition	400	
Creditors for Expenses				3,000	
Salaries	450		Less: Depreciation	300	2,700
Audit fees	250	700	**Current Assets**		
Subscription received in			Cash in hand		
advance		270	Subscription Due		
			Insurance Prepaid		1,600
					750
					60
		15,110			**15,110**

Working Notes

1. Opening Statement of Financial Position

Liabilities	Rs.	Assets	Rs.
Bank Loan	2,000	Freehold Ground	10,000

Creditor for Expenses:		Sports Equipment	2,600
Salaries	400	Cash in Hand	1,390
Audit Fees	200	Subscription due	600
Subscription received in advance	450		
Capital Fund (Balancing figure)	11,540		
	14,590		14,590

2. Subscription:		3. Salaries	
As per Income and Expenditure A/c	7,500	As per Income and Expenditure A/c	4,750
Add: Subscription outstanding 2017	600	Add: Outstanding of 2017	400
	8,100		5,150
Add: Subscription received in advance for 2019	270	Less: Outstanding of 2018	450
	8,370		**4,700**
Less: Subscription received in advance on 2017	450	4. Sports Equipments	
	7,920	Closing balance	2,700
Less: Subscription outstanding for 2018	750	Add: Depreciation	300
	7,170		3,000
		Less: Opening balance	2,600
		Purchases	**400**

Illustration 10

Prepare Income & Expenditure Account for the year ended and Statement of Financial Position as at December 31, 2018 from the below mentioned information:

Receipt	Rs.	Payments	Rs.
January, Opening Balance		Salary	80,600
- Bank	40,450	House Rent	60,600
- Cash	5050	Printing & Stationery	10,145
Subscription		Postage	205
(including Rs. 2,000 for 2017)	300,000	Furniture Purchase	20,095
Interest on Investment	10,500	Construction of Court	208,200
(Investment Rs. 300,000)		Cash Balance	3012
Sale of Vehicle	30,250	Bank Balance	4,403
Interest on Bank Deposit	1010		
	387,260		**387,260**

Additional Information

1. The amount of subscription includes Rs. 1,200/- pertaining to 2019
2. Rs. 30,000/- is yet to be received in respect of the subscription for the year 2018.
3. House rent Rs. 5050 for the month of December 2018 is outstanding. House rent paid also includes Rs. 5050 being towards last year's outstanding.
4. Stationary expenses of Rs. 500 is till to be paid.
5. The book value of the Vehicle was Rs. 20,500

Solution

INCOME & EXPENDITURE ACCOUNT
FOR THE YEAR ENDED DECEMBER 31, 2018

Dr. Cr.

		Rs.			Rs.
To, Salary		80,600	By Subscription	300,000	
To House Rent	60,600		Add : Receivable	30,000	
Add: For Dec. 2018	5,050			330,000	
	65,650		Less: Last Year's Receipt	(-) 2,000	
Less: Paid for last year	5,050	60,600	Less: Advance for 2019	(-) 1,200	
To, Printing & Stationery	10,145				326,800
Add: Outstanding	500	10,645	By Interest on Investment		10,500
To, Postage			By Interest on Deposit		1,010
To Excess of Income over Expenditure		205	By, Gain on sale of Vehicle		9,750
		196,010			
		348,060			**348,060**

STATEMENT OF FINANCIAL POSITION
AS AT DECEMBER 31, 2018

Liabilities	Rs.	Assets	Rs.
Capital Fund	558,960	Furniture	20,095
Creditors (Stationery)	500	Investment	300,000
Outstanding House Rent	5,050	Court	208,200
Advance Subscription 2019	1,200	Subscription Receivable	30,000
		Bank Balance	4,403
		Cash Balance	3,012
	565,710		**565,710**

Working of Statement of Financial Position (1.1.2018)

Liabilities	Rs.	Asset	Rs.
Capital Fund	362,950	Vehicle	20,500
(Balancing Figure)		Investments	300,000
House Rent Outstanding	5,050	Subscription Receivable	2,000
		Cash at Bank	40,450
		Cash in Hand	5050
	369,800		**369,800**

Capital Fund Account

Dr. Cr.

Liabilities	Rs.	Asset	Rs.
31.12.2018		1.1.2018	

To Balance c/d	558,960	By Balance b/d 31.12.2018 By Income & Expenditure A/c	362,950 196,010
	558,960		**558,960**
		1.1.2019 By Balance b/d	558,960

Summary

In this unit we have discussed about non-profit making organization and conventionally it prepares Receipts and Payments Account to show total cash earning and total cash expenditure. Accrual adjustments are made against cash receipts and cash payments and also distinctions are made between capital and revenue expenditure before preparing Income and Expenditure Account. Preparing the Statement of Financial Position is more or less same like profit-making organizations but one should be careful for treatment of fund and fund investments to be shown in the Statement of Financial Position of non-profit making organization.

Self-Examination Questions

1. Express the process of Receipts and Payments Account prepared by non-profit making organization. How does it differ from Income and Expenditure Account?
2. How do you treat the following at the time of preparation of financial Statements of a non-profit making organization/

   (i) Donation; (ii) Life membership fees; (iii) Admission Fees
   (iv) Subscription (v) Liabilities for expenses.
3. From the following information prepared Receipts and Payments Accounts and Income and Expenditure Accounts of ABC Club for the year ended 31st December 2018.

   Subscription received for the year 2018 Rs. 120,000, Subscription receipts for 2017 Rs, 20,000, Subscription received in advance for 2019 Rs. 5,000. Donations received Rs. 25,000, Sale of old furniture Rs, 200 (cost Rs. 500. WDV Rs. 400) Wages of groundman Rs. 24,000, General Expenses Rs. 30,000, Expenses for the tournaments Rs. 50,000, Repairs to ground Rs. 10,000, Audit fees Rs. 500, cash at bank Rs. 60,000, Subscription outstanding Rs. 15,000. Wages outstanding Rs. 10,000, Office furniture Rs. 15,000, Depreciation is usually charged @ 20%. The Club decided to keep Rs. 500 in hand at the end of the year and to invest the balance other than balance laying with bank in 20% in shares of XYZ Ltd.
4. The Receipt and Payment Account of B.P. Memorial Hospital is given below form which you are required to prepare an income and Expenditure Account for the year ended 31.12.2018.

Receipts and Payments Accounts

Receipts	Rs.	payments	Rs.
Sale of Investment	50,000	Salary o Staff	425,000
Bill of cost	11,25,000	General Expenses	75,000
		Audit Fees	10,000
		Balances:	
		Cash in hand	340,000
		Cash at Bank	325,000
	11,75,000		11,75,000

Other information:

i. Specialist's fees Rs. 250,000
ii. Bill for equipment Rs. 550,000
iii. Charge depreciation @ 10% on equipments, balance of which at the beginning of the year was Rs. 750,000
iv. Misc. income not accounted Rs. 500
v. During the year the hospital authority made a camp for children eye operation for which is expended Rs. 15,000. The contractor did not raise the bill yet.
vi. Donations not accounted for Rs. 15,000
vii. The Chairman of the hospital traveled to foreign country and collected donations amounting to Rs. 15,00,000 which are not yet accounted and traveling expenses amounting to Rs. 40,000 are yet to be adjusted.

You are also required to redraft the Receipts and Payments Account.

5. Kathmandu Football Association gives you the following Statement of Financial Position dated 31.12.2017

Liabilities	Rs.	Assets	Rs.
Capital Fund	11,00,000	Lease hold ground	450,000
Tournament Fund	200,000	Furniture	50,000
Prize Fund	100,000	Tournament Fund Investment	200,000
Current Liabilities	50,000	Prize Fund Investment	100,000
		Other Investment	300,000
		Sports Equipments	50,000
		Cash at Bank	280,000
		Cash in hand	20,000
	14,50,000		14,50,000

Receipts during the year: Subscription are Rs, 10,00,000, Donations for tournament are Rs. 15,000. Donation for Prize are Rs. 25,000, Income from investment s Rs. 60,000.

Expenditure: Sports material is Rs. 250,000. Repairs to the ground is Rs. 50,000, Wages to the staff is Rs. 250,000, Expenses for tournament are 50,000. Expenses for prize are Rs. 40,000, Construction cost of Club Building is Rs. 125,000.

Outstanding expenses: Audit fees is Rs. 3,000, Stationery Rs. 4,000, fees of the coach Rs. 40,000, Bills of Supplies of Sport material is Rs. 25,000. Bills of the suppliers of prizes Rs. 5,000. Charge Depreciation @ 20% on office equipments, Construction of Building is in progress: Contractor raises the bill Rs. 250,000 which has been approved by Management committee.

You are asked to Prepare Income and Expenditure Account for the year ended 31.12.2018 and Statement of Financial Position as on that date.

CHAPTER- 8

PARTNERSHIP ACCOUNTS

UNIT 1:

Introduction to Partnership Accounts

Learning Objectives

1. *Understand the features of a partnership firm and the need for a partnership Dead.*
2. *Learn the technique of maintaining Profit and Loss Appropriation Account.*
3. *Be familiar with the two methods of maintaining partner's capital accounts, namely Fixed Capital Method and Fluctuating Capital Method.*
4. *Be sure that interest on capital and drawdings, salaries/commissions are to be shown in the Profit and Loss Appropriation Account.*

1. DEFINITION AND FEATURES OF PARTNERSHIP

The sole proprietorship has its limitations such as limited capital, limited managerial ability and limited risk-bearing capacity. Hence, when a business expands or when it is to be set up on a scale, which needs more capital and involves more risk, two or more persons join hands to run it. They agree to share the capital, the management, the risk and profits of the business. Such mutual economic relation based on written or oral agreement amongst these persons is termed as partnership. The persons who have entered into partnership are individually known as 'partners' and collectively as ' firm’

A partnership is an entity which involves two or more individuals acting as co-owners with a view to earn profit. This type of entity is very common and popular because it has some advantage with compare to other types of entities. These are

(1) it is easy to form and winding up,
(2) it allows several individuals to combine their talent and skills in a particular business venture,
(3) it provides a means of mobilizing required fund to finance various resources to operate business,
(4) it allows the sharing of risk for rapid growing business and
(5) less legal formalities with respect to incorporation and dissolution of partnership business.

The partnership formed shall be in accordance with prevailing laws that prescribed ceiling of partners based on types and nature of business activities. If the assets of the firm are insufficient to meet the liabilities of firm, the partners shall have to meet them from their personal properties. In other word, each partner is liable for activities of other partners. Capital contributed by partners as per partnership deed or agreement will be shown in each partner’s capital account and net profit or loss shall also be adjusted in their respective capital account as per agreed profit and loss sharing ratio. Any withdrawal made by partner will ultimately be adjusted in their capital account. In the event of dissolution of partnership fund, if the firm is insufficient to meet the liabilities on disposal of various asset of firm, partners are liable to payoff the liabilities from their personal property.

From the accounting point of view, the main thing is that relations among the partners will be governed by mutual agreement. The agreement is known as Partnership Deed which is to be properly stamped. It should be comprehensive to avoid disputes later on. It is usual, therefore, to find the following clauses in a Partnership Deed which may or may not be registered.

1. Name of the firm and the partnership business;
2. Commencement and duration of business;
3. Amount of Capital to be contributed by each partner;
4. Rate of interest to be allowed to each partner on his capital and on his loan to the firm, and to be charged on his drawings;
5. Disposal of profit, particularly the ratio in which profits are to be shared;
6. Amount to be allowed to each partner as drawings and the timings of such drawings;
7. Whether a partner will be allowed a salary, commission etc;
8. Any variations in the mutual rights and duties of partners;
9. Method by which the goodwill is to be calculated on the retirement or death of a partner;

10. Procedures by which a partner may retire and the method of payment of his dues;
11. Basis of the determination of the executors of a deceased partner and the method of payment;
12. Treatment of losses arising out of the insolvency of a partner;
13. Procedure to be followed for settlement of disputes among partners;
14. Preparation of accounts and their audit.

Normally, a partnership deed covers all the matter relating to the mutual relationship amongst the partners. But if the deed is silent on certain matters or in the absence of any deed or any express agreement, the relevant provisions of the Partnership Act shall become applicable.

1.1 POWERS OF PARTNERS

In other words, unless notice has been given to the contrary, certain contracts entered into by a partner on behalf of the partnership, even without consulting other partners are binding amongst the partner

In case of trading firm,partners have the following powers;

(a) Buying and selling goods;
(b) Receiving payments on behalf of the firm and giving valid receipts;
(c) drawing, accepting and endorsing cheque, bills of exchange and promissory notes in the name of the firm;
(d) Borrowing money on behalf of the firm with or without pledging the stock-in-trade.
(e) Engaging servants for the business of the firm.

In certain cases an individual partner has no power to bind the firm. This is to say that third parties cannot bind the firm unless all the partners have agreed. These cases are:

(a) Submitting a dispute relating to the firm to arbitration;
(b) Opening a bank account on behalf of the firm in the name of a partner;
(c) Compromise of relinquishment of any claim or portion of claim by the firm;
(d) Withdrawal of a suit or proceeding filed on behalf of he firm;
(e) Admission of any liability in a suit or proceedings against the firm;
(f) Acquisition of immovable property belonging to the firm;
(g) Entering into partnership on behalf of the firm;

Where there is neither partnership deed nor express agreement or partnership deed is there but it is silent on any matter, then the relevant provisions of Partnership Act would be applicable. In the absence of any written or oral agreement, the under mentioned provisions of the Partnership Act shall apply for accounting purposes.

1. no partner has the right to salary,
2. no interest is to be allowed on capital,
3. no interest is to be charged on the drawings,
4. interest not exceeding 10% is to be allowed on a partner's loan to the firm, and
5. Profit and loss are to be shared equally.

1.2 ACCOUNTS

There is not much difference between the accounts of a partnership firm and that of sole proprietorship. The only difference to be noted is that instead of one Capital Account there will be as many Capital Accounts as there are partners.

i. Partners' Capital Accounts

At the formulation of a new partnership, the partnership agreement provides for a fixed amount of capital to be contributed by each partner from his private resources. In the Statement Of Financial Position of a partnership firm, there are several Capital Account – one for each partner. Capital contribution from the partner can be either cash or assets like machinery, vehicle, stock etc. The ratio of the partners' capitals may be changed by mutual consent. It generally changes when there is a change in the constitution, that is, change in the profit ratio; admission, retirement or death of a partner. Along with other physical assets (also goodwill), if a partner brings any liability to the business, the net amount (Assets-Liabilities) will represent his capital contribution.

The capital account of partners may be maintained in any one of the following method

1. *Fixed Capital Accounts*
2. *Fluctuating Capital Account*

1. Fixed Capital Account:

In case of Fixed Capital Account, the partners are not allowed to change their capitals during the lifetime of business except in extra-ordinary circumstance. Under this method, the capital balance of the partner remain unaltered and all the transactions which can affect the balance of the partner are passed through current account . So under this arrangement capital account and current account of each partners are prepared . All the entries relating to drawing, interest on drawing, salary to partner, share of profit is made through current accounts.

Format of Capital Account and Current Account

CAPITAL ACCOUNT

PARTICULAR	X	Y	Z	PARTICULAR	X	Y	Z
To, Balance C/d				By, Balance B/d			
				By, Balance B/d			

CURRENT ACCOUNT

PARTICULAR	X	Y	Z	PARTICULAR	X	Y	Z
To, Drawings To, Interest on drawings To, Balance C/d				By, Balance B/d By, Interest on capital By, Salary By, Commission By, Share of Profit			
				By, Balance B/d			

2. Fluctuating Capital Account:

When the partnership firm decides not to keep separate current accounts for the partners, all the entries in regards to partners' drawings, salaries, interest and share of profit are passed through the Capital Accounts of partners. In such a case, the Capital Accounts of the partners keep on fluctuating. There is one danger in this method, if a partner draws more than what he is entitled to, regarding share of profit, salaries, etc., there will be depletion of capital.

Format

CAPITAL ACCOUNT

PARTICULAR	X	Y	Z	PARTICULAR	X	Y	Z
To, Drawings To, Interest on drawings To, Balance C/d				By, Balance B/d By, Interest on capital By, Salary By, Commission By, Share of Profit			
				By, Balance B/d			

Illustration 1

Amit and Sumit commenced business as partners on April 1, 2018. Amit contributed Rs. 40,000 and Sumit Rs. 25,000 as their share of capital. The partners decided to share their profits in the ratio of 2:1. Amit was entitled to a salary of Rs. 6,000 p.a. Interest on capital was to be provided

@ 6% p.a. The drawings of Amit and Sumit for the year ending March 31, 2019 were Rs. 4,000 and Rs. 8,000, respectively. The profits of the firm after providing Amit's salary and interest on capital were Rs. 12,000.

Draw up the Capital Accounts of the partners:
(i) When capitals are fluctuating, and
(ii) When capitals are fixed.

Solutions

i) When capitals are fluctuating

Amit's Capital Account

Date	Particulars	J.F	Rs.	Date	Particulars	J.F	Rs.
	Drawings		4,000		Cash		40,000
	Balance c/f		52,400		Salary		6,000
					Interest on Capital		2,400
					Profit and Loss Appropriation A/c.(Share of profit 2/3 of Rs. 12,000)		8,000
			56,400				**56,400**

Sumit's Capital Account

Date	Particulars	J.F	Rs.	Date	Particulars	J.F	Rs.
	Drawings		8,000		Cash		25,000
	Balance c/f		22,500				
					Interest on Capital		1,500
					Profit and Loss Appropriation A/c.(Share of profit 1/3 of Rs. 12,000)		4,000
			30,500				**30,500**

(ii) When capitals are fixed.

Amit's Capital Account

Date	Particulars	J.F	Rs.	Date	Particulars	J.F	Rs.
	Balance c/f		40,000		Cash		40,000
			40,000				**40,000**

Amit's Current Account

Date	Particulars	J.F	Rs.	Date	Particulars	J.F	Rs.
	Drawings		4,000		Salary		6,000
	Balance c/f		12,400		Interest on Capital		2,400
					Profit and Loss Appropriation A/c.(Share of profit 2/3 of Rs. 12,000)		8,000
			16,400				**16,400**

Sumit's Capital Account

Date	Particulars	J.F	Rs.	Date	Particulars	J.F	Rs.
	Balance c/f		25000		Cash		25000
			25000				**25000**

Sumit's Current Account

Date	Particulars	J.F	Rs.	Date	Particulars	J.F	Rs.
	Drawings		8,000		Interest on Capital		1,500
					Profit and Loss Appropriation A/c.(Share of profit 1/3 of Rs. 12,000)		4,000
					Balance c/f		2,500
			8,000				**8,000**

ii. Profit and Loss Appropriation

In a sole trading concern, the net profit discloses by the Statement Of Profit or Loss belongs to the sole trader and is transferred to his capital account. However in a partnership firm, the net profit as shown by the Statement Of Profit or Loss need certain adjustments with regards to interest on capitals, interest on drawings, salary and commission to the partners. For this purpose, profit and loss Appropriation account may be prepared which is merely an extension of the Statement Of Profit or Loss. Profit and loss appropriation account show how net profit has been distributed among the Partners.

This account is credited with net profit and interest on drawing and debited with interest on capitals, salary or commission to partners. Net loss will be shown on the debit side. After these adjustments have been made, this account will show the amount of profit or loss which shall be distributed among the partners in the agreed profit sharing ratio.

Format of Profit and Loss Appropriation Account

PROFOMA PROFIT & LOSS APPROPRIATION ACCOUNT

Particular	Rs.	Particular	Rs.
To, Profit and Loss(For Net Loss) To, Partner's Salary To, partner's Commission To, Interest on Partner's Capitals To Partner's Capital/ Current A/c (balance)		By, Profit and Loss(For Net Profit) By, Interest on partner's drawing By, Partner's Capital/Current A/c (balance)	

The various adjustment made in the profit and loss appropriation account are explained below

i. Interest on capital

Interest on capital is allowed to partners only if the partnership deed spcifically allows it. Interest is usually calculated on the opening capital and on the capital introduced during the year. If the dates on which additional capital introduced during the year is not given, interest will be calculated for six months

Journal entries

a) To Adjust interest on Capital in case of Fluctuating Capital

Interest on Capitals A/c Dr
To, Partner's capital A/c

b) To adjust interest on capital in case of Fixed Capital

Interest on Capital A/c Dr
To, Partner's Current A/c

***c)* To close the interest on capital account**

Profit & Loss Appropriation A/c Dr
To, Interest on capital A/c

Illustration 2

On 31st Ashad 2076., after the close of the accounts, the capital accounts of Pramod and Samir stood in the books of firm at Rs 400,000 and Rs 500,000 respectively. On 1st Bhadra 2075 Pramod introduced an additional capital of Rs 100,000 and Samir withdraw Rs 50,000 from his capital. On 1st Magh 2075 Pramod withdraw Rs 200,000 from his capital and Samir introduced Rs 250,000. Interest on capital is allowed @ 6% p.a . The profit for the year ended 31st Ashad 2076 amount to Rs 200,000 and the partner's drawing of profit had been Rs 100,000 and 50,000 by Pramod and Samir respectively. Calculate the interest on capital for the year ending 31st Ashad 2076 if the capital are (i) fixed capital and (ii) Fluctuation Capital

Solution

(i) If the Capital are Fixed

Calculation of Opening Capital

Particular	Pramod	Samir
Closing Capital	400,000	500,000
Add; Withdrawal of Capital	200,000	50,000
Less : Addition of Capital	100,000	250,000
Opening Capital	**500,000**	**300,000**

Calculation of interest

Particular	Pramod	Samir
Interest on Opening Capital		
Rs 500,000 * 6/100 * 12/12	30,000	
Rs 300,000 * 6/100 * 12/12		18,000
Add: Interest on Additional Capital		
Rs 100,000 * 6/100 * 11/12	5,500	
Rs 250,000 *6/100 * 6/12		7,500
Less: Interest on Capital withdrawal		
Rs 200,000 * 6/100 * 6/12	6,000	
Rs 50,000 * 6/100 * 11/12		2,750
	29,500	**22,750**

(i) If the Capital are Fluctuation

Calculation of Opening Capital

Particular	Pramod	Samir
Closing Capital	400,000	500,000
Add; Withdrawal of Capital	200,000	50,000
Add : Withdrawal of Profit	100,000	50,000
Less : Addition of Capital	100,000	250,000
Less: Profit of the Partners	120,000	80,000
	480,000	**270,000**

Calculation of interest

Particular	Pramod	Samir
Interest on Opening Capital		
Rs 480,000 * 6/100 * 12/12	28000	
Rs 270,000 * 6/100 * 12/12		16,200
Add: Interest on Additional Capital		
Rs 100,000 * 6/100 * 11/12	5,500	
Rs 250,000 *6/100 * 6/12		7,500
Less: Interest on Capital withdrawal		
Rs 200,000 * 6/100 * 6/12	6,000	
Rs 50,000 * 6/12 * 11/12		2,750
	27,500	**20,950**

ii. Interest on Drawing

Drawing is the amount withdrawn in cash or in kind , for personal purpose. A Drawing Account is opened in the name of each partner and the drawing are debited to this account. At the end of every year, the drawing account is closed by a transfer to the respective partner's capital or current account.

Sometimes interest is not only allowed on the capital, but is also charged on drawing. Interest on partner's drawing is charged only if the partnership deed specifically allows it at a particular rate. The interest on drawing is gain of the firm and it is credited to Profit and Loss Appropriation Account and debited to the Partners Capital or Current Account. If the dates on which amounts are drawn are not given, interest will be calculated for six months on the whole amount on the assumption that the money was drawn evenly through out the year.

Journal Entries

a) To charge interest on drawings in case of fluctuating capital

Partner's Capital A/c Dr
To, Interest on drawing A/c

b) To charge interest on drawings in case of Fixed capital

Partner's Current A/c Dr
To, Interest on drawing A/c

c) To Close the interest on drawing account

Interest on drawing A/c Dr
To, Profit & Loss Appropriation A/c

Different cases of interest on drawing account are:

a) If the fixed amount is withdrawn in the beginning of every month:
Take the period at the average of the periods applicable to the first and last installment.
The period of first installment is 12 months.

The period of last installment is 1 month.
Average period = (12 + 1) / 2
= 6½ months

b)If the fixed amount is withdrawn in the middle of every month:

Take the period at the average of the periods applicable to the first and last installment.
The period of first installment is 11½ months.
The period of last installment is ½ month.
Average period = (11½ + ½) / 2
= 6 months

c)If the fixed amount is withdrawn at the end of every month:

Take the period at the average of the periods applicable to the first and last installment.
The period of first installment is 11 months.
The period of last installment is 0 month.
Average period = (11 + 0) / 2
= 5½ months

d)When the dates of drawings are not given:

The average of the total period is to be taken
Average Period = Total period /2

1) If the drawings are for one year without dates, the average period is calculated as follows:

Average Period = 12 months/2
= 6 months

2) If the drawings are for 6 months without dates, then,

Average Period = 6 months/2
= 3 months

Illustration 3

X, a partner, has drawn the following sum of money. Calculate the interest on drawing on different date

	Rs.
On 31st January, 2018	5,000
On 31st March 2018	4,000
On 30th June 2018	6,000
On 31st October 2018	8,000
On 31st November, 2018	10,000

Accounts are closed on 31st December every year. Interest is chargeable on drawings at 6% per annum.

Solution:

The interest on x's drawing will be calculated as follows:

Date	Drawing	Month	Interest Amoount
On 31st January, 2018	5,000	11	275
On 31st March 2018	4,000	9	180
On 30th June 2018	6,000	6	180
On 31st October 2018	8,000	2	80
On 31st November, 2018	10,000	1	50
	33,000		**765**

Illustration 4:

Pramod and Samir started business on 1st Baishak 2075 with capital of Rs 500,000 and 600,000 respectively. Calculate the interest on drawing of Samir @ 10% p.a for the year ended 31st Chaitra 2075 in the following alternative case

i. If Samir withdrew during the year were Rs 200,000
ii. If Samir withdrew Rs 20,000 p.m in the beginning of every month
iii. If Samir withdrew Rs 20,000 p.m in the end of every month
iv. If Samir withdrew the following amount as follow
Baishak 31st Rs 60,000 , Ashad 31st Rs 40,000, Kartik 1st 80,000
Poush 31st Rs 30,000 , Falgun 1st 50,000

Solution:

a) Interest on drawing has been calculated for an average period of six month assuming that drawing were made eventually throughout the year

Interest on drawing = Rs 200,000 * 6/12 * 10/100
= Rs 10,000

b) Average period for the calculation of drawing

= (Total Time period + Time interval)/2
= (12 +1)/2
=6.5 months

Interest on drawing = Rs 240,000 * 6.5/12 * 10/100
= Rs 13,000

c) Average period for the calculation of drawing

= (Total Time period - Time interval)/2
= (12-1)/2
=5.5 months

Interest on drawing = Rs 240,000 * 5.5/12 * 10/100
= Rs 11,000

d) Average product of drawing

Date of Withdrawal	Drawing Amount	Period of withdrawal	Amount for which drawn
Baishak 31st	60,000	11	660,000
Ashad 31st	40,000	9	360,000
Kartik 1st	80,000	6	480,000
Poush 31st	30,000	3	90,000
Falgun 1st	50,000	2	100,000
			1,690,000

Interest on drawing = Rs 1,690,000 * 1/12 * 10/100
= Rs 14,083.33

Alternatively,
The interest on Samir's drawing will be calculated as follows:

Date of Withdrawal	Drawing Amount	Period of withdrawal	Interest
Baishak 31st	60,000	11	5,500
Ashad 31st	40,000	9	3,000
Kartik 1st	80,000	6	4,000
Poush 31st	30,000	3	750
Falgun 1st	50,000	2	833
			14,083

iii. Salary or Commission to Partners

Some partners may devote more time or possess better skills and experience in comparison with their fellow partners. As a results, they should be allowed a special compensation either in the form of salary or commission.

Commission may be allowed as a percentage of net profit before charging the commission or after charging the commission. Commission under the two methods is computed as under:

i. Percentage of net Profit before charging such commission

$$\text{Net Profit before commission x} \frac{\text{Rate of commission}}{100}$$

$$\text{Net Profit before commission x} \frac{\text{Rate of commission}}{100 + \text{Rate of commission}}$$

ii. Percentage of net profit after charging such commission

Journal entries

a. To adjust salary or commission to a partner in case of fluctuating Capital

Salary or Commission A/c Dr
To Partner's Capital A/C

b. To adjust salary or commission to a partner in case of fixed Capital

Salary or Commission A/c Dr
To Partner's Current A/C

c. To close salary or commission account

Profit & Loss Appropriation A/c Dr
To salary or Commission A/c

Illustration 5

X and Y start business on 1st January 2018, with Capital of Rs. 90,000 and Rs. 60,000. According to the Partnership Deed, B is entitled to a salary of Rs, 1,500 per month and interest is to be allowed on capital at 6% per annum. The remaining profits are to be distributed amongst the partners in the ratio of 5:3. During 2018 the firm earned a profit, before charging salary to B and interest on capital amounting to Rs. 75,000. During the year A withdrew Rs. 15,000 and B withdrew Rs. 25,000 for domestic purposes.

Give journal entries relating to division of profit and prepare the Profit and Loss Appropriation Account and the Capital Accounts of Partners.

Solution

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Date	Particular		Debit	Credit
2018	Profit and Loss A/c	Dr.	18,000	
31-Dec	To, B's Capital Account			18,000
	(For Salary due to B @ Rs. 1,500 per month)			
	Profit and Loss A/c	Dr.	9,000	
	To, A's Capital Account			5,400
	To, B's Capital Account			3,600
	(For interest due on Capital @ 6% per annum)			
	Profit and Loss A/c	Dr.	48,000	
	To, A's Capital Account			30000

	To, B's Capital Account (For remaining profit of Rs. 48,000 divided between A and B in the ratio of 5:3)		18000

Profit and Loss Appropriation Account

Date	Particular	Rs.	Date	Particular	Rs.
2018	To, B's Capital A/c-Salary	18,000		By, Net Profit	75,000
31-Dec	To, A's Capital A/c-interest	5,400			
	To, B's Capital A/c-interest	3,600			
	To, Profit transferred to:				
	A's Capital A/c	30,000			
	B's Capital A/c	18,000			
		75,000			**75,000**

A's Capital Account

Date	Particular	Rs.	Date	Particular	Rs.
2018			2018		
31-Dec	To, Cash	15,000	1-Jan	By, Cash	90,000
	To, Balance c/d	110,400	31-Dec	By, Profit & Loss A/c interest	5,400
				By, Profit & Loss A/c 5/8 profit share	30,000
		125,400			**125,400**
			2019		
			1-Jan	By, Balance b/d	110,400

B's Capital Account

Date	Particular	Rs.	Date	Particular	Rs.
2018			2018		
31-Dec	To, Cash	25,000	1-Jan	By, Cash	60,000
	To, Balance c/d	74,600	31-Dec	By, Profit & Loss A/c	

				Salaries	18,000
			31-Dec	By, Profit & Loss A/c interest	3,600
				By, Profit & Loss A/c 5/8 profit share	18,000
		99,600			**99,600**
			2019 1-Jan	By, Balance b/d	74,600

Illustration 6

Rakesh and Robin start business with capital of Rs. 500,000 and Rs. 300,000 on 1st January, 2018. Robin is entitled to a salary of Rs 4,000 per month. Interest is allowed on capitals and it's drawing at 6% per annum. Profits are to be distributed equally after the above noted adjustments. During the year Rakesh withdrew Rs. 80,000 and Robin withdrew Rs, 100,000. The profit for the year before allowing for the terms of the Partnership Deed came to Rs. 300,000. Assuming the capitals to be fixed; prepare the Profit and Loss Appropriation Account and the Capital and Current Accounts relating to the partners.

Solution

Profit and Loss Appropriation Account

Date	Particular	Rs.	Date	Particular	Rs.
2018					
31-Dec	To, Robin's Current A/c-Salary	48,000		By, Net Profit	300,000
	To, Sundries-interest on Capitals:			By, Sundries-interest on Drawing:	
	Rakesh's Current A/c	30,000		Rakesh Current A/c (6% on Rs. 80,000 for 6 months)	2,400
	Robin's Current A/c	18,000		Robin Current A/c(6% on Rs. 100,000 for 6 months)	3,000
	To, Profit transferred to				
	Rakesh's Current A/c	104,700			
	Robin's Current A/c	104,700			
		305,400			305,400

Rakesh's Capital Account

Date	Particular	Rs.	Date	Particular	Rs.
2018 31-Dec	To, Balance c/d	500,000	2018 1-Jan	By, Cash	500,000
		500,000			**500,000**
			2019 1-Jan	By, Balance b/d	500,000

Robin's Capital Account

Date	Particular	Rs.	Date	Particular	Rs.
2018 31-Dec	To, Balance c/d	300,000	2018 1-Jan	By, Cash	300,000
		300,000			**300,000**
			2019 1-Jan	By, Balance b/d	300,000

Rakesh's Current Account

Date	Particular	Rs.	Date	Particular	Rs.
2018 31-Dec	To, Cash-Drawing To, Profit & Loss A/c Interest on drawing To, Balance c/d	80,000 2,400 52,300	2018 31-Dec	By, Profit & Loss A/c interest By, Profit & Loss A/c - 1/2 profit share	30,000 104,700
		134,700			**134,700**
			2019 1-Jan	By, Balance b/d	52,300

Robin's Current Account

Date	Particular	Rs.	Date	Particular	Rs.
2008 31-Dec	To, Cash-Drawing	100,000	2008 31-Dec	By, Profit & Loss A/c	

	To, Profit & Loss A/c Interest on drawing	3,000		Salary	48,000
				interest	18,000
	To, Balance c/d	67,700		By, Profit & Loss A/c 1/2 profit share	104,700
		170,700			**170,700**
			2009		
			1-Jan	By, Balance b/d	67,700

Illustration 7

Brahma, Bihsnu and Mahesh are in partnership sharing profit and losses in he ratio of 2:1:1. It is agreed that interest on capital will be allowed @10% per annum and interest on drawing will be charged @ 8% per annum. (No interest will be charged /allowed on Current Accounts)

The following are the particulars of the Capital and Drawings Accounts of the partners:

	Brahma	Bishnu	Mahesh
	Rs.	Rs.	Rs.
Capital 1st January	37,500	20,000	15,000
Current Account 1st January	10,000	2,500	(Dr. 2,500)
Drawings	7,500	5,000	5,000

The account for 2018 showed a net profit of Rs. 39,600 before taking into accounts interest on capitals and drawings and subject to following rectification of errors:

(a) Life insurance premium of Brahma amounting to Rs. 300 paid by the firm on 30th June 2018 has been charged to Miscellaneous Expenses A/c

(b) Repairs of Machinery amounting to Rs, 6,000 has been debited to Plan Account and depreciation thereon charged @ 20%

(c) Traveling expenses of Rs. 2,000 of Bishnu for a pleasure trip to Thailand paid by the firm on 30th June 2018 has been debited to Traveling Expenses Account.

You are required to prepare the Profit and Loss Appropriation Account for the year ended 31st December 2018 and Partners' Current Account for the year.

Solution

Profit and Loss Appropriation Account
for the year ended 31st December, 2018

Date	Particular	Rs.	Date	Particular	Rs.
2018					
31-Dec	To, Interest on capital			By, Net Profit -adjusted	37,100
	Brahma	3,750		By, Interest on Drawing:	

	Bishnu	2,000		Brahma's Current A/c	312
	Mahesh	1,500		Bishnu's Current A/c	280
	To, Profit transferred to			Mahesh's Current A/c	200
	Brahma's Current A/c	15,322			
	Bishnu's Current A/c	7,660			
	Mahesh's Current A/c	7,660			
		37,892			**37,892**

Partners' Current Accounts

Particulars	Brahma Rs.	Bishnu Rs.	Mahesh Rs.	Particulars	Brahma Rs.	Bishnu Rs.	Mahesh Rs.
To, Balance b/d			2,500	By, Balance b/d	10,000	2,500	
To, Drawing	7,500	5,000	5,000	By, Profit and Loss App. A/c (Interest on Capital)	3,750	2,000	1,500
To, Life insurance premium	300			By, Profit and Loss App. A/c (Share of profit)	15,322	7,660	7,660
To, Traveling Expenses		2,000					
To, Profit and Loss App. A/c- Interest on drawing	312	280	200				
To, Balance c/d	20,960	4,880	1,460				
	19,072	**12,160**	**9,160**		**29,072**	**12,160**	**9,160**

Working Notes:

1. Adjusted Profit

Particular	**Rs.**	**Rs.**
Net profit as per Profit and Loss A/c		39,600

Add: Drawing by Brahma-Life insurance premium charged to Misc. exp.	300	
Drawing by Bishnu: Personal traveling expenses charged to firm's traveling expenses	2,000	2,300
Less: Repairs to Machinery wrongly capitalised	6,000	
Less: Depreciation @ 20%	1,200	4,800
		37,100

2. Interest in Drawings:

Particular	**Brahma**	**Bishnu**	**Mahesh**
Drawings	7,500	5,000	5,000
Add: Rectification adjustment	300	2,000	-
	7,800	7,000	5,000
Interest @ 8% p.a. for 6 months	312	280	200

Illustration 8

A and B partners with a capital of Rs. 40,000 and Rs. 20,000 respectively. They shares profit and losses in proportion to their capitals after charging interest on capital @ 5% and a partners' salary of Rs. 30,000 p.a. to B. From 1.1.2018, A decided to retire from the firm's active work in the partnership and it is accordingly agreed that :

i. B shall in future be entitled to a partnership salary of Rs. 50,000 p.a.
ii. Interest to be allowed on capital @ 5% p.a.
iii. C, the manager of the firm, shall be introduced as a partner, without capital, as and from 1.1.2018, with a salary of Rs. 75,000 p.a. The excess of over Rs. 40,000 (his previous salary as manager) being chargeable against A.
iv. C shall be entitled to 1/10th of the profits after charging interest on capital and partnership salary.
v. The balance of the profit will be divided as 3/5th and 2/5th to A and B respectively.

The profit during the year 2018 was Rs. 250,000. Show Profit and Loss Appropriation Account and Partners' Capital Accounts under Fluctuating capital method. Assuming that the salaries have been drawn during the year. Drawings of the partners (excluding salaries) were A-Rs. 50,000, B-Rs. 30,000; and C-Rs. 10,000.

Solution

Profit and Loss Appropriation Account
for the year ended 31st December, 2018

Date	**Particular**	**Rs.**	**Date**	**Particular**	**Rs.**
2018					
31-Dec	To, Interest on capital			By, Net Profit -	250,000

	A	2,000			
	B	1,000			
	To, Partners' Salary				
	B	50,000			
	C (Note 2)	40,000			
	To, Profit transferred (Note 1)				
	A's Capital A/c	84,780			
	B' s Capital A/c	56,520			
	C's Capital A/c	15,700			
		250,000			**250,000**

Partners' Capital Accounts

Particulars	**A Rs.**	**B Rs.**	**C Rs.**	**Particulars**	**A Rs.**	**B Rs.**	**C Rs.**
To, C's Capital (Note 2)	35,000			By, Balance b/d	40,000	20,000	
To, Drawing (Note 3)	50,000	80,000	85,000	By, Profit and Loss App. A/c (Interest on Capital)	2,000	1,000	
To, Balance c/d	41,780	47,520	5,700	By, Profit and Loss App. A/c (Salaries)		50,000	40,000
				By, Profit and Loss App. A/c- Share of Profit	84,780	56,520	15,700
				By, Capital A/c (Note 2)			35,000
	126,780	**127,520**	**90,700**		**126,780**	**127,520**	**90,700**

Working Note: (1) Calculation of share of Profit

C – 1/10th of Rs. (250,000 – 3,000 – 90,000) = 15,700
A – 3/5th of Rs. (250,000 – 3,000 – 90,000 – 15,700) = 84,780
B – 2/5th of Rs. (250,000 – 3,000 – 90,000 – 15,700) = 56,520

(2) C will get salary of Rs. 75,000. However, only Rs. 40,000 is to be charged to the Partnership firm and balance is to be adjusted against A's Capital Account.

(3) Drawing of B and C includes their salaries.

Illustration 9

The following is the Statement Of Financial Position of M/s XY&Z as on December 31,2017

STATEMENT OF FINANCIAL POSITION

Liabilities	**Rs.**	**Rs.**	**Assets**	**Rs.**
Sundry Creditors		12,600	Cash in hand	1,200

Bills Payable		8,400	Cash at Bank	11,400
Capitals			Sundry Debtors	25,200
X	45,000		Stock-in-Trade	20,100
Y	30,000		Furniture and fittings	6,000
Z	15,000	90,000	Plant and Machinery	48,000
Current Accounts			Current Account: Z	1,560
X	1,440			
Y	1,020	2,460		
		113,460	-	**113,460**

X, Y and Z share profit and losses in the ratio of 3:2:1 after charging interest on capital at 6% per annum.

During 2018, the monthly drawings of the partners were:

	Rs.
X	1,200
Y	900
Z	750

On 31st December 2018 the assets and liabilities of the firm were:

	Rs.		Rs.
Cash in hand	900	Sundry Debtors	28,800
Stock-in-trade	30,600	Furniture and Fittings	5,400
Plant and Machinery	75,000	Sundry Creditors	10,200
Bills Payable	7,200	Bank overdraft	18,000

You are asked to:

(a) ascertain the profit or loss made by the firm in 2018 and

(b) show the Statement Of Financial Position of the firm as on 31st December 2018

Solution:

(a) Statement of Profit (or Loss)

Particular	**Rs.**	**Rs.**
Current Account (Net) as on 31.12.18		15,300
Add: Drawing during the year		
X (1,200 X 12)	14,400	
Y (900 X 12)	10,800	
Z (750 X 12)	9,000	34,200
Less : Current Accounts on 1.1.18		49,500
X	1,440	

Y	1,020	
	2,460	
Less: Z's Debit balance	1,560	900
Profit earned during 2008		**48,600**

(a) Statement Of Financial Position of M/s X.Y & Z as on 31st December 2018

Liabilities	**Rs.**	**Rs.**	**Assets**	**Rs.**
Sundry Creditors		10,200	Cash in hand	900
Bills Payable		7,200	Sundry Debtors	28,800
Bank Overdraft		18,000	Stock-in-Trade	30,600
Capitals as on 1st Jan 2018			Furniture and fittings	5,400
X	45,000		Plant and Machinery	75,000
Y	30,000		Z's Current A/c	2,460
Z	15,000	90,000		
Current Accounts :				
X	11,340			
Y	6,420	17760		
		143,160	-	**143,160**

Working Notes:

M/s X ,Y & Z

1. Statement of Affairs as on 31st December 2018

Liabilities	**Rs.**	**Rs.**	**Assets**	**Rs.**
Sundry Creditors		10,200	Cash in hand	900
Bills Payable		7,200	Sundry Debtors	28,800
Bank Overdraft		18,000	Stock-in-Trade	30,600
Capitals as on 1st Jan 2018			Furniture and fittings	5,400
X	45,000		Plant and Machinery	75,000
Y	30,000			
Z	15,000	90,000		
Current Accounts (Balancing figure)		15,300		
		140,700	-	**140,700**

2. Profit and Loss Appropriation Account for the year ending 31.12.2018.

Particular	Rs.	Rs.	Particular	Rs.
To, Interest on capitals:			By, Net Profit	48,600
X	2,700			
Y	1,800			
Z	900	5,400		
To, Capitals Accounts:				
X	21,600			
Y	14,400			
Z	7,200	43,200		
		48,600		48,600

3 Partners Current Accounts as on 31st December, 2018

Particulars	X Rs.	Y Rs.	Z Rs.	Particulars	X Rs.	Y Rs.	Z Rs.
To, Balance b/d	-	-	1,560	By, Balance b/d	1,440	1,020	-
To, Drawings	14,400	10,800	9,000	By, Profit and Loss App. A/c (Interest on Capital)	2,700	1,800	900
To, Balance c/d	11,340	6,420		By, Profit and Loss App. A/c	21,600	14,400	7,200
				By, Balance c/d			2,460
	25,740	**17,220**	**10,560**		**25,740**	**17,220**	**10,560**

1.3 GOODWILL

Goodwill is also one of the special aspects of partnership accounts which requires adjustment at the time of a change in the profit sharing ratio, the admission of a partner or the retirement or death of a partner.

Over a period of time, a well-established business develops an advantage of good name, reputation and wide business connections. This helps the business to earn more profits as compared to a newly set up business. In accounting, the monetary value of such advantage is known as 'goodwill'. It is regarded as an intangible asset. In other words, goodwill is the value of the reputation of a firm in respect of the profits expected in future over and above the normal profits. It is generally observed that when a person pays for goodwill, he/she pays for something, which places him in the position of being able to earn super profits as compared to the profit earned by other firms in the same industry.

In simple words, goodwill can be defined as "the present value of a firm's anticipated excess earnings" or as "the capitalized value attached to the differential profit capacity of a business".

Thus, goodwill exists only when the firm earns super profits. Any firm that earns normal profits or is incurring losses has no goodwill.

1.3.1 Purchase Goodwill:

Purchase goodwill arises when one business buys another and the purchase consideration paid is more than value of net tangible assets received. It can never exist in a new business except by purchase. It is acceptable practice to recognize only the purchased goodwill in the accounting system. Therefore, goodwill should enter into the books of account of a business only in connection with a valuation prescribed to it in the acquisition price of a business. Following are the important features of purchased goodwill:

i. It arises on acquisition.
ii. It is demonstrated by a purchase transaction.
iii. Price paid for goodwill depends upon the purchaser's expectation of future profits.
iv. It is normally recognized in financial statement.

1.3.2 Self-generated or Inherent Goodwill

It is internally generated goodwill for any specific purpose like change in profit sharing ratios among the existing partners, new admission of partner, retirement of partner etc. This type of goodwill normally write-off immediately after necessary adjustment of partners' capital accounts.

1.4 METHODS FOR GOODWILL VALUATION

There are four methods for valuation of goodwill namely: Average profit basis, Super profit basis, Annuity method and capitalization method. Method to be adopted in valuating goodwill will depend upon the circumstances of each particular case. At the time of valuation of goodwill, the partnership deed should be examined and valuation should be done on that basis. If the partnership deed is silent, the valuation should be done in such a manner as must have been agreed upon by the partners.

1.4.1 Average Profit Basis

a. Simple Average Profits Method :

Under this method, the goodwill is valued at agreed number of 'years' purchase of the average profits of the past few years. It is based on the assumption that a new business will not be able to earn any profits during the first few years of its operations. Hence, the person who purchases a running business must pay in the form of goodwill a sum which is equal to the profits he is likely to receive for the first few years. The goodwill, therefore, should be calculated by multiplying the past average profits by the number of years during which the anticipated profits are expected to accrue.

Illustration 10

The profit for the last five years of a firm were as follows

Year	Profit
2014	Rs. 4,00,000
2015	Rs. 3,98,000
2016	Rs. 4,50,000
2017	Rs. 4,45,000
2018	Rs. 5,00,000

Calculate goodwill of the firm on the basis of 4 years purchase of 5 years average profits.

Solution

Year	Profit
2014	Rs. 4,00,000
2015	Rs. 3,98,000
2016	Rs. 4,50,000
2017	Rs. 4,45,000
2018	Rs. 5,00,000
TOTAL	**Rs. 21,93,000**

$$\text{Average Profit} = \frac{\text{Total profit of last 5 years}}{\text{No. of years}} = \frac{\text{Rs. } 21{,}93{,}000}{5} = \text{Rs.}4{,}38{,}600$$

Goodwill = Average Profits × No. of years purchased = Rs. 4,38,600 × 4 = Rs. 17,54,400

b. Weighted Average Profit Method :

This method is a modified version of the earlier method. Under this method each year's profit is multiplied by the respective number of weights for eg. 1,2,3,4 etc., in order to find out value of product and the total of products is then divided by the total of weights in order to ascertain the weighted average profits. Thereafter, the weighted average profit is multiplied by the agreed number to find out the value of goodwill.

Weighted Average Profit = Total of Products of Profits / Total of weights

Goodwill = Weighted Average Profits × Agreed Number of years'(Purchase)

Weighted average profit method of valuation of goodwill is better than the simple average profit method because it gives weightage to latest profit, which is likely to be maintained in the future by the firm. It is applicable when the profit shows a rising or falling trend.

Illustration 11

The profits of a firm for the year ended 31st March for the last five years were as follows :

Year	Profit (Rs.)
2014	20,000
2015	24,000
2016	30,000
2017	25,000
2018	18,000

Calculate the value of goodwill on the basis of three years' purchase of weighted average profits after weights 1,2,3,4 and 5 respectively to the profits for 2014, 2015, 2016, 2017 and 2018.

Solution

Year	Profit (Rs.)	Weight	Product
2014	20,000	1	20,000
2015	24,000	2	48,000
2016	30,000	3	90,000
2017	25,000	4	1,00,000
2018	18,000	5	90,000
	TOTAL	**15**	**3,48,000**

Weighted Average Profit = Rs 3,48,000 / 15 = Rs 23,200

Goodwill = 23,200 × 3 = Rs. 69,600

1.4.2 Super profit Basis:

The basic assumption in the average profits method of calculating goodwill is that, if a new business is set up, it will not be able to earn any profits during the first few years of its operations. Hence, the person who purchases an existing business has to pay in the form of goodwill a sum equal to the total profits he is likely to receive for the first 'few years'.

It is also contended that the buyer's real benefit does not lie in total profits; it is limited to such amounts of profits which are in excess of the normal return on capital employed in similar business. A business unit may possess some advantages which enable it to make extra profit over and above the amount that would be earned if the capital of the business was invested elsewhere with similar risks. Therefore, it is desirable to value, goodwill on the basis of the excess profits and not the actual profits. The excess of actual profits over the normal profits is termed as super profits.

Under this method, the partner who gains in terms of profit sharing ratio has to contribute only for excess profit because normal profit he can earn by joining any partnership.

Normal profits can be ascertained as follows

$$\boxed{\textbf{Normal Profits} = \frac{\textbf{Capital Employed} \times \textbf{Normal Rate of Return}}{\textbf{100}}}$$

These steps are to be followed to find out the super normal profit.

1. Identify and calculate the capital employed by the partnership firm;
2. Identify the average maintainable profit earned by the partnership firm based on past few years' figures;
3. Determine normal rate of return prevailing in the locality for similar firms;
4. Apply normal rate of return on capital employed to arrive at normal profit;
5. Deduct normal profit from the average profit of the firm. It the average profit of the firm is more than the normal profit, there exists super profit and goodwill.

Illustration 12

The books of business showed that the capital employed on December 31,2018, Rs. 5,00,000 and the profits for the last five years were: 2014-Rs. 40,000; 2015- Rs. 50,000; 2016-Rs. 55,000; 2017-Rs. 70,000 and 2018-Rs. 85,000. You are required to find out the value of goodwill based on 3 years purchase of the super profits of the business, given that the normal rate of return is 10%.

Solution

$$\text{Normal Profit} = \frac{\text{Capital Employed} * \text{Normal Rate of Return}}{100}$$

$$= \frac{5,00,000 * 10}{100}$$

$$= \text{Rs } 50,000$$

Average Profits :

Year	Profit Rs.
2014	40,000
2015	50,000
2016	55,000
2017	70,000
2018	85,000
Total Profit	**Rs. 3,00,000**

Average Profit = Rs. 3,00,000/5 = Rs. 60,000
Super Profit = Rs. 60,000 – Rs. 50,000 = Rs. 10,000
Goodwill = Rs. 10,000 × 3 = Rs. 30,000

1.4.3 Annuity Method

In the super profit method explained above, time value of money is not considered. Although it was expected that super profit would be earned in five future years, still no devaluation was done on the value of money for the time difference. In fact when money will be received in different points of time, its value should be different depending upon the rate of interest. Under this method, goodwill is estimated as the present value of the future super profits.

Illustration 13

A firm has the forecasted profits for the coming 5 years as follows :

Year	**I**	**II**	**III**	**IV**	**V**
Profits (Rs.)	1,00,000	1,20,000	90,000	1,00,000	1,50,000

The total assets of the firm are Rs. 10,00,000 and outside liabilities are Rs. 2,00,000. The present value factor at 10% are as follows :

Year	I	II	III	IV	V
PVF	0.9091	0.8264	0.7513	0.6830	0.6209

Calculate the Value of goodwill.

Solution

Year	I	II	III	IV	V
Profits (Rs.)	1,00,000	1,20,000	90,000	1,00,000	1,50,000
Normal Profit	80,000	80,000	80,000	80,000	80,000
Super Profit	20,000	40,000	10,000	20,000	70,000
PVF	0.9091	0.8264	0.7513	0.6830	0.6209
Present Value of Super Profits	18,182	33,056	7,513	13,660	43,463

Value of Goodwill = Rs. 18,182 + 33,056 + 7,513 + 13,660 + 43,463
= Rs. 1,15,874

1.4.4 Capitalization Basis:

Under this basis, value of whole business is determined applying normal rate of return. If such value (arrived at by applying normal rate of return) is higher than the capital employed in the business, then the difference is goodwill.

Under this method the goodwill can be calculated in two ways(a) by capitalizing the average profits, or

(b) by capitalizing the super profits.

(a) Capitalization of Average Profit :

In this method, the value of goodwill is ascertained by deducting the actual capital employed (net assets) in the business from the capitalized value of the average profits on the basis of normal rate of return. This involves the following steps :

(i) Ascertain the average profits based on the past few years' performance.

(ii) Capitalize the average profits on the basis of the normal rate of return as follows :

Total value of business =. $\boxed{\textbf{Average Profits} \times \textbf{100/Normal Rate of Return}}$

(iii) Ascertain the actual capital employed (net assets) by deducting outside liabilities from the total assets (excluding goodwill).

Capital Employed = Total Assets (excluding goodwill) – outside liabilities

(iv) Compute the value of goodwill by deducting net assets from the total value of business, i.e. (ii) – (iii).

Illustration 14

A business has earned average profits of Rs. 1,00,000 during the last few years and the normal rate of return in a similar type of business is 10%. Ascertain the value of goodwill by capitalization method, given that the value of net assets of the business is Rs. 8,20,000.

Solution

Capitalized Value of Average Profits = 1,00,000 / 10 * 100 = Rs 10,00,000
Goodwill = Capitalized Value – Net Assets = 10,00,000 – 8,20,000 = Rs. 1,80,000

(b) Capitalization of Super Profits :

Under this method following steps are involved :

(i) Calculate Capital employed of the firm, which is equal to total assets minus outside liabilities.
(ii) Calculate required profit on capital employed by using the following formula :

Profit = Capital Employed × Required Rate of Return/100

(iii) Calculate average profit of past years, that is, 3 to 5 years.

(iv) Calculate super profits by deducting required profits from average profits.

(v) Multiply the super profits by the required rate of return multiplier, that is,

Goodwill = Super Profits × 100/Normal Rate of Return

Illustration 15

Calculate Goodwill if :

(i) The goodwill of a firm is estimated at three years' purchase of the average profits of the last five years which are as follows :

Years:	**2014**	**2015**	**2016**	**2017**	**2018**
Profits (Loss):	Rs.10,000	15,000	4,000	(5,000)	6,000

(ii) If in the firm total capital employed is Rs.1,00,000 and normal rate of return is 8%, the average profit for last 5 years is Rs. 12,000 and goodwill is estimated at 3 years' purchase of super profits, remuneration to partners Rs. 3000.

(iii) Rama Brothers earn a net profit of Rs. 30,000 with a capital of Rs. 2,00,000. The normal rate of return in the business is 10%. Use capitalization of super profits method to value the goodwill.

Solution

(i) Total Profit =Rs. 10,000 + 15,000 + 4,000 + 6,000 – 5,000 =Rs. 30,000
Average Profit =Rs. 30,000/5 =Rs. 6,000
Goodwill = Average Profit × 3 =Rs. 6,000 × 3 =Rs. 18,000.

(ii) Average Profit = Rs. 12,000
Remuneration to Partners = Rs. 3,000
Average actual profit = Rs. 12,000 – Rs. 3,000 = Rs. 9,000

Normal Profit	= Rs. 1,00,000 × 8/100	= Rs. 8,000
Super Profit = Average Profit – Normal profit = Rs. 9,000 – 8,000		= Rs. 1,000
Goodwill = Super Profit × 3	= 1,000 × 3	= Rs. 3,000

(iii) Normal Profit	= Rs. 2,00,000 × 10/100	= Rs. 20,000
Super Profit = Average Profit – Normal Profit = Rs. 30,000 – 20,000		=Rs.10,000
Goodwill = Super Profit × 100/Normal Rate of Return = 10,000 × 100/10		= Rs. 1,00,000

Illustration: 16

Hari and Haran are in equal partnership. The agreed to take Hiren as one-fourth partner. For this it was decided to find out the value of goodwill. M/s Hari and Haran earned profits during 2015 to 2018 as follows:

Year	Profit
2015	150,000
2016	155,000
2017	160,000
2018	180,000

On 31.12.2018 capital employed by M/s Hari and Haran was 550,000. Rate of normal profit is 20%. Find out the value of goodwill following various methods.

Solution

Calculation of Average Profit

Year	**Profit**	**Weight**	**Weighted Profit**
2015	150,000	1	150,000
2016	155,000	2	310,000
2017	160,000	3	480,000
2018	180,000	4	720,000
		10	**16,60,000**

Weighted Average Profit Rs. = 16,60,000/10 = Rs. 166,000

Method (1): Average Profit Basis

Assumption: Goodwill is valued at 3 year's purchase

Value of Goodwill: Rs. 166,000 X 3 = 498,000

Method (2): Super profit basis

Average Profit	Rs. 166,000
Normal Profit	
20% on Rs. 550,000	Rs.110,000
	Rs. 56,000

Assumption: Goodwill is valued at 3 year's purchase.
Value of Goodwill: Rs.56,000 X 3 = Rs. 168,000

Method (3): Annuity Basis

Assumption:
(a) Interest rate is equivalent to normal profit rate i.e. 20% p.a.
(b) Goodwill is valued at 3 year's purchases.
Value of Goodwill: Rs. 56,000 X 2.1065 = Rs. 117,964

Method (4): Capitalization Basis

Normal Value of capital employed:
= Average profit / Normal rate of return = Rs. 166,000/0.20
= Rs. 830,000

Normal Value of Capital Employer	Rs. 830,000
Capital employed in M/s Hari and Haran	Rs. 550,000
Value of goodwill	**Rs.280,000**

Illustration 17

Wise, Clever and Dull were trading in partnership sharing profits and losses in the ratio 4:3:3 respectively. The accounts of the firm are made up to 31st December every year. The partnership deed provided, inter alia, that:

On the death of a partner, the goodwill was to be valued at three years' purchase of average profits of the three years up to to the date of death after deducting interest @ 8 percent on capital employed and a fair remuneration of each partner. The profits are assumed to be earned evenly throughout the year.

On 30th June, 2018, Wise died and it was agreed on his death to adjust goodwill in the capital accounts without showing any amount of goodwill in the Balance Sheet.

It was agreed for the purpose of valuation of goodwill that the fair remuneration for work done by each partner would be Rs. 15,000 per annum and that the capital employed would be Rs.1,56,000. Clever and Dull were to continue the partnership, sharing profits and losses equally after the death of Wise.

The following were the amounts of profits of earlier years before charging interest on capital employed:

2015	Rs 67,200
2016	Rs 75,600
2017	Rs 72,000
2018	Rs 62,400

Required

Value of goodwill and show the adjustment thereof in the books of the firm.

Solution

Computation of the value of goodwill:

(i) Average Profit for three years, ending 30th June: before death:

	Rs.	Rs.
Year ending 30tn June, 2016:		
½ of 2015 profits	33,600	
½ of 2016 Profits	37,800	71,400
Year ending 30th June,2017:		
½ of 2016	37,800	
½ of 2017 Profits	36,000	73,800
Year ending 30th June,2018:		
½ of 2017	36,000	
½ of 2018 Profits	31,200	67,200
Total		2,12,400
Average		70,800
(ii) **Super Profit**		
Average profits earned:		70,800
Less: Partner's remuneration	45,000	
Less: 8% on capital employed	12,480	57,480
Super Profits		13,320
Goodwill @ three years' purchase		Rs 39,960

Adjustment entries for Goodwill

Goodwill Account	Dr.	39,960	
To Capital Accounts			
Wise			15,984
Clever			11,988
Dull			11,988

(Goodwill, valued @ Rs.39,960 adjusted in the Capital accounts of partners on the death of Mr. Wise in the old profit sharing ratio)

Clever's Caital Account	Dr		19,980
Dull's Capital Account	Dr.		19,980
To Goodwill Account	39,960		

(goodwill written off between continuing partners In the new profits sharing ratio)

Illustration 18

The following particulars are available in respect of business carried by Rahul

		Rs.
Capital Invested		180,000
Trading results:		
2015	Profit	50,000
2016	Profit	40,000
2017	Loss	10,000
2018	Profit	60,000

Market Rate of interest on investment 10%
Rate of risk return on capital invested in business 2%
Remuneration from alternative employment
of the proprietor (If not engaged in business) Rs. 8,000 p.a.

You are required to calculate the value of goodwill on the basis of 5 years' purchases of super profit of the business calculated on the average profit of the last four years.

Solution

Average Maintainable Profit:

Particular		**Rs.**
Trading profit during	2015	50,000
	2016	40,000
	2018	60,000
		150,000
Less: Loss during	2017	10,000
Total		140,000
Average profit (Total/ 4)		35,000
Less: Remuneration for the proprietor		8,000
Average maintainable profit		**27,000**
Normal profit (12% on capital employed)		21,600
Super profit		5,400
Goodwill at 5 year's purchase of super profit		**27,000**

1.5 Adjustment of Goodwill in case of change in Profit Sharing Ratio

If the partners of a firm decide to change their Profit Sharing Ratio, the gaining partner (i.e. the partner whose share has increased as a result of change) must compensate the sacrificing partner (i.e. the partner whose share has decreased as a result of change) by paying the proportionate amount of goodwill. So, in the event of change in profit sharing ratio, the value of goodwill should be determined and preferably adjusted through capital accounts of the partners on the basis of profit sacrificing ratio. Another alternative is that goodwill is raised in the books of accounts of the firm crediting the partners' capital accounts in their old profit sharing ratio and then immediately written off the same by debiting the partners capital accounts in their new profit sharing ratio.

Illustration 19:

Sita, Gita and Mita are partners sharing profits and losses in the ratio of 6:5:4. Form 1st January 2019, they decide to share profits and losses equally. The partnership deed provides that in the event of any change in profit sharing ratio, the goodwill should be valued at two years' purchase so the average profits of the preceding 5 years. The profits and losses of the preceding years are 2014 profit Rs. 130,000, 2015 profit Rs. 190,000, 2016 Profit 100,000, 2017 Profit 110,000 and 2018 loss Rs. 50,000. Give the necessary journal entry to record the above change.

Solution

Value of Goodwill:

Average Profit = $\frac{\text{Rs.}(130{,}000+190{,}000+100{,}000+110{,}000-50{,}000)}{5}$ = Rs. 96,000

Goodwill would be Rs. 96,000 X 2 = 192,000

Entry:

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Particular		**Debit**	**Credit**
Goodwill Account	Dr.	192,000	
To, Sita's Capital Account			76,800
To, Gita's Capital Account			64,000
To, Mita's Capital Account			51,200
(Value of goodwill raised in the books on the occasion of change in profit sharing ratio and credited to partners' account in their old ratio 6:5:4)			
Sita's Capital Account	Dr.	64,000	
Gita's Capital Account	Dr.	64,000	
Mita's Capital Account	Dr.	64,000	
To, Goodwill Account			192,000
(goodwill written off by debiting partners' capital account in their new profit sharing ratio 1:1:1)			

<u>Alternatively the following entry could be used</u>

Calculation of profit Sacrificing/gaining Ratio: Old ratio – New ratio = (+ sacrificed) or (- Gaining)

Sita 6/15 – 1/3 = 1/15 sacrificed
Gita 5/15 – 1/3 = 0
Mita 4/15 – 1/3 = -1/15 gain.

Because of change in profit sharing ratio Sita will lose her future profit where as Mita will gain. But this change will not effect the profit sharing ratio of Gita. Therefore, Mita shall have to compensate to Sita Rs. 12,800. (Rs. 192,000 X 1/15)

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Particular		**Debit**	**Credit**
Mita's Capital Account	Dr.	12,800	
To, Sita's Capital Account			12,800
(The adjustment made for goodwill on change in profit sharing ratio)			

Note: As per the NAS, alternative entry will be preferable**.**

Summary

In this unit, we have discussed the techniques of goodwill and accounting treatment thereof for partnership business. Goodwill is the value of reputation of a firm in respect of profits expected in future over the above the normal rate of profit. Basically, valuation of goodwill arises on changing of existing profit sharing ratios, admission or retirement of partner and dissolution of firm as well.

Goodwill is valued on the basis of expected profit to be anticipated in future which is expected to be over and above the normal profit that can be earned in normal circumstances. Goodwill can be calculated under four different methods. Under the average profit basis, average profit of pasts 3-5 years are determined and then multiplied by agreed number of years for valuation of goodwill. Under super profit method, a normal rate of return is chosen from the average businesses run in the same locality. By applying the normal rate of profit on the capital employed by the partnership normal profit is derived. If the average profit of the partnership is more than the normal profit, there exist super profit. Goodwill is taken as the super profit for agreed number of years. Under the annuity method, value of super profit, is discounted values of super profit. Under this method, time value of money is considered. Under capitalisation method, value of partnership business is determined by applying the normal rate of return on average profit of the partnership. Then normal value of the business is compared with the capital employed of the business. If the normal value of business is higher than the capital employed, there exist goodwill. Goodwill is taken as the excess of normal value of the business over the capital employed.

There are four approaches for accounting treatment of goodwill in partnership accounts namely, goodwill raised and to be shown in books of account, goodwill raised and immediately written off, share of goodwill brought in cash by incoming partner and share of goodwill settled privately.

In the case of admission of partner share of goodwill of new partner which have to be brought in by new partner or adjusted in his capital account, to be adjusted on the basis of sacrificing ratios of old partners because due to admission of new partner existing partners shall have to be sacrificed in future profit of the firm. Similarly, in the case of retirement share of goodwill of

outgoing partners to be contributed by continuing partners on the basis of gaining ratio. Because, the continuing partners would gain in the profit sharing ratio due to death or retirement of a partner.

Self-Examination Questions

I. Multiple Choice Questions (MCQs)

1. A and B are partners sharing profits and losses in the ratio of 3:2 having the capital of Rs. 80,000 and Rs. 50,000 respectively. They are entitled to 9% p.a. interest on capital before distributing the profits. During the year firm earned Rs. 7,800 after allowing interest on capital. Profits apportioned among A and B is
   a) 4,680 and 3,120.
   b) 4,800 and 3,000.
   c) 5,000 and 2,800.
   d) None of the above.

2. The relationship between persons who have agreed to share the profit of a business carried on by all or any of them acting for all is known as
   a.Joint venture
   b. Partnership
   c. Association of Person
   d. Body of individuals

3. What would be the profit sharing ratio if the partnership act is complied with
   a. As per Agreement
   b. Equally
   c. To capital ratio
   d. None of the above

4. In the absence of an agreement , partners are entitled to
   a. Salary
   b. Commission
   c. Interest on Loan
   d. Profit share in capital ratio

5. Following is the difference between partnership deed and partnership agreement
   a) Partnership deed is in writing and partnership agreement is oral
   b) Partnership deed is signed by all the partners but partnership agreement is signed by majority of the partners
   c) Partnership deed is registered in the court of law whereas partnership agreement is not registered
   d) Partnership deed is not subject to changes unless all partners agree to it. Partnership agreement can be amended with the consent of more than 50% partners

6. Ram and Shyam are partners with the capital of Rs 25,000 and Rs 15,000 respectively . Interest payable on capital is 10% p.a .Find the interest on capital for both the partners when the profit earned by the firm is Rs 2400
   a. Rs 2500 and Rs 1500
   b. Rs 1500 and Rs 900
   c. Rs 1200 and Rs 1200
   d. None of the above

7. Manjila and pooja are partners sharing profit and losses in the ratio 4:1. Dipika was manager who received the salary of Rs 4000 p.m in addition to a commission of 5% on net profits after charging such commission. Profit for the year is rs 678,000 before charging salary. Find the total remuneration of Dipika

   a. Rs 78,000 b. Rs 88,000
   c. Rs 87,000 d. Rs 48,000

8. What time would be taken in consideration if equal monthly amount is drawn as drawing at the end of each month

   a. 6 months b. 6.5 months
   c. 5.5 months d. 5 months

9. The profit of last three years are Rs 42,000, Rs 39,000, and Rs 45,000 find out the goodwill of the two year's purchase

   a. Rs 42,000 b. Rs 84,000
   c. Rs 120,000 d. Rs 36,000

10. Following are the factors affecting goodwill except

    a. Nature of business b. Efficiency of management
    c. Technical know how d. Location of customers

11. Weighted average method of calculation of goodwill should be followed when

    a. Profit are uneven b. Profits has increasing trend
    c. Profits has decreasing trend d. Either b or c

12. A and B are partners with capitals of Rs 10,000 and Rs 20,000 respectively and sharing profit equally. They admitted C as their third partner with a fourth profits of the firm on the payment of Rs 12,000.The amount of hidden goodwill is

    a. Rs 10,000 b. Rs 6,000
    c. Rs 8,000 d. Rs 24,000

(Solution: Total Capital = 12000*4/1 = 48000

Goodwill of old partners (3/4) = 48000-(10000+20000+12000) = 6000

Total Hidden Goodwill = 6000*4/3 = 8,000

13. The profits for the last three years are Rs 40,000 Rs 60,000 and Rs 66,500 . The total liabilities of the firm are Rs 10,00,000 of which outsiders liabilities is Rs 542,500 . The rate of interest expected from capital invested is 10%. The value of goodwill on capitalization is

    a. Rs 97,000 b. Rs 97,250
    c. Rs 97,500 d. Rs 97,750

14. The profit for 2016 is Rs 4000, for 2017 is Rs 52,200 and for 2018 is Rs 62,400. Closing stock for 2017 and 2018 includes the defective items of Rs 4,400 and Rs 12,400 respectively which were considered as having market value NIL. The value of goodwill on average profit method is

a. Rs 35,200 b. Rs 35,400
c. Rs 35,600 d. Rs 35,800

15. A, B and C are partners in a firm. Profits before interest on partner's loan was Rs 12,000 and B determined interest @24% p.a on his loan of Rs 160,000 . There was no agreement on this point. Calculate the amount payable to A,B and C respectively
    a) Rs 4000 to each partner
    b) Loss of Rs 8,800 for A and C but B will take Rs 29,600
    c) A- Rs 800, B- Rs 10,400 and C-Rs 800
    d) Rs 4800 to each partner

II. Practical Questions (PQs)

1. Why is it required to raise value of goodwill in partnership accounts?
2. Explain briefly methods for valuation of goodwill.
3. Hemraj. Devraj and Khemraj are in partnership sharing profits and losses equally. They agreed to take Nemraj as 1/6 the partner. The new profit sharing ratio will be as 4:3:3:2. past profits of the firm were as follows:
   2016 – Rs. 600,000, 2017 – Rs. 750,000 and 2018 – Rs. 900,000.
   Capital employed as on 31.12.2018 was Rs. 30,00,000. Normal rate of return 25%. Determine the value of goodwill using (i) Super profit method and (ii) Capitalization method.
   Show the accounting treatment of goodwill using the super profit value under the following circumstances.
   (i) Goodwill is raised in the books.
   (ii) Goodwill is raised in the books but written off immediately.
   (iii) Nemraj brought the necessary amount of goodwill.
   (iv) Nemraj settled the goodwill privately.

4. A, B and C were in partnership. A and B sharing profits in the proportion of three to one, and C receiving a salary of Rs. 250,000 plus 5% of the profit after charging his salary or 1/7 of the profit of the firm whichever is the large. Any excess of the latter over the former is, under the partnership agreement, to be charged to A. The profit for the year ended 31.12. 2008 was Rs. 20,70,000. You are required to show the distribution of the profit among the partners

5. A, B and C are in partnership. Their partnership deed provide that:
   (i) Interest on capital is to be provided @ 5%.
   (i) Interest on drawings is to be charged @ 10% p.a.
   (ii) Each partner is entitled to salary for their duty in the firm @ Rs. 4,000 p.a.
   (iii) A is to receive commission of 10% on the net profit before charging the above provisions.
   (iv) B is to receive commission of 10% on net profit after charging such commission and above provisions.
   (v) First net distributable profit of Rs, 40,000 to be apportioned in the ratio of 5:4:1 and the balance to be shared equally

The opening balances were as follows:

(a) Capital Accounts: A - Rs. 100,000 B - Rs. 60,000 C – Rs. 40,000

(b) Current Accounts: A – Rs. 20,000(Cr.)B – Rs. 5,000 (Cr.) C – Rs. 6,000 (cr.)

(c) Loan Account Rs. 50,000 (Interest on loan provided in the Statement Of Profit or Loss)

(d) Net profit for the year was Rs. 350,000. You are required to prepare: Profit and Loss Appropriation Account.

6. Das and Bashu had a firm in which they had invested Rs. 150,000. On the average the profit was Rs. 50,000. The usual rate of earning in the industry was 18%. Goodwill is to be valued at 4 years purchase of profit in excess of profits @ 15% on the money invested. Value the goodwill.

7. A and B sharing in proportion of 3 and 2 had capital of Rs 120,000 and Rs. 85,000 respectively. They agreed to admit C into partnership as from 1st January 2009 on the following terms in return for a third share in future profits.

(i) That C should bring in Rs. 120,000 as capital.

(ii) That as C is unable to bring his share of goodwill in cash, the goodwill of the firm be valued at Rs. 75,000 and a goodwill account be raised in the firm's books.

Set out the journal entries required, capital accounts of the partners and the goodwill account, State the future sharing proportions of the partners.

ANSWER

Multiple Choice Questions (MCQs)

1	A	6	A	11	D
2	B	7	A	12	C
3	B	8	C	13	C
4	C	9	B	14	B
5	A	10	A	15	C

CHAPTER- 8

PARTNERSHIP ACCOUNTS

UNIT 2:

Admission of New Partner

Learning Objectives

1. *Try to understand the reason behind revaluation of assets and computation of liabilities required in case of admission of new partner.*
2. *Learn the accounting treatments under two circumstances (a) when revalued assets and liabilities are shown in Statement Of Financial Position and (b) when revalued assets and liabilities are not shown in Statement Of Financial Position.*
3. *Learn the technique of treating reserve balance on admission and arriving at new profit sharing ratio.*
4. *Observe the technique of inferring goodwill although figure of goodwill is not mentioned clearly.*

2. INTRODUCTION

Subsequent to the formation of a partnership a new partner may be admitted with the consent of all existing partners. A new partner may be admitted for different reasons such as more capital, influence or special skill. Admission of a partner is one of the modes of reconstituting the firm under which old partnership comes to an end and a new one between all partners (including incoming partner) comes into existence. Once the person become a partner, he will acquire two main right in the firm i.e. right to share the assets of the firm and right to share the future profits of the firm.

When a new partner joins a firm, it is desirable to bring all appreciation or reduction in the value of assets into accounts as on the date of admission. Similarly, if the books contain any liability which has not been paid or if the books do not contain a liability which has to be paid, suitable entries should be passed. The purpose of such entries is to make an updated Statement Of Financial Position on the date of admission. Also, all profits which have accrued but not yet brought into books and similarly, all losses which have occurred but no recorded, should now be brought into books so that the Capital Accounts of the old partners reflect the proper figure. As result of passing of such entries, any subsequent profits or losses will be automatically shared by the incoming partner along with others.

2.1 ADJUSTMENT REQUIRED AT THE TIME OF ADMISSION OF A NEW PARTNER

The various matters that need adjustment at the time of admission of a new partner are given below:

i. Adjustment in Profit Sharing Ratio,
ii. Adjustment of Goodwill,
iii. Adjustment of Profit/Loss arising from the Revaluation of Assets and Liabilities,
iv. Adjustment of Accumulated Profits, Reserves and Losses,
v. Adjustment of Capital (if agreed).

2.2 COMPUTATION OF NEW PROFIT SHARING RATIO

When a new partner is admitted and there is no agreement to the contrary, it is supposed that old partners will continue to have inter se at the old profit sharing ratio.

1. **When the new share of the incoming partner is given but sacrifice of the old partners are not given**

Illustration 1:

A and B are partners sharing profits in the ratio of 3:2. They admit C for 1/5th share as new partner. Calculate new profit sharing ratio and sacrificing ratio of old partners.

Solution:

a) New Profit Sharing ratio:

Let the total profit be = 1
C's share = 1/5
Remaining share of A and B = 1-1/5 =4/5

Old Ratio of A = 3/5
New Share of A = 4/5 *3/5 =12/25

Old Ratio of B = 2/5
New Share of B = 4/5 * 2/5 = 8/25

Old Share of C= 1/5
New share of C = 1/5 *5/5 = 5/25

New Profit Sharing Ration (A,B,C) = 12: 8: 5

b) Sacrifice ratio

Sacrifice = Old share- New Share

A's Sacrifice = 3/5-12/25 =3/25

B's Sacrifice = 2/5- 8/25 =2/25

Sacrifice ratio (A:B) =(3/25:2/25)

2. Unequal sacrifice of the old partners (Unequal sacrifice)

Illustration 2:

A and B are partners sharing profits in the ratio of 3:2. They admit C for 1/5th share of future profits which C acquires 3/20th from A and 1/20th from B. Calculate new Profit sharing ratio and sacrificing ratio of old partners.

Solution

a. New Profit Sharing ratio:

Old share of A = 3/5
Sacrifice of A =3/20
New Share of A = 3/5-3/20 =9/20

Old share of B = 2/5
Sacrifice of B = 1/20
New share of B= 2/5-1/20 =7/20

Share of C = 1/5
New share of C= 1/5*4/4 = 4/20

New Ratio = 9:7:4

b. Sacrifice ratio

Sacrifice ratio (A:B) =(3/20:1/20)

3. Equal sacrifice of the old partners (Equal sacrifice)

Illustration 3:

A and B are partners sharing profits in the ratio of 3:2. They admit C for 1/5th Share which acquires equally from A and B. Calculate new profit sharing ratio and sacrificing ratio of old partners.

Solution:

a) New Profit sharing ratio

Old share of A= 3/5		
Sacrifice of A on share of C	= 1/5*1/2	=1/10
New Share of A	= 3/5-1/10	=5/10
Old share of B= 2/5		
Sacrifice of B on share of C	= 1/5*1/2	=1/10
New Share of B	= 2/5-1/10	=3/10
Share of C		=1/5
New share of C	=1/5*2/2	=2/10

New Profit sharing ratio (A:B:C) = 5:3:2

4. Entire Sacrifice by one partner only

Illustration 4:

A and B are partners sharing profits in the ratio of 3:2. They admit C for 1/5th share which he acquires entirely from A. Calculate a) new ratio and b) Sacrificing ratio.

Solution:

a) New Profit sharing ratio

Old share of A	= 3/5	
Sacrifice of A on share of C	= 1/5	
New Share of A	= 3/5 - 1/5	=2/5
Old share of B	= 2/5	
New Share of B	= 2/5	
Share of C		=1/5
New share of C		=1/5
New Profit sharing ratio (A:B:C)	= 2:2:1	

b. Sacrifice ratio

Sacrifice ratio (A) =1/5

5. When the new share of the incoming partner is not given.

Illustration 5:

A and B are partners sharing profits in the ratio of 3:2. They admit C as new partner which he acquires 1/5th of A's share and 2/5 of B's share. Calculate a) New ratio and b) Sacrificing ratio.

Solution:

a) New Profit sharing ratio

Old share of A= 3/5		
Sacrifice of A on share of C	= 3/5 * 1/5	=3/25
New Share of A	=3/5 – 3/25	=12/25
Old share of B= 2/5		
Sacrifice of B on share of C	= 2/5*2/5	=4/25
New Share of B	= 2/5-4/25	=6/25
New share of C	=3/25 + 4/25	=7/25

New Profit sharing ratio (A:B:C) = 12:6:7

b. Sacrifice ratio

Sacrifice ratio (A:B) =3/25:4/25

6. When the new share of all the partner is given.

Illustration 6:

X and Y are partners sharing profits in the ratio of 3:2. They admit Z as a new partner. The new profit sharing ratio among X, Y and Z is 4:3:2. Find out the sacrificing ratio.

Solution:

a) New Profit sharing ratio

New share of Z	=2/9
New Profit sharing ratio (X:Y:Z)	= 4:3:2

b. Sacrifice ratio

Old share of X		= 3/5
New Share of X =4/9		
Sacrifice of X	= 3/5 -4/9	= 7/45

Old share of Y		= 2/5
New Share of Y	=3/9	
Sacrifice of Y	=2/5- 3/9	=3/45
Sacrifice ratio (X:Y)		=7/45:3/45

Illustration 7:

X and Y are in partnership sharing profits and losses at the ratio of 5:3. They take Z as a new partner. Calculate the new profit sharing ratio if-

(i) Z purchases 1/10 share from X.
(ii) X and Y agree to sacrifice 1/10 share to Z in the ratio of 2:3.
(iii) Simply Z gets 1/10 share of profit.

Solution:

(i) New Profit Sharing ratio

X	5/8-1/10 = 21/40
Y	3/8 i.e. 15/40
Z	1/10 i.e. 4/40

Therefore, X:Y:Z=21:15:4

(ii)

X's Sacrifice	1/10 x 2/5	=	2/50
Y's Sacrifice	1/10 x 3/5	=	3/50

New profit sharing ratio.

X	5/8 – 2/50	=	117/200
Y	3/8 – 3/50	=	63/200
Z	1/10	=	20/200

I.e. 117:63:20

(iii) Balance share to be divided between X and Y

1-1/10	=	9/10

Distribution:

X 9/10 x 5/8	=	45/80
Y 9/10 x 3/8	=	27/80
Z 1/10	=	8/80

i.e. 45:27:8

2.3 GOODWILL VALUATION NECESSARY IN CASE OF ADMISSION OF A PARTNER ?

As per the NAS 27, internally generated goodwill shall not be recognized as an assets because it is not an identifiable resource (i.e. it is not separable nor does it arise from contractual or other legal rights) controlled by the entity that can be measured reliably as cost. In other words, goodwill should be recorded in the books only when some consideration in money or money's worth has been paid for it. In case of admission/retirement/ death of a partner or in case of change in profit sharing ratio among partners, goodwill cannot be raised in the books of the firm because no consideration in money or money's worth is paid for it. However, if any partner brings any premium over and above his capital contribution at the time of his admission, such premium should be distributed to other existing partners on the basis of profit sacrificing ratio.

The profit sacrificing ratio is computed by deducting the new profit sharing ratio from the old profit sharing ratio. If the difference is positive, there is a profit sacrifice and in case the difference is negative, there is a gain in terms of higher future profit sharing ratio. In case of admission of a partner, only those existing partners are entitled to a share for goodwill who have sacrificed a part of their profits in favor of the new partner. Sometimes, goodwill may be evaluated in case of admission of a partner when incoming partner is unable to bring in cash any premium for goodwill. In that situation also, the value of goodwill should not be raised in the books since it is inherent goodwill. Rather it is preferable that such value of goodwill should be adjusted through partners' capital accounts, It may also be noted that when the incoming partner pays any premium of goodwill privately to the existing partners, no entry is required in the books of the firm. In that case, the amount to be paid to each partner should be calculated as per the profit sacrificing ratio.

Since the goodwill of a partnership firm belongs to the old partners, it is apparent that some adjustment must be made to the Capital Accounts of the old partners upon the introduction of a new partner. When a new partner is admitted into a partnership, certain adjustments in accounts become necessary, this is because the new partner will acquire a share in the profits or the firm and because of this, the old partners will sacrifice its share. Suppose, A and B are partners sharing profits in the ratio of 3:2. If their profit are Rs. 20,000. A will get Rs. 12,000 and B will get Rs.8,000 as per their profit sharing ratio. If C is admitted and given one fourth share in profits, then out of Rs. 20,000 he will get Rs. 5,000. The remaining Rs. 15,000 will be divided between A and B; A and B will get Rs. 9,000 and Rs. 6,000 respectively. Thus, on the admission of C, A and B will sacrifice Rs. 3,000 and Rs.2,000 per year. Therefore, C will have to compensate A and B for this loss However, on C's admission the profits will not remain at Rs. 20,000. But extra profits will arise and therefore, A and B get a share of the extra profits then the profit they previously got. But it should be noted that the additional profits will be earned by the combined efforts of all the partners A, B and C. Therefore, if A and B get a share of the extra profits they are not particularly obliged to C. Out of the present profits of Rs 20,000 they have to give up a share in favor of C and therefore, they are entitled to a compensation. The problem of compensation is the main problem while dealing with admission of a partner. This is tackled through goodwill.

Illustration 8:

Nikesh and Bikesh are equal partners. They agreed to take Ritesh as one-third partner. The new profit sharing ratio is 4:2:3. Nikesh and Bikesh agreed to raise Rs. 108,000 as value of goodwill and wanted to write it off immediately.

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Particular		**Debit**	**Credit**
Goodwill Account	Dr.	108,000	
To, Nikesh's Capital A/c			54,000

To, Bikesh's Capital A/c		54,000
(Goodwill raised at its proper value in books and credited to Niksh and Bikesh in their old profit sharing ratio)		
Nikesh's Capital A/c Dr.	48,000	
Bikesh's Capital A/c Dr.	24,000	
Ritesh's Capital A/c Dr.	36,000	
To, Goodwill A/c		108,000
(Goodwill written off in the new profit sharing ratio.)		

Alternative, same result can be had by passing the entry in profit –sacrificing ratio.

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Particular	Debit	Credit
Ritesh' Capital A/c Dr.	36,000	
To, Nikesh's Capital A/c		6,000
To, Bikesh's Capital A/c		30,000
(Goodwill adjustment in the profit sacrificing ratio Nikesh - Rs. 108,000 X 1/18 Bikesh – Rs. 108,000 X 5/18)		

It is always preferable in this situation not to raised goodwill account but to show goodwill adjustment through partners' capital account.

Illustration 9:

A, B and C are in partnership sharing profits in the ratio 2:2:1. They want to admit D into partnership with one-fifth share. D brings in Rs. 30,000 as capital and Rs. 10,000 as premium for goodwill. Prepare necessary Journal entries.

Solution

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Particular	Debit	Credit
Bank A/c Dr	40,000	
To, A's Capital Account		4000
To, B's Capital Account		4000
To, C's Capital Account		2000
To, D's Capital Account		30,000

(Amount brought in by D, premium for goodwill credited to existing partners' capital accounts in the profit sacrificing ratio)		

Illustration 10 :

Xerox and York are partners in a firm sharing profits and losses in the ratio of 3:2. They admit Zebra as a partner for 1/5 share. Zebra acquires his share from Xerox and York in the ratio of 2:3. The goodwill of the firm has been valued at Rs. 50,000. Zebra brings in the necessary amount in cash as his share of firm's goodwill and Rs. 120,000 as his capital. Pass the necessary journal entries under each of the following cases:

Case (a) When no goodwill appears in the books and the amount of goodwill is retained in the firm.

Case (b) When no goodwill appears in the books and the amount of goodwill is withdrawn by the concerned partners to the extent of 30% of what is credited to them.

Case (c) When goodwill appears in the books at Rs. 20,000.

Solution

Case (a). When no goodwill appears in the books and the amount of goodwill is retained in the firm.

JOURNAL VOUCHER

Particular	**Debit**	**Credit**
Bank Account Dr.	130,000	
To, Xerox's Capital Account		4,000
To, York's Capital Account		6,000
To, Zebra's Capital Account		120,000
(Amount brought in by Zebra, premium for goodwill credited to existing partners' capital accounts in the profit sacrificing ratio)		

Case (b) When no goodwill appears in the books and the amount of goodwill is withdrawn by the concerned partners to the extent of 30% of what is credited to them.

JOURNAL VOUCHER

Particular	**Debit**	**Credit**
Bank Account Dr.	130,000	
To, Xerox's Capital Account		4,000
To, York's Capital Account		6,000
To, Zebra's Capital Account		120,000

(Amount brought in by Zebra, premium for goodwill credited to existing partners' capital accounts in the profit sacrificing ratio)			
Xerox's Capital Account	Dr.	1,200	
York's Capital Account	Dr.	1,800	
To, Bank Account			3,000
(30% of the amount of goodwill credited to Xerox and York withdrawn by them.)			

Case (c) When goodwill appears in the books at Rs. 20,000

JOURNAL VOUCHER

Particular		Debit	Credit
Xerox's Capital Account	Dr.	12,000	
York's Capital Account	Dr.	8,000	
To, Goodwill Account			20,000
(The existing goodwill written-off in the share of ratio)			
Bank Account	Dr.	130,000	
To, Xerox's Capital Account			4,000
To, York's Capital Account			6,000
To, Zebra's Capital Account			120,000
(Amount brought in by Zebra, premium for goodwill credited to existing partners' capital accounts in the profit sacrificing ratio)			

Illustration 11:

Assuming that the capitals are fixed in previous Illustration 10. Pass the necessary journal entries:

Solution:

Case (a)

JOURNAL VOUCHER

Particular		Debit	Credit
Bank Account	Dr.	130,000	
To, Xerox's Current Account			4,000
To, York's Current Account			6,000

To, Zebra's Capital Account		120,000
(Amount brought in by Zebra, premium for goodwill credited to existing partners' Current accounts in the profit sacrificing ratio)		

Case (b)

JOURNAL VOUCHER

Particular	Debit	Credit
Bank Account Dr.	130,000	
To, Xerox's Current Account		4,000
To, York's Current Account		6,000
To, Zebra's Capital Account		120,000
(Amount brought in by Zebra, premium for goodwill credited to existing partners' Current accounts in the profit sacrificing ratio)		
Xerox's Current Account Dr.	1,200	
York's Current Account Dr.	1,800	
To, Bank Account		3,000
(30% of the amount of goodwill credited to Xerox and York withdrawn by them.)		

Case (c)

JOURNAL VOUCHER

Particular	Debit	Credit
Xerox's Current Account Dr.	12,000	
York's Current Account Dr.	8,000	
To, Goodwill Account		20,000
(The existing goodwill written-off in the share of ratio)		
Bank Account Dr.	130,000	
To, Xerox's Current Account		4,000
To, York's Current Account		6,000
To, Zebra's Capital Account		120,000

(Amount brought in by Zebra, premium for goodwill credited to existing partners' Current accounts in the profit sacrificing ratio)		

Illustration 12:

A and B are equal partners. They admitted C as a third partner and for this purpose goodwill was valued at Rs. 120,000. Show the journal entries for following various cases.

Case 1. Where C is admitted as equal partner.
Case 2. Where new profit sharing ratio is 3:2:1
Case 3. Where new profit sharing ratio is 4:3:3

Solution:

Case 1. Where C is admitted as equal partner.

Since C is admitted as equal partner, both old partners have sacrificed equally. Therefore, C's share of goodwill shall be credited equally to A and B. C should bring Rs. 40,000 for goodwill which will be credited to A and B 's Capital account equally. The entry will be:

JOURNAL VOUCHER

Particular		Debit	Credit
C's Capital Account	Dr.	40,000	
To, A's Capital Account			20,000
To, B's Capital Account			20,000
(Adjustment for goodwill)			

Case 2.: Where new profit sharing ratio is 3:2:1

Calculation of profit sacrificing ratios:
Old ratio – New ratio = Profit sacrificing ratio
Partner A 1/2 – 3/6 = 0
Partner B 1/2 – 2/6 = 1/6

So the entire goodwill should be credited to B's Capital Account. C should bring (120000*1/6 = Rs. 20,000) for goodwill which will be credited to B's Capital account as only he has scarified the profit share. The entry will be:

JOURNAL VOUCHER

Particular		Debit	Credit
C's Capital Account	Dr.	20,000	
To, B's Capital Account			20,000
(Adjustment of Goodwill by C crediting B's Capital A/c)			

Case 3. Where new profit sharing ratio is 4:3:3

Calculation of profit sacrificing ratios:
A 1/2 – 4/10 = 1/10
B 1/2 – 3/10 = 2/10

So goodwill should be shared in the ratio of 1:2. C should bring (120000*3/10 = Rs. 36,000) for goodwill which will be credited to A and B’s Capital as 1:2 as they have scarified the profit share. The entry will be:

JOURNAL VOUCHER

Particular		Debit	Credit
C's Capital Account	Dr.	36,000	
To, A's Capital Account			12,000
To, B's Capital Account			24,000
(Adjustment of goodwill by crediting old partners' capital accounts in profit sacrificing ratio 1:2)			

Illustration 13:

The following is the Statement Of Financial Position of Y and G as at 31st December 2018.

STATEMENT OF FINANCIAL POSITION

Liabilities	Rs.	Assets	Rs.
Creditors	20,000	Cash at Bank	10,000
Capital:		Sundry Assets	55,000
Y	25,000		
G	20,000		
	65,000		**65,000**

The partners shared profit and losses in the ratio 3:2. On the above date, B was admitted as partner on the condition that he would pay Rs. 20,000 as Capital, Goodwill was to be valued at 3 years' purchase of the average of four years' profit which were:

2004 – Rs. 9,000; 2005 – 14,000; 2006 – 12,000 and 2007 – Rs. 13,000

The profit sharing ratio is 6:5:5

Give journal entries and Statement Of Financial Position under various method of treatment of goodwill.

Solution

Value of goodwill

Average profit = (Rs.9,000 + Rs. 14,000 + Rs. 12,000 + Rs. 13,000)/4 = Rs. 12,000. Hence value of Goodwill is Rs. 36,000 (Rs. 12,000 x 3)

Case (a): Goodwill raised

JOURNAL VOUCHER

Particular		Debit	Credit
Bank Account	Dr.	20,000	
To, B's Capital Account			20,000
(Amount brought in by B as Capital so Goodwill raised)			
Goodwill Account	Dr.	36,000	
To, Y's Capital Account			21,600
To, G's Capital Account			14,400
(Goodwill raised in the books and credited to existing partners' capital accounts in their profit sharing ratio)			

M/S Y, G AND B
STATEMENT OF FINANCIAL POSITION AS ON 31.12.2018

Liabilities	Rs.	Assets	Rs.
Creditors	20,000	Cash at Bank	30,000
Capital:		Sundry Assets	55,000
Y	46,600	Goodwill	36,000
G	34,400		
B	20,000		
	121,000		**121,000**

Case (b) Goodwill raised and written off.

In addition to the two journal entries given under case (a) the following additional entry will be made:

JOURNAL VOUCHER

Particular		Debit	Credit
Y's Capital Account	Dr.	13,500	
G's Capital Account	Dr.	11,250	
B's Capital Account	Dr.	11,250	
To, Goodwill Account			36,000
(Goodwill written off to all partners in the new profit sharing ratio)			

M/s Y, G and B

Statement Of Financial Position as on 31.12.2018

Liabilities	Rs.	Assets	Rs.
Creditors	20,000	Cash at Bank	30,000
Capital:		Sundry Assets	55,000
Y	33,100		
G	23,150		
B	8,750		
	85,000		**85,000**

Case (c): Goodwill adjusted through partners' capital accounts

JOURNAL VOUCHER

Particular		Debit	Credit
Bank Account	Dr.	20,000	
To, B's Capital Account			20,000
(Amount brought in by B as Capital)			
B's Capital Account	Dr.	11,250	
To, Y's Capital Account			8,100
To, G's Capital Account			3,150
(B's share of goodwill adjusted to existing partners' capital accounts in the profit sacrificing ratio 18/80:7/80)			

M/s Y, G and B

Statement Of Financial Position as on 31.12.2018

Liabilities	Rs.	Assets	Rs.
Creditors	20,000	Cash at Bank	30,000
Capital:		Sundry Assets	55,000
Y	33,100		
G	23,150		
B	8,750		
	85,000	-	**85,000**

Working Note: Calculation of Profit Sacrificing Ratio;

Y 3/5 – 6/16 = 18/80
G 2/5 – 5/16 = 7/80

Case (d): Goodwill brought in cash

JOURNAL VOUCHER

Particular		Debit	Credit
Bank Account	Dr.	31,250	
To, Y's Capital Account			8,100
To, G's Capital Account			3,150
To, B's Capital Account			20,000
(Amount brought in by B as capital and as goodwill; credited to Y and G in the profit sacrificing ratio)			

M/s Y, G and B

Statement Of Financial Position as on 31.12.2018

Liabilities	Rs.	Assets	Rs.
Creditors	20,000	Cash at Bank	41,250
Capital:		Sundry Assets	55,000
Y	33,100		
G	23,150		
B	20,000		
	96,250		**96,250**

Case (e): Goodwill brought in cash, but withdrawn

In addition to the treatment under case (d) above, the following additional entry will be made:

JOURNAL VOUCHER

Particular		Debit	Credit
Y's Capital Account	Dr.	8,100	
G's Capital Account	Dr.	3,150	
To, Bank Account			11,250
(Amount withdrawn by Y and G in respect of Goodwill credited to them)			

M/s Y, G and B

Statement Of Financial Position as on 31.12.2018

Liabilities	Rs.	Assets	Rs.
Creditors	20,000	Cash at Bank	30,000

Capital:		Sundry Assets	55,000
Y	25,000		
G	20,000		
B	20,000		
	85,000	`	**85,000**

Case (f) Goodwill paid privately

There will be no entry for goodwill but b will pay Rs. 8,100 to Y Rs. 3,150 To G. For capital brought in by B, the entry will be:

JOURNAL VOUCHER

Particular	Debit	Credit
Bank Account Dr.	20,000	
To, B's Capital Account		20,000
(Amount brought in by B as capital)		

M/s Y, G and B
Statement Of Financial Position as on 31.12.2018

Liabilities	Rs.	Assets	Rs.
Creditors	20,000	Cash at Bank	30,000
Capital:		Sundry Assets	55,000
Y	25,000		
G	20,000		
B	20,000		
	85,000	-	**85,000**

2.4 ADJUSTMENT IN RECORD TO REVALUATION OF ASSETS AND LIABILITIES

Revaluation is the recording of the assets or the liabilities at its current value. It is a process of placing a different valuation on an asset or a liability from its book value. At time of admission of a partner, the assets and liabilities are revalued as that the profit or loss arising from the revaluation upto date of admission of a new partner in order to fair presentation and valuation of various assets and liabilities. Any gain arises because of increase in value of assets or reduction of liabilities shall only be enjoyed by old partners. The new partner should not be given any benefit of appreciation in the value of assets. Similarly, he should not be burden for any undisclosed liabilities or losses. For proper adjustment in respect of appreciation or depreciation, a Revaluation Account (Profit and Loss Adjustment Account) should be opened, to which all the items of increase or decrease in the value of assets and liabilities are shown. In other words, when a new partner is admitted into the partnership, assets are revalued and liabilities are reassessed. The Revaluation Account is debited with all reduction in the value of assets and increase in liabilities and credited with increase in the value of assets and decrease in the value of liabilities. The difference in two sides of the account will show profit or loss. This is transferred to the Capital Account of old partners in the old profit sharing ratio. The required entries are as follows:

JOURNAL ENTRIES

S.n	Particular		Rs.
i	**For increase in the value of an assets**		
	Concerned Assets (individually) A/c	Dr.	
	To, Revaluation A/c		
	(Increase of assets value recorded)		
ii	**In the case of decrease reverse entry will be passed.**		
iii	**For increase in the amount of liabilities**		
	Revaluation Account	Dr.	
	To, Concerned Liabilities (Individual) A/c		
	(The increase in amount of liabilities recorded)		
iv	**In the case of decreases reverse entry will be passed.**		
	-		
v	**For recording unrecorded assets**		
	Unrecorded Assets A/c	Dr.	[at agreed value}
	To, Revaluation Account		
	(An agreed value of unrecorded asset brought into account.)		
vi	**For recording unrecorded liabilities**		
	Revaluation Account	Dr.	
	To, Unrecorded Liabilities Account		
	(An agreed amount of unrecorded liabilities brought into account)		
vii	**For transfer of balance of Revaluation Account**		
	If credit side exceeds debit side (Net gain)		
	Revaluation Account	Dr.	

	To, Old partners' Capital Accounts (Net gain on revaluation transferred to old partners' capital accounts in their old profit sharing ratio) **If debit side exceeds credit side (Net loss)** Old Partners' Capital Account Dr. To, Revaluation Account (Net loss on revaluation transferred to old partners' capital accounts in their old profit sharing ratio)	

As result of the above entries, the capital account balances of the old partners will change and the assets and liabilities will have to be adjusted to their proper values. They will now appear in the Statement Of Financial Position at revised figures. Alternatively, the partners may agree that revalued figures will not be shown in the Statement Of Financial Position. Assets and liabilities would appear in the Statement Of Financial Position at their old values. For this one additional entry is necessary.

JOURNAL ENTRIES

S.n	Particular	Rs.
	Capital Account Dr. (of all partners including newly admitted partner) To, Revaluation Account	[With the amount of revaluation profit in the new profit sharing ratio]
Or	Revaluation Account Dr. To, All Partners' Capital Account. (of all partners including newly admitted partners)	[with the amount of revaluation or loss in the new profit sharing ratio]

Illustration 14:

The following is the Statement Of Financial Position of Raja and Ram (who shares profits in the ratio of 3:2) as on 1st January 2019.

Statement Of Financial Position

Liabilities	Rs.	Assets	Rs.
Creditors	45,000	Cash at Bank	5,000

Capital:		Sundry Debtors	35,000
Raja	80,000	Stock	15,000
Ram	100,000	Buildings	128,000
		Plan and Machinery	42,000
	225,000		**225,000**

On this date Shyam was admitted on the following

i. He is to pay 75,000 as his capital and Rs. 25,000 as his share of goodwill for one-fourth share in profit.

ii. The new profit sharing ratio will be 2:1:1

iii. The assets are to be revalued as under

	Rs.
Building	140,000
Plant and Machinery	32,000
Stock	15,000
Sundry Debtors	31,500
(because of doubtful debts)	

v. It was found that there was a liability for 1,000 for goods received but not recorded in books

Give journal entries to record the above. Also give the Statement Of Financial Position after Shyam's admission.

Solutions

JOURNAL VOUCHER

Date	Particular	Debit	Credit
2019			
1-Jan	Bank Account Dr.	100,000	
	To, Shyam's Capital Account		100,000
	(Amount brought in by Shyam for capital and Goodwill)		
	Goodwill Account Dr.	100,000	
	To, Raja's Capital Account		60,000
	To, Ram's Capital Account		40,000
	[Goodwill raised at full value i.e. 25,000 x (4/1) and credited to the old partners in the old ratio]		

	Raja's Capital A/c Dr.	50,000	
	Ram's Capital A/c Dr.	25,000	
	Shyam's Capital A/c Dr.	25,000	
	To, Goodwill A/c		100,000
	(Goodwill written off to all partners in the new ratio)		
	Revaluation A/c Dr.	14500	
	To, Plant and Machinery A/c		10,000
	To, Provision for Doubtful debts A/c		3,500
	To, Sundry Creditors A/c		1,000
	(Recording of the reduction in the value of assets and liability which had been previously omitted)		
	Building A/c Dr.	12,000	
	To, Revaluation A/c		12,000
	(Increase in the value of building brought in to account)		
	Raja's Capital A/c Dr.	1,500	
	Ram's Capital A/c Dr.	1,000	
	To, Revaluation A/c		2,500
	(Loss on revaluation debited to Raja and Ram in the old profit ratio)		

STATEMENT OF FINANCIAL POSITION
OF
RAJA, RAM AND SHYAM AS AT JANUARY 1, 2019

Liabilities	**Rs.**	**Assets**		**Rs.**
Creditors	46,000	Cash at Bank		105,000
Capital:		Sundry Debtors	35,000	
Raja	88,500	Less: Provision for D/d	3,500	31,500

Ram	114,000	Stock	15,000
Shyam	75,000	Buildings	140,000
		Plant and Machinery	32,000
	323,500	-	**323,500**

Instead of entries given above regarding capital brought in by shyam and treatment of goodwill the following two entries can be passed.

JOURNAL VOUCHER

Particular	**Debit**	**Credit**
Bank Account Dr.	100,000	
To, Shyam's Capital Account		75,000
To, Raja's Capital Account		10,000
To, Ram's Capital Account		15,000
(Amount brought in by Shyam for capital and Goodwill)		

Alternative, if the partners would agree to ignore the revalued figure of assets and liabilities in the Statement Of Financial Position, then an additional journal entry would have to be passed,

JOURNAL VOUCHER

Particular	**Debit**	**Credit**
Revaluation Account Dr.	2,500	
To, Raja's Capital A/c		1,250
To, Raja's Capital Account		625
To, Shyam's Capital Account		625

2.5 RESERVES IN THE STATEMENT OF FINANCIAL POSITION

Outstanding balance of Reserve and Surplus at the time of admitting the new partner shall be transferred to old partners' Capital Accounts in their old profit sharing ratio. (In examination problems it should be done even if there are no instructions on this point.)

Illustration 15:

M/s Dhakal, Basnet and Maskey in a firm sharing profits and losses in the ratio 2:2:1. There Statement Of Financial Position as on 31st December 2018 as below:

STATEMENT OF FINANCIAL POSITION

Liabilities	Rs.	Assets	Rs.
Sundry Creditors	12,850	Land and Buildings	25,000
Outstanding Liabilities	1,500	Furniture	6,500
General Reserve	6,500	Stock	11,750
Capital:		Sundry Debtors	5,500
Mr. Dhakal	12,000	Cash in Hand	140
Mr. Basnet	12,000	Cash at Bank	960
Mr. Maskey	5,000		
	49,850		**49,850**

The partners have agreed to take Mr. Nakarmi as a partner with effect from 1st January 2019 on the following terms:

1. Mr. Nakarmi shall bring Rs. 5,000 towards the capital.
2. The value of stock should be increased by Rs. 2,500.
3. Reserve for bad and doubtful debts should be provided at 10%.
4. Furniture should be depreciated by 10%.
5. The value of land and buildings should be enhanced by 20%.
6. The value of the goodwill be fixed at Rs. 15,000.
7. General Reserve will be transferred to the partner's Capital Accounts.
8. The new profit sharing ratio shall be :
9. Mr. Dhakal 5/15, Mr. Basnet 5/15, Mr. Maskey 3/15, Mr. Nakarmi 2/15.
10. The goodwill account shall be written back to the partner's account in accordance with the new profit sharing proportion.
11. The outstanding liabilities include Rs, 1,000 due to Mr. Silwal which has been paid by Mr. Dhakal. Necessary entries were not made in the books.

Prepare (i) Revaluation Account, (ii) The Capital Accounts of the Partners, and (iii) the Statement Of Financial Position of the firm as newly constituted.

Solution

Revaluation Account

Particulars	Rs.	Particulars	Rs.
To, Provision for bad and Doubtful debts	550	By, Stock A/c	2,500
To, Furniture A/c	650	By, Land and Buildings	5,000
To, Capital:			
Mr. Dhakal	2,520		

Mr. Basnet	2,520		
Mr. Maskey	1,260		
	7,500	**-**	**7,500**

Capital Accounts of Partners

Particulars	Dhakal Rs.	Basnet Rs.	Maskey Rs.	Nakarmi Rs.	Particulars	Dhakal Rs.	Basnet Rs.	Maskey Rs.	Nakarmi Rs.
To, Goodwill	5,000	5,000	3,000	2,000	By, Balance b/d	12,000	12,000	5,000	-
					By, General Reserve	2,600	2,600	1,300	-
To, Balance c/d	19,120	18,120	7,560	3,000	By, Cash	-	-	-	5,000
					By, Goodwill A/c	6,000	6,000	3,000	-
					By, Outstanding Liabilities	1,000	-	-	-
					By, Revaluation A/c	2,520	2,520	1,260	-
	24,120	**23,120**	**10,560**	**5,000**		**24,120**	**23,120**	**10,560**	**5,000**

Statement Of Financial Position of M/s Dhakal, Basnet, Maskey and Nakarmi

Liabilities	**Rs.**	**Assets**	**Rs.**
Sundry Creditors	12,850	Land and Buildings	30,000
Outstanding Liabilities	500	Furniture	5,850
Capital:		Stocks	14,250
Mr. Dhakal	19,120	Sundry Debtors 5,500	
Mr. Basnet	18,120	Less: Provision for D/D 550	4950
Mr. Maskey	7,560	Cash in hand	140
Mr. Nakarmi	3,000	Cash at Bank	5,960
	61,150		61,150

2.6 PROPORTIONATE CAPITAL AND INFERENCE OF GOODWILL

Proportionate capital means balances of capital account of the partners in accordance with the profit sharing ratio. Proportion capital is maintained generally following 'fixed capital method'. Let us take an example X and Y are in partnership sharing profit and loss in the ratio of 4:3. If total capital of the firm is Rs. 700,000. X should contribute Rs. 700,000 x 4/7 = Rs. 400,000. Similarly, Y should contribute Rs. 700,000 x 3/7 = Rs. 300,000.

The question of inferring goodwill arises only in case of proportionate capital. If the newly admitted partner brings capital more than what is required as per profit sharing ratio, than it is to be presumed that he has contributed the excess for goodwill. Let us take above example, where X and Y contributed toward capital as Rs. 400,000 and Rs. 300,000 respectively. Now they decided to admit Z giving 1/5 share for which Z agrees to bring RS. 200,000. Since total capital is Rs. 700,000. Z should contribute Rs. 140,000 (Rs. 700,000 x 1/5) for 1/5 share. Instead he agrees to pay Rs. 200,000. So for $1/5^{th}$ share he is paying Rs. 40,000 for goodwill. Thus total value of goodwill is Rs. 40,000 x 5 i.e. Rs, 200,000.

Illustration 16:

Mr. M and N are in partnership sharing profits and losses equally. The Statement Of Financial Position of M/s M and N as on 31 Dec. 2018, was as follows.

Statement Of Financial Position

Liabilities	**Rs.**	**Assets**	**Rs.**
Sundry Creditors	25,000	Land and Buildings	190,000
Capital:		Stocks	45,000
Mr. M	150,000	Cash in hand	1,400
Mr. N	150,000	Cash at Bank	88,600
	325,000		**325,000**

On 1.1.2019 they agreed to take R as 1/3 partner to increase the capital base to Rs. 450,000. R agrees to pay Rs. 225,000. Show the necessary journal entries, partners' capital Accounts and Statement Of Financial Position as on 1.1.2019.

Solution

In the books of M/s M, N and R
JOURNAL VOUCHER

Particular		**Debit**	**Credit**
Bank Account	Dr.	225,000	
To, R's Capital A/c			225,000
(Cash brought in by R for $1/3^{rd}$ share)			
Goodwill Account	Dr.	225,000	
To, M's Capital Account			112,500
To, N's Capital Account			112,500
(Inferred value of goodwill raised in the books)			

M's Capital Account	Dr.	75,000	
N's Capital Account	Dr.	75,000	
R's Capital Account	Dr.	75,000	
To, Goodwill Account			225,000
(Value of goodwill written of in the in the new profit sharing ratio.)			
M's Capital Account	Dr.	37,500	
N's Capital Account	Dr.	37,500	
To, Bank Account			75,000

Workings:

1. Old Profit sharing Ratio 1:1
2 New Profit sharing Ratio 1:1;1
3. R's share of capital Rs. 450,000 x 1/3 = Rs. 150,000
4. Goodwill Rs. 225,000-150,000 = 75,000 for 1/3 shares
   Total goodwill : Rs. 75,000 x 3 = Rs. 225,000

Partners' Capital Accounts

Particulars	M Rs.	N Rs.	R Rs.	Particulars	M Rs.	N Rs.	R Rs.
To, Goodwill	75,000	75,000	75,000	By, Balance b/d	150,000	150,000	-
To, Bank A/c	37,500	37,500		By, Bank A/c	-	-	225,000
To, Balance c/d	150,000	150,000	150,000	By, Goodwill A/c	112,500	112,500	
	262,500	**262,500**	**225,000**		**262,500**	**262,500**	**225,000**

STATEMENT OF FINANCIAL POSITION
of M/s M, N and R as on 1.1.2019

Liabilities	Rs.	Assets	Rs.
Sundry Creditors	25,000	Land and Buildings	190,000
Capital:		Stocks	45,000
Mr. M	150,000	Cash in hand	1,400
Mr. N	150,000	Cash at Bank	238,600
Mr. R	150,000		
	475,000		475,000

Illustration 17:

On 31 December 2018, the Statement Of Financial Position of M/s Pandey, Rai and Sharma, sharing profits and losses in the ratio of 6:5:3 stood as

STATEMENT OF FINANCIAL POSITION

Liabilities	Rs.	Assets	Rs.
Bills Payable	12,600	Goodwill	10,500
Sundry Creditors	37,800	Land and Buildings	90,300
General Reserve	21,000	Furniture	14,700
Capital:		Stocks	58,800
Mr. Pandey	70,800	Sundry Debtors	52,920
Mr. Rai	59,700	Cash	3,780
Mr. Sharma	29,100		
	231,000	-	**231,000**

The agreed to admit Mr. Thakur into partnership, giving him 1/8th share, on 1.1.2019 on the following terms:

(1.) Furniture be depreciated by Rs. 1,840; (2) Stock shall be valued 10% less than the Statement Of Financial Position value; (3) A provision of Rs. 2,640 be made for outstanding repair bill; (4) The value of land and buildings having appreciated be brought upto Rs. 119,700; (5) Value of goodwill brought up to Rs, 28,140; (6) Thakur should bring in cash Rs. 29,400 as his capital.

After making the above adjustment, the capital accounts of the old partners by adjusted on the basis of proportion of Thakur's capital to his share in the business bringing in or taking out cash. You are required to prepare Revaluation Account, Capital Accounts of the partners and Statement Of Financial Position as on 1.1.2019.

Solution

Revaluation Account

Particulars	Rs.	Particulars	Rs.
To, Furniture A/c	1,840	By Land and Buildings	29,400
To, Stock Ac/	5,880		
To, Creditors (Outstanding Bills)	2,640		
To, Capital:			
Mr. Pandey	8,160		
Mr. Rai	6,800		
Mr. Sharma	4,080		
	29,400	-	**29,400**

Partners' Capital Accounts

Particulars	Pandey Rs.	Rai Rs.	Sharma Rs.	Thakur Rs.	Particulars	Pandey Rs.	Rai Rs.	Sharma Rs.	Thakur Rs.
To, Cash	7,320	6,800	-	-	By, Balance b/d	70,800	59,700	29,100	-
					By, General Reserve	9,000	7,500	4,500	-

To, Balance c/d	88,200	73,500	44,100	29,400	By, Revaluation A/c	8,160	6,800	4,080	
					By, Goodwill A/c	7,560	6,300	3,780	-
					By, Cash	-	-	2,640	29,400 -
	95,520	**80,300**	**44,100**	**29,400**		**95,520**	**80,300**	**44,100**	**29,400**

Statement Of Financial Position as on 1.1.2019

Liabilities	**Rs.**	**Assets**	**Rs.**
Capital:		Goodwill	28,140
Mr. Pandey	88,200	Land and Buildings	119,700
Mr. Rai	73,500	Furniture	12,860
Mr. Sharma	44,100	Stocks	52,920
Mr. Thakur	29,400	Sundry Debtors	52,920
Bills Payable	12,600	Cash	21,700
Sundry Creditors	40,440		
	288,240		**288,240**

Working Note:

1. Calculation of new profit sharing ratio:
   Share given to Mr. Thakur 1/8
   Balance of share = 1-1/8 = 7/8
   Mr. Pandey's Share = 7/8 x 6/14= 42/112 i.e. 6/16
   Mr. Rai = 7/8 x 5/14 = 5/16
   Mr. Sharma = 7/8 x 3/14 = 3/16
   Mr. Thakur = 1/8 = 2/16

Therefore, New profit sharing ration 6:5:3:2

2. Calculation of partners' capital on basis of Mr. Thakur's Capital

   Taking Mr. Thakur's capital as base, the partners' capitals are to be in the new profit sharing ratio.

   Total capital = Rs. 29,400 x 8/1 = Rs. 235,200. Therefore, Mr. Pandey's Capital = Rs. 235,200 x 6/16 = Rs. 88,200, Mr. Rai's Capital = Rs. 235,200 x 5/16 = Rs. 73,500, Mr. Sharma's Capital = Rs. 235,200 x 3/16 = Rs. 44,100.

Illustration 18:

A, B,. C and D are partners in a firm. Their capital account stood at Rs 30,000 Rs 15,000, Rs 15,000 and Rs 10,000 respectively on 1st January 2018. They shared profits and losses in the proportion of 5: 3: 2: 2. D’share of profit (excluding interest on capital) is guaranteed by the firm to be not less than Rs 16,000 per annum. C's share of profit (including interest on capital and salary) is guaranteed by A at a minimum of Rs 26,000 per annum. The profits for the year ended 31st December 2018 amounting to Rs 91,000 before considering interest on capital of 10% per annum and salary to C is Rs 1,000 per month which is allowed under the partnership deed.

Required: Prepare the profit and loss appropriation account for the year ended 31st December 2018

Solution:

Profit and Loss Appropriation Account
for the year ending on 31st December 2018

Particular		**Amount**	**Particular**	**Amount**
To Interest on Capital			By Profit and Loss Account	91,000
A		3,000		
B		1,500		
C		1,500		
D		1,000		
To C's Salary		12,000		
To Profit transferred to				
A (72000 * 5/12)	30,000			
Less: D's Deficiency borne	2,000			
Less: C's Deficiency borne	1,300	26,700		
B(72000* 3/12)	18,000			
Less: D's Deficiency borne	1,200	16,800		
C(72000*2/12)	12,000			
Less: D's Deficiency borne	800			
Add: Deficiency recovered from A	1,300	12,500		
(26000-1500-12000-12000+800)				
D (72000*2/12)	12,000			
Add: Deficiency recovered from				

A (4000*5/10)	2,000			
B(4000*3/10)	1,200			
C(4000*2/10)	800	16,000		
		91,000		**91,000**

Summary

We have seen that incase of admission of a new partner, apart from goodwill valuation it is essential to revalue assets and recompute liabilities. Any profit or loss arising out of such revaluation that should be transferred to old partners' capital account in their old profit sharing ratio.

Proportionate capital implies that capital to be contributed by the partners in accordance with their profit sharing ratio. Any excess amount contributed by incoming partner is to be presumed as share of goodwill.

Self-Examination Questions

1. Give the journal entries to records the following arrangements:
   a. A and B are partners sharing profits in the ratio of 3:2. They admit C into partnership, C paying a premium of Rs. 10,000 for 1/4 share of profit. No goodwill account appears in the books. They withdrew the premium.
   b. A and B are partners sharing profits in the ratio of 3:2. They admit C into partnership, C paying a premium of Rs. 10,000 for 1/4 share of profit. The new ratio is 3:3:2. Goodwill Account appears in the books at Rs, 10,000. It was decided that goodwill should continue to appear in books at Rs. 8,000.
   c. A and B are partners sharing profits in the ratio 3:2. They admit C into the firm for 3/7th profit which he takes 2/7 from A and 1/7th from B and brings Ra 3,000 as premium out of his share of Rs.4,500. Goodwill Account does not appear in the books of A and B but the new firm decide that goodwill should appear in the books at its fractional value of Rs 2,100.

2. A and B are in partnership sharing profits and losses equally. They want to take C as partner for $1/4^{th}$ share. Show the necessary journal entries for the following transactions in relation to admission of C.
   i. Property, Plant & Equipment are revalued from Rs. 172,000 to Rs. 210,000.
   ii. A liability for outstanding expenses Rs. 10,000 is not so far recorded in the books.
   iii. General Reserve balance Rs. 40,000
   iv. C contribute Rs. 75,000 for capital and Rs. 40,000 for goodwill.
   v. A and B withdrew the amount of goodwill.

3.

Statement Of Financial Position of Anil and Sunil as on 31.12.2018

Liabilities	**Rs.**	**Assets**	**Rs.**
Capital Accounts:		Property, Plant & Equipment	300,000
Anil	240,000	Stock	90,000
Sunil	180,000	Bank	120,000
Reserve	30,000		
Sundry Creditors	60,000		
	510,000		**510,000**

They agreed to admit Nabil as 1/5 partner. Sundry creditors include Rs. 30,000 payable to Nabil which is adjusted against his due for capital. It was decided that Anil and Sunil will continue at the same ratio and the new profit sharing ratio between Sunil and Nabil is 2:1. They also agreed to make capital proportionate taking Nabil's capital as base. Property, Plant & Equipment are revalued by Rs. 90,000 and outstanding liability for damage Rs. 30,000. Nabil contributed Rs. 180,000 for adjustment for his claims. Pass necessary journal entries in the books of M/s Anil and Sunil on admission of Nabil and redraft the Statement Of Financial Position.

4. Rani and Millee are partners in a firm sharing profits and losses in the ratio of 2/3 and 1/3, The Statement Of Financial Position of the firm on 31st December 2018.

Liabilities	Rs.	Assets	Rs.	Rs.
Capital Accounts:		Goodwill		20,000
Rani	240,000	Investments		200,000
Milli	196,000	Stock		120,000
Reserve	84,000	Bills Receivable		40,000
Investment provision	16,000	Debtors	160,000	
Workmen compensation Fund	48,000	Less: Reserve for D/D	20,000	140,000
Sundry Creditors	56,000	Bank		120,000
	640,000			640,000

On the above date, Tina is admitted for 2/5 share in the profits or losses of the firm. Following revaluations were made at the time of admission.

(a) Tina is required to bring in Rs, 400,000 as capital .
(b) The goodwill was calculated at Rs 12,000.
(c) Rani and Milli purchased machinery on hire purchase system for Rs. 75,000 of which only Rs. 7,500 are to be paid. Both machinery and unpaid liability did not appear in the Statement Of Financial Position.
(d) Accrued incomes not appearing in the books were Rs. 4,000.
(e) Market value of investment in 180,000.
(f) Claim on account of compensation is estimated at Rs. 6,000.
(g) Bad debts recovery of Rs. 14,000 has not been recorded.
(h) Provision for doubtful debts is required Rs. 24,000.

Prepare Revaluation Account, Partners' Capital Account and opening Statement Of Financial Position after admission of Tina.

1. Following is the Balance Sheet of Rajesh and Nikhil Sharing Profits and Losses in 3:2.

Liabilities	Rs	Assets	Rs
Creditors	10,000	Goodwill	6,000
Employees Provident Fund	8,000	Debtors	21,000
Contingency Reserve	28,500	Land & Building	18,000
Workmen's Compensation Fund	15,000	Plant & Machinery	7,000
Investment Fluctuation Fund	1,500	Investment (Market Value Rs. 4,000)	5,000
Capitals:		Stock	11,000
Rajesh	15,000	Bank	15,000
Nikhil	10,000	Advertisement	5,000
	88,000		88,000

On admission of Aaryan for 1/6th Share in the profits it was decided that:

a) All Debtors are considered good except Rs 1,500 which are consider as Doubtful.
b) Value of land and building to be increased by Rs. 3,000.
c) Value of Stock to be increased by Rs. 2,500.
d) The liability of workmen compensation fund was determined to be Rs 12,000.
e) Investments are to be brought down to market value.
f) Aaryan was to bring in as his share of goodwill Rs 10,000 in cash.
g) Aaryan was to bring further cash of Rs 15,000 for his Capital.
h) A Joint Policy for Rs 50,000 taken out by Rajesh and Nikhil on which premium totalling Rs 10,000 have been paid, has a surrender value of Rs 6,000.

Prepare Revaluation A/c, Capital A/c and Balance Sheet of the new firm.

CHAPTER- 8

Partnership Accounts

UNIT 3:

Retirement of a Partner

Learning Objectives

1. *Learn how to calculate gaining ratio of continuing partners.*
2. *Be familiar with the accounting treatment in relation of revaluation of assets.*
3. *Be familiar with final settlement of amount due to outgoing partners etc.*

3.1 INTRODUCTION

Retirement of a partner is one of the modes of reconstituting the firm under which an old partnership comes to an end a new one between the continuing partners comes into existence. In other words, readjustment takes place in case of retirement of a partner likewise the case of admission of a partner. Whenever a partner retires, the continuing partners make gain in terms of profit sharing ratio. So they arrange for the amount to be paid to discharge the claims of the retiring partners. Here, we will discuss the accounting treatments of partnership transactions relating to retirement of a partner. Generally assets and liabilities are revalued, value of goodwill is raised and surrender value of joint life policy, if any, is taken into account. Any revaluation profit is credited to the partners' capital accounts.

3.2 ADJUSTMENT REQUIRED

The following adjustments are required at the time of retirement of a partner:

1. Adjustment of profit sharing ratio;
2. Adjustment of goodwill;
3. Adjustment of profit and loss arising on the revaluation of Assets and Liabilities;
4. Adjustment of Accumulated Profits, Reserves and Losses; and

Adjustment of capitals (if agreed).

3.3 CALCULATION OF GAINING RATIO

On a retirement of a partner, the continuing partners will gain in terms of profit sharing ratio. The ratio in which the continuing partners acquire the outgoing partner's share is called as gaining ratio. This ratio is calculated by taking out the difference between new profit share and old profit share. The following are the different situations while calculating the new profit sharing ratio and the gaining ratio.

1. Nothing is mentioned about the new ratio

Illustration 1:

A,B and C sharing profits in the ratio of 5:3:2. C retires and old partner share on same ratio of previous share. Find out the new profit sharing ratio and gaining ratio.

Solution

Old ratio of A Share:		=5/10
New ratio of A Share:	=5/8	
Gain	= 5/8- 5/10	=5/40
Old ratio of B Share:		=3/10
New ratio of B Share:	=3/8	
Gain= 3/8- 3/10		=3/40
Gaining Ratio (A:B)		=5/40:3/40

2) Unequal gain

Illustration 2:

A,B and C are partners sharing profits in the ratio of 5 : 3 : 2. C retires and his share was taken up by A and B in the ratio of 2 : 1. Find out the new profit sharing ratio of A and B

Solution:

Old ratio of A Share: =5/10
Gaining ratio of A Share: =2/3 * 2/10 =4/30
New ratio of A Share = 5/10 + 4/30 =19/30
Old ratio of B Share: =3/10
Gaining ratio of B Share: = 1/3 * 2/10 = 2/30
New Ratio of B share = 3/10 +2/30 =11/30

New Ratio (A:B) =19:11

3) Equal gain

Illustration 3:

A, B and C are partners sharing profits in the ratio of 5 : 3 : 2. I retires and his share was taken up by A and B equally. Find out the new Profit sharing ratio of A and B

Solution:

Old ratio of A Share: = 5/10
Gaining ratio of A Share: = 1/2 * 2/10
New ratio of A Share = 5/10 + 1/10 =6/10

Old ratio of B Share: = 3/10
Gaining ratio of B Share: = 1/2 * 2/10
New Ratio of B share = 3/10 + 1/10 =4/10
New Ratio (A:B) = 3:2

4) Entire gain by one partner

Illustration 4:

A, B and C are partners sharing profits in the ratio of 5 : 3 : 2. C retires and his share was taken up entirely by B. Find out the new Profit sharing ratio and gaining ratio of continuing partners.

Solution :

a) New ratio:

Old ratio of A Share: =5/10
Old ratio of B Share: =3/10
Gaining ratio of B Share: = 2/10
New Ratio of B share = 3/10 + 2/10 =5/10
New Ratio (A:B) =1:1

b) Gaining ratio:

Gaining ratio = New ratio – Old ratio
Old ratio of A Share: =5/10
New Ratio of A share = 5/10
Gain of A = Nil
Old ratio of B Share: =3/10
New Ratio of B share = 5/10
Gain of B= 5/10 -3/10 =1/5

5) New ratio is given

Illustration 5:

X,Y and Z are partners sharing profits in the ratio of 5 : 3 : 2. Z retires and the ratio between X and Y is 3 : 2. Find out the gaining ratio

Solution:

Old ratio of A Share: =5/10
New ratio of A Share: = 3/5
Gaining Ratio of A share = 3/5 - 5/10 =1/10

Old ratio of A Share: =3/10
New ratio of A Share: = 2/5
Gaining Ratio of A share = 2/5 - 3/10 =1/10
Gaining ratio = 1/10 : 1/10

Illustration 6 :

X, Y and Z are partners sharing profits in the ratio of 1/2:3/10:1/5. Calculate the new profit sharing ratio and gaining ratio (a) If X retires (b) If Y retires (c) Z retires.

Solution:

Let us convert the old ratio in the form of fractions into one consisting of whole number, 1/2:3/10:1/5 = 5:3:2

New Ratio:

In such case, new ratio will be the same as the old ratio which existed between the remaining partners since the remaining partners continue to share the future profits and losses in he old ratio as existed immediately before the going out of a partner unless agreed otherwise. Thus, new ratio will be as under:

(a) between Y and Z 3:2
(b) between X and Z 5:2
(c) between X and Y 5:3
Gaining Ratio:

In such a case, gaining ratio will be the same as old ratio which existed between the remaining partners since the remaining partners gain in their old ratio unless agreed otherwise. Thus gaining ratio will be as under:

(a) between Y and Z	3:2
(b) between X and Z	5:2
(c) between X and Y	5:3

3.4 ACCOUNTING TREATMENT OF GOODWILL

When an existing partner of a firm decides to retire from the firm, the continuing partners will gain in future profits. The continuing partner who gains by acquiring an additional right to share future profits must compensate the outgoing partner who sacrifices by forgoing his right to share future profits. The amount of compensation will be equal to the proportionate amount of firm's goodwill. Thus, Outgoing partner's share of goodwill =Value of firms Goodwill x share of profit sacrifices.

Illustration 7 :

X, Y and Z are partners sharing profits and losses in the ratio of 2:2:1. Y retires and the goodwill of the firm is valued at Rs 21,600. Assuming that X and Z will share the future profit in the ratio of 5:4. Pass the necessary journal entries in each of the following alternative.

Case (a)	When no goodwill account appears in the books
Case (b)	When goodwill account appears at Rs. 21,600
Case (c)	When goodwill account appears at Rs. 14,400
Case (d)	When goodwill account appears at Rs. 28,800.

Solution

Calculation of gaining ratio:

X	5/9 – 2/5 = 7/45
Z	4/9 – 1/5 = 11/45
	Ratio X:Y=7/45:11/45

Case (a) When no goodwill account appears in the books

Compensation to be paid by X and Z to Y

X	Rs. 21,600 x 7/45 = Rs. 3,360
Z	Rs. 21,600 x 11/45 = Rs. 5,280

Total amount to be credited in Y' Capital Account = Rs. 8,640

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Particular		Debit	Credit
X's Capital Account	Dr.	3,360	
Z's Capital Account	Dr.	5,280	
To, Y's Capital Account			8,640

(Y's share of goodwill adjusted in the capital account of gaining partners in their gaining ratio of 7/45:11/45)		

Case (b) When goodwill account appears at Rs. 21,600

JOURNAL VOUCHER

Particular		**Debit**	**Credit**
X's Capital Account	Dr.	8,640	
Y's Capital Account	Dr.	8,640	
Z's Capital Account	Dr.	4,320	
To, Goodwill Account (The existing goodwill written off in old ratio)			21,600
X's Capital Account	Dr.	3,360	
Z's Capital Account	Dr.	5,280	
To, Y's Capital Account (Y's share of goodwill adjusted in the capital account of gaining partners in their gaining ratio of 7/45:11/45)			8,640

Case (c) When goodwill account appears at Rs. 14,400

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Particular		**Debit**	**Credit**
X's Capital Account	Dr.	5,760	
Y's Capital Account	Dr.	5,760	
Z's Capital Account	Dr.	2,880	
To, Goodwill Account (The existing goodwill written off in old ratio)			14,400
X's Capital Account	Dr.	3,360	
Z's Capital Account	Dr.	5,280	
To, Y's Capital Account (Y's share of goodwill adjusted in the capital account of gaining partners in their gaining ratio of 7/45:11/45)			8,640

Case (d). When goodwill account appears at Rs. 28,800.

JOURNAL VOUCHER

Particular		**Debit**	**Credit**
X's Capital Account	Dr.	11,520	
Y's Capital Account	Dr.	11,520	
Z's Capital Account	Dr.	5,760	
To, Goodwill Account			28,800
(The existing goodwill written off in old ratio)			
X's Capital Account	Dr.	3,360	
Z's Capital Account	Dr.	5,280	
To, Y's Capital Account			8,640
(Y's share of goodwill adjusted in the capital account of gaining partners in their gaining ratio of 7/45:11/45)			

3.5 REVALUATION OF ASSETS AND LIABILITIES ON RETIREMENT OF A PARTNER

On retirement of a partner, it is required to revalue assets and liabilities just as in the case of admission of a partner. If there is revaluation profit, then such profit should be distributed amongst the existing partners including the retiring partner at the existing profit sharing ratio. On the other hand, if there is loss of revaluation such is also to be distributed to all the partners including the retiring partner at the existing profit sharing ratio. To arrive at, profit or loss on revaluation of assets and liabilities, a Revaluation Account or Profit and Loss Adjustment Account is prepared and closed by transferring balance to all partners' capital accounts including outgoing partners.

If it is decided that revalued figures of assets and liabilities will not appear in the Statement Of Financial Position of the continuing partners, then a journal entry should be passed only counting the amount payable or chargeable to the retiring partner which the continuing partners will share at the ratio of gain. In the first instance the journal entry for distribution of profit or loss on revaluation which will appear in the Statement Of Financial Position also is as follows:

Revaluation A/c Dr.
To, Partners' Capital
(For revaluation profit)

Partners' Capital A/c Dr.
To, Revaluation A/c
(For loss on revaluation)

Illustration 8 :

A, B and C shares profit and losses equally and there is a revaluation profit of Rs. 30,000 calculated on A's retirement, then Rs. 10,000 becomes due to A which is to be borne by B and C equally. Pass the necessary Journal Entries

JOURNAL ENTRIES

Date	Particular		Debit	Credit
	B's Capital A/c	Dr.	Rs. 5,000	
	C's Capital A/c	Dr.	Rs. 5,000	
	To, A/s Capital			Rs. 10,000

Alternatively, following journal entries are required for Rs, 20,000 increase in Property, Plant & Equipment and Rs. 10,000 decrease in sundry creditors:

Date	Particular		Debit	Credit
1)	Property, Plant & Equipment A/c	Dr.	20,000	
	Sundry Creditors A/c	Dr.	10,000	
	To, A's Capital A/c			10,000
	To, B's Capital A/c			10,000
	To, C's Capital A/c			10,000
	(Distribution of Revaluation profit amongst the existing partners at the old profit sharing ratio)			
2)	B's Capital A/c	Dr.	15,000	
	C's Capital A/c	Dr.	15,000	
	To, Property, Plant & Equipment			20,000
	To, Sundry Creditors A/c			10,000

In this case it is not necessary to open a separate Revaluation Account

Illustration 9:

The Statement Of Financial Position of A,B and C sharing profits and losses in the ratio of 5: 3:2 on 31st march 20X5 was as under

Liabilities	Rs.	Assets		Rs.
A's Capital	46,000	Land & Building		30,000
B's Capital	34,000	Plant and Machinery		35,000
C's Capital	25,000	Stock		12,800
		Debtors	16,000	
Creditors	15,600	Less Provision	800	15,200
		Cash and Bank		27,600
	120,600			**120,600**

On the same date , B retires from the firm and A and C decided to share future profits and loss in the ration of 3:2. The following adjustments were agreed upon

- That an amount of Rs 1,100 included in Sundry Debtors be written off as no longer receivable
- That a provision for doubtful debt be maintained at an existing rate
- that stock be written down by Rs 1,055
- That Land and building be written up by Rs 11,000
- That Pant and machinery be reduced to Rs 34,000
- That an amount of Rs 700 included in sundry creditors be written back as no longer payable
- That a joint life policy for Rs 5,000 be recorded at its surrender value which as on 31.03.20X2 is 10% of the sum assured
- That a provision of Rs 600 be made for an outstanding repair bill
- That B's Capital Account is to be transferred to his loan account

Required: Give the necessary journal entries and prepare the Statement Of Financial Position of the reconstituted firm

Solution

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Particular		**L.F**	**Debit**	**Credit**
Bad Debts	Dr		1,100	
To, Debtors A/c				1,100
(Being the bad debts written off)				
Provision for doubtful debts A/c	Dr		800	
Revaluation A/c	Dr		300	
To, Bad debts A/c				1,100
(Being the balance in bad debts a/c transferred)				
Revaluation A/c	Dr		1,055	
To Stock A/c				1,055
(Being the fall in value of stock recorded)				
Land & Building A/c	Dr		11,000	
To, Revaluation A/c				11,000
(Being an increase in value of building recorded)				
Revaluation A/c	Dr		1,000	
To Plant & Machinery				1,000
(Being reduce in value of Plant recorded)				

Sundry Creditors A/c	Dr		700	
To Revaluation A/c				700
(being reduce in amount of creditor recorded)				
Joint Life policy A/c	Dr		500	
To Revaluation A/c				500
(being the surrender value of Joint life policy @ 10% of Rs 5000 recorded)				
Revaluation A/c	Dr		600	
To, Outstanding Repairs A/c				600
(Being unrecorded liability Provided for)				
Revaluation A/c	Dr		745	
To Provision for doubtful debts A/c				745
(being the provision created @5% on Rs 14900 ie Rs (16000-Rs 1100)				
Revaluation A/c	Dr		8,500	
To, A's Capital				4,250
To, B's Capital				2,550
To, C's Capital				1,700
(being transfer of net profit on revaluation)				
B's Capital A/c	Dr		36,550	
To B's Loan A/c				36,550
(Being transfer of B's capital A/c to B's Loan A/c				

Statement Of Financial Position of A and C as at 31st March 20X5

Liabilities	**Rs.**	**Assets**	**Rs.**
A's Capital	50,250	Land & Building	41,000
C's Capital	26,700	Plant and Machinery	34,000
B's Loan	36,550	Stock	11,745
Creditors	14,900	Debtors 16,000	
Outstanding Repairs	600	Less Bad debts 1,100	

		Less Provision 745	14,155
		Cash and Bank	27,600
		Joint Life Policy	500
	129,000		**129,000**

3.6 ADJUSTMENT FOR RESERVES AND ACCUMULATED PROFITS/LOSSES

If, at the time of retirement of a partner, any reserve, accumulated profits or losses exist in the books of the firm, these should be transferred to the Capital Accounts of all partners including outgoing partner in their old sharing ratio so that the due share of an outgoing partner in the reserves, accumulated profits/losses upto the date of retirement gets adjusted in his Capital Account. Alternatively, only the retiring partner's share may be transferred to his Capital Account if the others continue at the same profit sharing ratio.

Illustration 10:

A. B and C were in partnership sharing profits and losses at the ratio 3:2:1. A retired and B and C agreed to share profits and losses at the ratio 2:1. Reserve balance was Rs. 90,000. Requirement; Pass the necessary Journal Entries

Solution:

JOURNAL VOUCHER

Date	**Particular**		**Debit**	**Credit**
1)	Reserve A/c	Dr.	90,000	
	To, A's Capital A/c			45,000
	To, B's Capital A/c			30,000
	To, C's Capital A/c			15,000
	(Transfer of Reserve to partners' capital account at 3:2:1 on A's retirement)			
Or				
2)	Reserve A/c	Dr.	45,000	
	To, A's Capital			45,000
	(Transfer of A's share of Reserve of the Capital Account on this retirement)			

Note that alternative (2) has the same implications because B and C continued at the same ratio 2:1 as they did before A's retirement.

Illustration 11:

X, Y and Z were equal partners. Z decided to retire. X and Y decided to continue at the ratio of 3:2. Reserve standing at the date of retirement of Z was Rs. 90,000. In this case adjustment of Z's share was not sufficient since the relationship between X and Y was also changed.

Requirement:

i. Journalize the entry if continuing partner doesn't want to show the reserve in Statement Of Financial Position
ii. Journalize the entry if continuing partner want to show reserve in the Statement Of Financial Position

Solution:

X's gain: 3/5 – 1/3 = (9-5)/15=4/15
G's gain: 2/5 – 1/3 = (6-5)/15=1/15
Gaining Ratio : X:Y=4/15:1/15

i. Journal entry if continuing partner doesn't want to show the reserve in Statement Of Financial Position

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Date	Particular		Debit	Credit
	Reserve A/c	Dr.	90,000	
	To, X's Capital A/c			30,000
	To, Y's Capital A/c			30,000
	To, Z's Capital A/c			30,000
	(Transfer of reserve on Z's retirement)			
	Note: *Gaining ratio is different from previous profit sharing ratio i.e 1:1, So alternative (1) is to be followed in this case*			

ii. If the continuing partners want to show reserve in the Statement Of Financial Position, the journal entry will be:

JOURNAL VOUCHER

Date	Particular		Debit	Credit
	X's Capital A/c (90,000X4/15)	Dr.	24,000	
	Y's Capital A/c (90,000X1/15)	Dr.	6,000	
	To, Z's Capital A/c			30,000
	(Adjustment entry for Z's share of reserve)			

3.7 FINAL PAYMENT TO RETIRING PARTNER

The amount due to the retiring partner is settled in the manner prescribed in the partnership deed. The amount due is either paid off immediately or is paid in installments with or without interest as per agreement. To determine the amount due to retiring partner following adjustment are necessary in the Capital Account:

(1) Transfer of reserve
(2) Transfer of goodwill
(3) Transfer of profit/loss on revaluation.

After adjustment of the above mentioned items, the Capital Account balance standing to the credit of the retiring partner represents amount due to him.

When continuing partners discharged the whole amount of claim at the time of retirement. Then the journal entry will appear as follow:

Retiring Partner's Capital A/c Dr.
To, Bank A/c

Sometimes the retiring partner agrees to retain some portion of his claim in the partnership as loan. The journal entry will be as follows:

Retiring Partner's Capital Account Dr
To, Retiring Partner's Loan A/c
To, Bank A/c

Illustration 12:

A, B and C were partners in a firm sharing profits and losses in the ratio 2:2:1 respectively. The Statement Of Financial Position of the firm as on 31.12.2018 as follows:

Statement Of Financial Position

Liabilities	Rs.	Assets	Rs.
Capital:		Buildings	60,000
A	40,000	Plant and Machinery	40,000
B	40,000	Furniture	10,000
C	30,000	Stocks	30,000
Reserve	15,000	Sundry Debtors	20,000
Bills Payable	12,000	Less: Provision	(1,000)
Sundry Creditors	25,000	Cash	3,000
	162,000		**162,000**

On 31.12.2018, B retired. The term of retirement provided the following:

(i) The goodwill of the firm was to be valued at Rs. 20,000;
(ii) Furniture, Plant and Machinery were depreciated by 10% and 5% respectively.
(iii) Stock and Building were to be appreciated by 20% and 10 % respectively.
(iv) The amount due to B was to be transferred to a separate Loan Account and earning interest @ 10% p.a.
(v) Provision for Bad Debts to be increased by Rs. 500

Show the revaluation account , Partners accounts and the Statement Of Financial Position of the firm after B's retirement.

Solution

In the books of Firm

Revaluation Account

Particulars	Rs.	Particulars	Rs.
To, Furniture A/c	1,000	By Buildings	6,000
To, Plant and Machinery	2,000	By, Stock A/c	6,000
To, Provision for bad debts	500		

To, Capital:			
Mr. A	3,400		
Mr. B	3,400		
Mr. C	1,700		
	12,000		**12,000**

Partners' Capital Accounts

Particulars	A Rs.	B Rs.	C Rs.	Particulars	A Rs.	B Rs.	C Rs.
To, B's Loan A/c		57,400	-	By, Balance b/d	40,000	40,000	30,000
To, Goodwill A/c	13,333	-	6,667	By, Reserve A/c	6,000	6,000	3,000
To, Balance c/d	44,067		32,033	By, Revaluation A/c	3,400	3,400	1,700
				By, Goodwill A/c	8,000	8,000	4,000
	57,400	**57,400**	**38,700**		**57,400**	**57,400**	**38,700**

Statement Of Financial Position as on 31.12.2018

Liabilities	Rs.	Assets	Rs.
Capital:		Property, Plant & Equipment:	
Mr. A	44,067	Buildings	66,000
Mr. C	32,033	Furniture	9,000
Mr. B's Loan A/c	57,400	Plant and Machinery	38,000
Sundry Creditors	25,000	Stocks	36,000
Bills Payable	12,000	Sundry Debtors	20,000
		Less: Provision for D/D	(1,500)
		Cash	3,000
	170,500		**170,500**

Illustration 13:

A and B partners in a business sharing profits and losses as A 3/5ths and B 2/5ths. Their Statement Of Financial Position as on 1st January 2019 is given bellow:

Statement Of Financial Position

Liabilities	Rs.	Assets	Rs
Capital:			
Mr. A	20,000	Plant and Machinery	20,000
Mr. B	15,000	Stocks	16,000
Reserve A/c	15,000	Sundry Debtors	15,000
Sundry Creditors	7,500	Balance at Bank	6,000
		Cash in hand	500
	57,500		**57,500**

B retires from the business owing to illness and A takes it over. The following revaluation was made:

1. The goodwill of the firm is value at Rs. 25,000
2. Depreciation Plant & Machinery by 7.5% and stock by 15%
3. Bad debts provision is raised against debtors at 5% and a discount reserve against creditors at 2%.

You are asked to Journalize the above transactions in the books of the firm and close the partners' accounts as on 1st January 2019. Give also opening Statement Of Financial Position of A.

Solution

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Date	Particular		Debit	Credit
2019	Goodwill Account	Dr.	25,000	
1-Jan	To, A's Capital A/c			15,000
	To, B' s Capital A/c			10,000
	(The amount of goodwill raised on B's retirement)			
	Reserve Account	Dr.	15,000	
	To, A's Capital A/c			10,000
	To, B' s Capital A/c			5,000
	(The amount of Reserve transferred on B's retirement)			
	Revaluation A/c	Dr.	4,650	
	To, Plant and Machinery A/c			1,500
	To, Stock Account			2,400
	To, Provision for Bad Debts Account			750
	(Reduction in value of assets and creation of provision for doubtful as per agreement with B)			
	Reserves for Discount on Creditors A/c	Dr.	150	
	To, Revaluation Account			150
	(Creation of reserve for discount on creditors at 2%)			
	A's Capital A/c	Dr.	2,700	
	B' s Capital A/c	Dr.	1,800	
	To, Revaluation A/c			4,500
	(Transfer of loss on revaluation of assets liabilities to Capital Account of A and B in the profit sharing ratio)			

	B's Capital A/c	Dr.	28,200	
	To, B's Loan Account			28,200
	(Transfer of B's Capital Account to his Loan Account)			

Partner's Capital Account

Particulars	A Rs.	B Rs.	Particulars	A Rs.	B Rs.
To Revaluation A/c	2,700	1,800	By Balance b/d	20,000	15,000
To B's Loan A/c		28,200	By Goodwill A/c	15,000	10,000
To Balance c/d	42,300		By Reserve A/c	10,000	5,000
	45,000	**30,000**		**45,000**	**30,000**

Note: In this case, goodwill is raised because the partnership business is sold to A. The value of goodwill appear in the Statement Of Financial Position of A.

Statement Of Financial Position of A as on 1st January 2019

Liabilities	Rs.	Assets	Rs.
Sundry Creditors	7,500	Goodwill	25,000
Less: Reserve for discount	(150)	Plant and Machinery	18,500
Mr. B's Loan A/c	28,200	Stocks	13,600
Mr. A's Capital A/c	42,300	Sundry Debtors	15,000
		Less: Provision for D/D	(750)
		Balance at Bank	6,000
		Cash in hand	500
	77,850		**77,850**

Illustration 14:

S, T, and R were partners sharing profits and losses at the 2:2:1. R wants retire on 31.12.2018. Given below the Statement Of Financial Position of the partnership as well as other information.

Statement Of Financial Position on 31 December 2018

Liabilities	Rs.	Assets	Rs.
Reserve	20,000	Property, Plant & Equipment	300,000
Capital Accounts:		Stocks	100,000
S	240,000	Debtors	100,000
T	160,000	Bills Receivable	40,000
R	120,000	Bank	100,000
Sundry Creditors	100,000		
	640,000		**640,000**

S and T agree to share profits and losses at the ratio of 3:2 in future. Value of goodwill is taken to be Rs. 100,000. Sundry assets are revalued upward by Rs. 60,000 and Stock by Rs. 20,000. Bills Receivable dishonored Rs. 10,000 on 31.12.2018 but not recorded in the books. Dishonored of bill was due to insolvency of the customer. S and T agree to bring sufficient cash to discharge claim of R and to make their capital proportionate. Also they wanted to maintain Rs. 150,000 bank balance for working capital. However, they did not want to show goodwill in the books of M/s S&T.

Solution

JOURNAL VOUCHER

Particular		Debit	Credit
S's Capital A/c	Dr.	20,000	
To, R's Capital			20,000
(Being the adjustment of goodwill on R's retirement)*			
Reserve A/c	Dr.	20,000	
To, S's Capital A/c			8,000
To, T's Capital A/c			8,000
To, R's Capital A/c			4,000
(Transfer of reserve to partners' capital account in their profit sharing ratio of 2:2:1)			
Property, Plant & Equipment A/c	Dr.	60,000	
Stock A/c	Dr.	20,000	
To, P/L Adjustment Account			80,000
(Increased in value of assets recorded)			
P/L Adjustment Account	Dr.	10,000	
To, Bills Receivable A/c			10,000
(Loss arising out of dishonored bill recorded)			
P/L Adjustment Account	Dr.	70,000	
To, S's Capital A/c			28,000
To, T's Capital A/c			28,000
To, R's Capital A/c			14,000
(Profit on revaluation transferred to partners' capital A/cs on R's retirement).			
Bank Account	Dr.	2,08,000	

To, S's Capital A/c		140,000
To, T's Capital A/c		68,000
(Cash brought in by S and T as per agreement)		
R's Capital Account Dr.	158,000	
To, Bank A/c		158,000
(Payment made to R on retirement)		

* On R' retirement, he is entitled to a share of goodwill equivalent to Rs. 20,000 (1/5 of 100,000). This will be borne only by S because he has only gained due to R' s retirement.

Statement Of Financial Position on 31 December 2018 (After R' Retirement)

Liabilities	Rs.	Assets	Rs.
		Property, Plant & Equipment	360,000
Capital Accounts:		Stocks	120,000
S	396,000	Debtors	100,000
T	264,000	Bills Receivable	30,000
		Bank	150,000
Sundry Creditors	100,000		
	760,000		**760,000**

Working notes:

1. **Partners' Capital Accounts**

Particulars	S Rs.	T Rs.	R Rs.	Particulars	S Rs.	T Rs.	R Rs.
To, R's Capital A/c	20,000	-	-	By, Balance b/d	240,000	160,000	120,000
To, Balance c/d	256,000	196,000	158,000	By, Reserve A/c	8,000	8,000	4,000
				By, P/L Adj. A/c	28,000	28,000	14,000
				By, S's Capital A/c	-	-	20,000
	276,000	**196,000**	**158,000**		**276,000**	**196,000**	**158,000**
To. Bank A/c			158,000	By, Balance b/d	256,000	196,000	158,000
To, Balance c/d	396,000	264,000		By, Bank A/c	140,000	68,000	
	396,000	**264,000**	**158,000**		**396,000**	**264,000**	**158,000**

2 Total capital

Property, Plant & Equipment (Rs. 300,000 +60,000)	360,000
Stock (Rs. 100,000+Rs. 20,000)	120,000
Debtors	100,000
Bills Receivable (Rs. 40,000-Rs. 10,000)	30,000
Bank	150,000
	760,000
Less: Sundry Creditors	100,000
Total Capital	660,000

S's share (660,000 x 3/5)	396,000
T's Shares (Rs. 660,000 x 2/5)	264,000

4,

Bank Account

Dr. **Cr.**

Particulars	Rs.	Particulars	Rs.
To, Balance b/d	100,000	By, R's Capital A/c	158,000
To, Capital Accounts:		By, Balance C/d	150,000
S Capital	140,000		
T Capital	68,000		
	308,000		**308,000**

3.8 PAYING PARTNERS LOAN IN INSTALLMENTS

Basically, when partner is retired form partnership firm it is legal obligation of remaining or continuing partners to pay the amount immediately. However, due to non-availability of required fund they may arrange some alternative. Therefore, paying a partner's loan is only a matter of arranging finance. However, sometimes it is stated that the loan is to be paid of in so many equal installments and that the balance is to carry interest. In such case what should be done is that the loan should be divided into equal parts. The interest for the period should be calculated and the payment should consist of the installment on account of the loan plus interest for the period. Suppose a partner's loan stands at Rs. 300,000 and that it has to be paid in four annual equal installments and that the loan is to carry at 6% per annum. The annual installment on account of loan comes to Rs. 75,000 along with interest on due amount. Then, for the first year the first interest is Rs. 18,000 i.e. 6% on Rs. 300,000. In the first year the amount to be paid will be Rs. 93,000. Balance of Rs. 225,000 will now be left. Next year the interest will be Rs. 13,500. The amount to be paid therefore will be Rs. 75,000 plus interest viz. Rs. 88,500.The loan account will appear in the books as under.

Retiring Partner's Loan Account

Dr. **Cr.**

Particulars	Rs.	Particulars	Rs.
To, Bank A/c	93,000	By, Capital A/c	300,000
To, Balance C/d	225,000	By, Interest A/c	18,000
	318,000		318,000
	-		-
To, Bank A/c	88,500	By, Balance b/d	225,000
To, Balance C/d	150,000	By, Interest A/c	13,500

	238,500		238,500
			-
To, Bank A/c	84,000	By, Balance b/d	150,000
To, Balance c/d	75,000	By, Interest A/c	9,000
	159,000		159,000
			-
To, Bank A/c	79,500	By, Balance b/d	75,000
		By, Interest A/c	4,500
	79,500	-	79,500

Summary

In this unit, we have discussed the technique of calculating gaining ratios, adjustment of revaluation of assets and recomputation of liabilities, maintenance of capital of continuing partners and final settlement of outgoing partner. Profit arising out of revaluation of assets and liabilities, value of goodwill and due to retiring partners, can be directly charged to the continuing partners in the gaining ratio. Alternatively, these can be firstly debited to all the partners in the old profit sharing ratio and thereafter, it can be debited in the capital account of continuing partners in their new profit sharing ratio.

Self-Examination Questions

I. Multiple Choice Questions (MCQs)

1. A, B and C are partners sharing profits in the ratio 2:2:1. On retirement of B, goodwill was valued as Rs. 30,000. Find the contribution of A and C to compensate B.
   (a) Rs. 20,000 and Rs. 10,000.
   (b) Rs. 8,000 and Rs. 4,000.
   (c) They will not contribute anything.
   (d) Information is insufficient for any comment.

2. Outgoing partner is compensated for parting with firm's future profits in favour of remaining partners. In what ratio do the remaining partners contribute to such compensation amount?
   (a) Gaining Ratio.
   (b) Capital Ratio.
   (c) Sacrificing Ratio.
   (d) Profit Sharing Ratio.

3. A, B and C are partners with profits sharing ratio 3:5:2. B retires. If A & C shares profits of B in 5:3, then find the new profit sharing ratio.
   (a) 49:31.
   (b) 17:11.

(c) 31:11.
(d) 14:21.

4. A, B and C are partners sharing profits and losses in the proportion of 1/2, 1/3 and 1/6. B retired and the new profit sharing ratio between A and C is 4:3 and the Reserve of 240,000 is divided among the partners in the ratio:
(a) 120,000: 40,000: 60,000.
(b) 150,000: 50,000: 40,000.
(c) 140,000: 60,000: 20,000.
(d)120,000: 80,000: 40,000.

5. A, B and C are partners sharing profits in the ratio 3:2:1. On retirement of B, goodwill was valued as 360,000. Find the contribution of A and C to compensate B.
(a) Rs 70,000 and 40,000.
(b) Rs 90,000 and Rs 30,000.
(c) Rs 1800,000 and 180,000.
(d) Information is insufficient .

6. A, B and C were partners in a firm sharing profits and losses in the ratio of 3:2:1 respectively with the capital balance of Rs 75,000 for A , Rs 50,000 for B and Rs 25,000 for C. B declared to retire from the firm and balance in reserve on the date was Rs 150,000. If goodwill of the firm was valued as 350,000 and profit on revaluation was 250,000 then what amount will be transferred to the loan account of B.
(a) 300,000.
(b) 500,820
(c) 450,000.
(d) 150,000.

7. A, B and C are partners sharing profits and losses in the ratio of 2:2:1. C retires on a decided date and Goodwill of the firm is to be valued at 300,000. Find the amount payable to retiring partner on account of goodwill.
(a) 40,000.
(b) 50,000.
(c) 60,000.
(d) 20,000.

8. A, B and C were partners sharing profits and losses in the ratio of 3:2: 1. A retired and Goodwill of the firm is to be valued at Rs 240,000. What will be the treatment for goodwill?
a) Credited to Revaluation Account at 240,000.
(b) Adjusted through partners' capital accounts in gaining/sacrificing ratio.
(c) Only A's capital account credited with 120,000.
(d) Only A's capital account credited with 240,000.

9. Balances of A, B and C sharing profits and losses in proportionate to their capitals, stood as A – Rs 200,000; B – Rs 300,000 and C - Rs 200,000. A desired to retire from the firm, B and C

share the future profits equally, Goodwill of the entire firm be valued at Rs 140,000 and no Goodwill account being raised.

a) Credit A's Account with Rs 40,000 and debit B's Capital Account with Rs 15,000 and C's Capital Account with Rs 25,000..
b) Credit A's Account with Rs 40,000 and debit B's Capital Account with Rs 30,000 and C's Capital Account with Rs 10,000.
c) Credit A's Account with Rs 40,000 and debit B's Capital Account with Rs 10,000 and C's Capital Account with Rs 30,000.
d) Credit A's Account with Rs 40,000 and debit B's Capital Account with Rs 20,000 and C's Capital Account with Rs 20,000.

II. Partical Questions (PQs)

1. A, B and C are in partnership sharing profits and losses equally. C retired on and from 1st Jan 2008. A and B agreed to continue sharing profit and losses at 3:2. Find out the gaining ratio.

2.Statement Of Financial Position of M/s A, B, and C as on 31.12.2008.

Liabilities	Rs.	Assets	Rs.
Capital Accounts		Property, Plant & Equipment	120,000
A	40,000	Stock	40,000
B	60,000	Debtors	15,000
C	60,000	Bank	5,000
Reserve	10,000		
Sundry Creditors	10,000		
	180,000		180,000

A decided to retire on and from 1.1.2009. For this purpose goodwill was valued Rs. 50,000. They agreed to take Property, Plant & Equipment at Rs. 140,000 and stock at Rs. 50,000. But goodwill and revaluation profit would not appear in the books of M/s A.B, and C in connection with A's retirement. The amount standing in the capital account of C, 75% of the amount due to him to be used by continuing partner as loan and to be paid out in 5 equal installments plus 10% p.a.

3.Prashant, Amit and Prakash were in partnership sharing profits and losses at the ratio of 5:3:2. Capital Accounts of the partners showed the following balances as on 31.12.2009.

Prashant	Rs.170,000
Amit	Rs.90,000
Prakash	Rs.102,000

It was found that stock Rs. 90,000 is valued 10% below the cost and market price is Rs. 110,000. One piece of furniture was taken from the firm by Prashant on 1.1.2009 but the balance still standing at the books. W.D.V. of such furniture as on 31.12.2009 was Rs. 8,500. The firm charged 10% depreciation on reducing balance method. Goodwill Rs. 100,000 was to be raised in the books for immediate writing off. Reserve balance on 31.12.2009 was Rs. 30,000.

Prashant wanted to retire with effect from 31.12.2009. he agreed to take only 60% of his claim allowing loan to the firm for the balance @ 15% p.a. Amit and Prakash wanted make their capital proportionate.

Prepare partners' Capital Accounts and Bank Accounts assuming an opening balance of Rs. 10,000 and draft the opening Statement Of Financial Position of Mr. Amit and Prakash.

4.The Statement Of Financial Position of M/s A, B and C showed as follows:

Liabilities	Rs.	Assets		Rs.
Capital Accounts		Free Hold Assets		9,000
A	12,575	Plant		15,000
B	10,000	Stock		5,500
C	8,500	Debtors	6,150	
		Less: Provision B/D	100	6,050
Sundry Creditors	7,000	Bank		2,525
	38,075			38,075

B agrees to take over their business. A and C retiring on the following terms:

(a) That the Goodwill of the firm be valued at Rs. 7,500

(b) That plant and stock be reduced by 10%

(c) That freehold property be appreciated by Rs. 1,000.

(d) That reserve for doubtful dents be brought up to Rs. 250

B has brought in sufficient cash to pay off A and C. The partners used to share profits in the profits in the proportion of 2/5, 2/5 and 1/5.

Show the necessary journal entries, partners' capital accounts and Statement Of Financial Position of B after retirement of A and C.

4. On 31st March 2018, the Balance Sheet of M/s Binod, Parash and Shakti sharing profits and losses in proportion to their capitals, stood as follows:

Liabilities	**Rs**	**Assets**	**Rs**
Capital Accounts		Land & Buildings	2,00,000
Binod	3,00,000	Machinery	2,00,000
Parash	2,00,000	Closing Stock	1,00,000
Shakti	1,00,000	Sundry Debtors	2,00,000
Sundry Creditors	2,00,000	Cash and Bank Balances	1,00,000
	8,00,000		**8,00,000**

On 31st March 2018 Binod desired to retire from the firm and the remaining partners decided to carry on. It was agreed to revalue the assets and liabilities on that date on the following basis:

(a) Land and Buildings be appreciated by 30%.

(b) Machinery be depreciated by Rs. 40,000.

(c) Closing stock to be valued at Rs 80,000.

(d) Provision for Doubtful Debts to be made at 5%.

(e) Old credit balances of Sundry Creditors Rs, 10,000 be written back.

(f) Joint life policy of partners surrendered and cash obtained Rs. 60,000.
(g) Goodwill of the entire firm be valued at Rs, 1,80,000 and Binod's share of the Goodwill be adjusted in the accounts of Parash and Shakti who share the future profits equally. No Goodwill account being raised.
(h) The total Capital of the firm is to be the same as before retirement. Individual Capitals be in their Profit Sharing Ratio.
(i) Amount due to Binod is to be settled on the following basis:
50% on retirement and the balance 50% within one year.

Prepare Revaluation Account, Capital Accounts of Partners Parash and Shakti, Loan Account of Binod, and Balance Sheet as at 31st March 2018 of M/s Parash and Shakti.

ANSWER

Multiple Choice Questions (MCQs)

1	b	6	a
2	a	7	c
3	a	8	b
4	d	9	c
5	b		

CHAPTER- 8

Partnership Accounts

UNIT 4:

Death of a Partner

Learning Objectives

1. *Try to understand the implication of transaction relating to death of partner and how to record payment of profit to Excutor of the deceased partners for part of the accounting year.*
2. *Be familiar with other accounting treatments in case of death of partner which are similar to the explained in case of retirement of a partner.*

The amount due to the deceased partner carries interest at the nutually agreed upon rate. In the absence of agreement, the representative of the deceased partner can receive, at their option, interest upto 10% per annum or the share of profits earned for the amount due to the deceased partner as per Partnership Act, 2020. Since no any specific rate is given in the act, for ease of calculation we take 6% as practiced in india.

4. INTRODUCTION

The accounting procedures on death of partner are very similar to those that cover a partner's retirement. The retirement of a partner is voluntary in character and can be anticipated but death of a partner may occur any time. When a partner dies, a firm has to face the problems. The problems arising on the death of a partner are mostly similar to those arising on retirement. Assets and liabilities have to be revalued and the resultant profit or loss has to be transferred to the Capital Accounts of all partners including the deceased partner. Goodwill is dealt with exactly the way already discussed in the case of retirement. Treatment of joint life policy (excluded for this level) will also be same as in the case of retirement. The only additional point is that as death may occur on any day, the representative of the deceased partner will be entitled to the partner's share of profits from the beginning of the year to the date of death. After ascertaining the amount due to the deceased partner, it should be credited to his Executor's Account.

4.1 SPECIAL TRANSACTION IN THE CASE OF DEATH: PAYMENT OF DECEASED PARTNER'S SHARE

The basic distinction between retirement and death of a partner relates to finalisation of amount payable to the Executor of the deceased partner. Although revaluation of goodwill is done in the same manner as it has been done in case of retirement, in addition, the executor of the deceased partner is entitled to share of profit upto the date of death.

For Example, A. B and C are in partnership sharing profits or losses at the ratio of 2:2:1. A died on 15th April 2018. The firm closes its books of account as on 31st December every year. So the executor of A is entitled for $3^{1/2}$ months profit. If A's share is immediately paid off then profit for 2017 can be taken as base for calculating $3^{1/2}$ months profit in 2018. If firm earned Rs, 120,000 in 2017, then $3^{1/2}$ months profit is Rs. 35,000. A's share comes to Rs. 35,000 x 2/5 = Rs. 14,000.

The journal entry is

Profit and Loss Suspense A/c	Dr.	14,000	
To, A's Capital A/c			14,000

(Share of A $3^{1/2}$ months profit in 2018 is transferred to his Capital Account on death.)

At the end of the year 2018 the profit and loss suspense account will be transferred to Profit and Loss A/c.

Illustration 1:

The Statement Of Financial Position of Black, Pink and Red as on 31st December 2017 was as under:

Statement Of Financial Position

Liabilities	Rs.	Assets	Rs.
Reserve	25,000	Property, Plant & Equipment	200,000
Capital Accounts:		Stocks	80,000
Black	125,000	Debtors	50,000

Pink	75,000	Bills Receivable	20,000
Red	75,000	Bank	50,000
Sundry Creditors	100,000		
	400,000		**400,000**

The profit sharing ratio was Black 5/10, Pink 3/10 and Red 2/10. On 1st May 2018 Pink died. It was agreed that :

(a) Goodwill should be valued at 3 years purchase of the average profits for 4 years. The profits were 2014- Rs. 50,000, 2015- Rs. 65,000, 2016- Rs. 60,000 and 2017 Rs. 75,000.

(b) The decease partner to be given share of profits upto the date of death on the basis of the previous year's profit.

(c) Property, Plant & Equipment were to be depreciated by 10%. A bill for Rs. 5,000 was found to be worthless. These are not to affect goodwill.

(d) A sum of Rs. 44,750 was to be paid immediately, the balance was to remain as a loan with the firm at 9% p.a. as interest.

Black and Red agreed to share profits and losses in future in the ratio of 3:2. They also agreed that goodwill should not continue to appear in the books. Give journal entries and prepare the Statement Of Financial Position of Black and Red.

Solution

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Date	Particular		Debit	Credit
2018				
May 1.	Reserve A/c	Dr.	25,000	
	To, Black's Capital Account			12,500
	To, Pink's Capital Account			7,500
	To, Red' Capital Account			5,000
	(Reserve transferred to Capital Accounts on the death of Pink)			
	Black's Capital Account	Dr.	18,750	
	Red's Capital Account	Dr.	37,500	
	To, Pink's Capital Account			56,250
	(Adjustment for goodwill on the death of Pink on the basis of gaining ratio)			
	Revaluation Account	Dr.	25,000	

	To, Property, Plant & Equipment Account			20,000
	To, Bills Receivable Account			5,000
	(Depreciation of Property, Plant & Equipment @ 10% and writing off of one bill for Rs. 5,000 on Pink's Death)			
	Black's Capital Account	Dr.	12,500	
	Pink's Account	Dr.	7,500	
	Red's Capital Account	Dr.	5,000	
	To, Revaluation Account			25,000
	(Loss on revaluation transferred to capital account)			
	Profit and Loss Suspense Account	Dr.	7,500	
	To, Pink's Capital Account			7,500
	(Pink's share of four months profit based on 2017)			
	Pink's Capital Account	Dr.	138,750	
	To, Pink's Executor's A/c			138,750
	(Amount standing to the credit of pink's Capital Account transferred to the credit of his Executor's Account)			
	Pink's Executors Account	Dr.	44,750	
	To, Bank Account			44,750
	(Amount paid to Pink's Executors)			

Partner's Capital Account

Particulars	Black Rs.	Pink Rs.	Red Rs.	Particulars	Black Rs	Pink Rs.	Red Rs.
To Pink's Capital A/c	18,750		37,500	By balance b/d	1,25,000	75,000	75,000
To Revaluation A/c	12,500	7,500	5,000	By Reserve A/c	12,500	7,500	5,000
To Pink's Executor's A/c		1,38,750		By Black's Capital A/c		18,750	
To Balance C/d	1,18,750		42,500	By Red's Capital A/c		37,500	
				By Profit	12,500	7,500	5,000

				and Loss Suspense A/c			
	1,50,000	**1,46,250**	**85,000**		**1,50,000**	**1,46,250**	**85,000**

Statement Of Financial Position of Black and Red as on 1st May 2018

Liabilities	Rs.	Assets	Rs.
Sundry Creditors	100,000	Property, Plant & Equipment	180,000
Pink's Executor A/c- 9% Loan	94,000	Stocks	80,000
Capital Accounts:		Debtors	50,000
Black	106,250	Bills Receivable	15,000
Red	37,500	Bank	5,250
		PL Suspense A/c	7,500
	337,750		**337,750**

Note: Students are advice to prepare ledger accounts.
Working Notes:

1. Calculation of gaining ratio:
   Black 3/5-5/10 = (6-5)/10 = 1/10
   Red 2/5-2/10 = (4-2)/10 = 2/10
   i.e. 1:2
2. Valuation of Goodwill
   Average profit = Rs.(50,000+65,000+60,000+75,000)/4 = Rs.62,500
   Value of goodwill = Rs.187,500 (3 years' purchase of average profit)
   Pink's Share = 3/10 x Rs187,500 = Rs. 56,250

Contribution to be made by Black on the basis of gaining ratio =RS. 56,250 x1/3 =Rs. 18,750
Contribution to be made by Red on the basis of gaining ratio =RS. 56,250 x2/3 =Rs. 37,500

Illustration 2 :

The partnership agreement of a firm consisting of three partners, A, B and C (who share profits in proportion of 1/2 , 1/4 and 1/4 and whose fixed capital are Rs. 10,000, Rs. 6,000 and Rs. 4,000 respectively) provides as follows:

(a) That partner be allowed interest at 10% p.a. on their fixed capital, but no interest be allowed on undrawn profits of charged on drawings.

(b) That upon the death of a partner, the goodwill of the firm to be valued at two years' purchase of the average net profit (after charging interest on capital) for the three years to 31st December preceding the death of a partner.

(c) That upon the death of a partner, he is to be credited to a Deceased Partner's Executor's A/c as on 31st December following his death.
(d) That the share of profit is to be credited to a deceased partner as on 31st December following his death.
(e) That the partnership books be closed annually on 31st December.

A died on 30th September 2018, the amount standing to the credit of his current account on 31st December, 2017 was Rs. 450 and from that date to the date of death he had withdrawn Rs. 3,000 form the business.

An unrecorded liability of Rs. 2,000 was discovered on 30th September, 2018. It was decided to record it and be immediately paid off.

The trading result of the firm (before charging interest on capital) had been as follows: 2015-Profit Rs. 9,640, 2016 profit Rs. 6,720; 2017 loss Rs. 640; 2018 profit Rs. 3,670.

The Partnership Firm has taken Joint life policy of Rs 10,000 each on lives of all partners. Assuming the surrender value of the policy to be 20 percent of the sum assured. You are required to prepare an account showing the amount due to A's legal representative as on 31st December 2018.

Solution

A's Capital Account

Date	Particular	Rs.	Date	Particular	Rs.
2018			2018		
30-Sep	To, Current A/c (3,000-450)	2,550	1-Jan	By, Balance b/d	10,000
31-Dec	Profit & Loss Adj. A/c (Unrecorded Liability)	1,000	31-Dec	Profit & Loss A/c	
	Balance transferred to A's Executor's A/c	18,525		Interest on Capital	1,000
				Share of Profit	835
				Goodwill	3,240
				Insurance Policies A/c	7,000
		22,075			**22,075**

Working Notes:

(i) Valuation of Goodwill

Year	Profit before interest on fixed capital (Rs.)	Interest Rs.	Profit after Interest (Rs.)
2015	9,640	2,000	7,640
2016	6,720	2,000	4,720
2017	(-) 640	2,000	(-) 2,640
	15,720	6,000	9,720

		Rs.
Average		3,240
Goodwill at two years purchase of average net profit	6,480	
Share of A in the goodwill		3,240
(ii) Profit on Joint Life Policy:		
A's Policy		10,000
B's and C's policy @ 20%		4,000
		14,000
Share of A		7,000
(iii) Share in profit for 2018.		
Profit for the year		3,670
Less: Interest in Capital		2,000
		1,670
A's Share of profit (1/2)		835

(iv) As unrecorded liability of Rs. 2,000 has been charged to Capital Account through profit and loss Adjustment Account on further adjustment in Current year's profit is required.

(v) Profit for 2015, 2016 and 2017 have not been adjusted (for valuing goodwill) for unrecorded liability want of precise information.

Illustration 3 :

Miku, Biku and Thiku are partners sharing profits and losses 4:3:3 respectively. The accounts of the firm are made up to 31st December every year. The partnership provided, inter alia, that:

On the death of a partner the goodwill was to be valued at three years' purchase of average profits of the three years upto to the date of death after deducting interest @ 8 per cent on capital employed and a fair remuneration of each partner. The profits are assumed to be earned evenly throughout the year.

On 30th June, 2018 Miku died and it was agreed on his death to adjust goodwill in the capital accounts without showing any amount of goodwill in the Statement Of Financial Position.

It was agreed for the purpose of valuation of goodwill that the fair remuneration for work done by each partner would be Rs. 18,000 per annum and the capital employed would be Rs. 196,000. Biku and Thiku were to continue the partnership, sharing Profits and losses equally after the death of Miku.

The following were the amounts of profits of earlier years before charging interest on capital employed.

Year	Rs.
2015	87,600
2016	104,800
2017	82,000
2018	48,800

You are required to compute the value of goodwill and show the adjustment thereof in the books of the firm.

Solution

A. Computation of the value of goodwill:

Particular	Rs.	Rs.
(1) Average profit for the three years, ending 30 June , before death:		
Year ending 30th June 2016		
1/2 of 2015 profit	43,800	
1/2 of 2016 profit	52,400	96,200
Year ending 30th June 2017		
1/2 of 2016 profit	52,400	
1/2 of 2017 profit	41,000	93,400
Year ending 30th June 2018		
1/2 of 2017 profit	41,000	
1/2 of 2018 Profit	24,400	65,400
Total		**255,000**
Average Profit earned		85,000
Less: Partners' remuneration	54,000	
Less: 8% on Capital employed	15,680	69,680
Adjusted average profit for valuation of goodwill		**15,320**
Goodwill @ three years' purchase		45,960

B. Adjustment entries for goodwill

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Particular		Debit	Credit
Goodwill Account	Dr.	45,960	
To, Miku's Capital Account			18,384
To, Biku's Capital Account			13,788
To, Thiku's Capital Account			13,788
(Goodwill valued @ Rs. 45,960 adjusted in the capital accounts of partners on the death of Mr. Miku in the old profit sharing ratio)			
Biku's Capital Account	Dr.	22,980	
Thiku's Capital Account	Dr.	22,890	
To, Goodwill Account			45,960

(Goodwill written off between continuing partners in the new profits sharing ratio)		

Illustration 4:

The following was the Statement Of Financial Position of XYZ Ltd in which X, Y and Z were partners sharing profits and losses in the ratio of 1:2:2 as on 31st March 20X3. Mr. Z died on 31st Dec 20X3. His account has to be settled under the following terms:

Statement Of Financial Position as on 31.03.20X3

Liabilities	Rs.	Assets	Rs.
Sundry Creditor	20,000	Goodwill	30,000
Bank Loan	50,000	Building	120,000
General Reserve	30,000	Computers	80,000
Capital Account		Stock	20,000
X	40,000	Sundry Debtors	20,000
Y	80,000	Cash at Bank	20,000
Z	80,000	Investment	10,000
	300,000		**300,000**

Goodwill is to be calculated at the rate of two year's purchase on the basis of average of last three years profit and losses. The profits and losses for the three years were as detailed below:

31.03.20X0 Profit 30,000
31.03.20X1 Profit 22,000
31.03.201X2 Profit 20,000

Profit for the period from 01.04.20X3 to 31.12.20X3 shall be ascertained proportionately on the basis of average profits and losses of the preceding three years.

During the year ending on 31.03.20X2 a car costing Rs 40,000 was purchased on 01.04.20X2 and debited to travelling expenses account on which depreciation is to be calculated at 20% p. a. This asset is to be brought into account at the depreciated value.

Other values of assets were agreed as follows

Stock at Rs 16,000 Building at Rs 140,000, computer at Rs 50,000, investment at Rs 6,000 . Sundry Debtors were considered good. You are asked to prepare partner's capital account and Statement Of Financial Position of the firm as on 31.12.20X3 assuming that other items of assets and liabilities remained the same.

Solution

Partner's capital Account

Particular	X	Y	Z	Particular	X	Y	Z
To, Goodwill a/c	6,000	12,000	12,000	By balance b/d	40,000	80,000	80,000
To, Z loan a/c	-	-	110,080	By General Reserve	6,000	12,000	12,000
To, Z's Capital a/c	6,400	12,800		By X's Capital			6,400

To, Balance c/d	35,440	70,880		By Y's Capital			12,800
				By P & L suspense			7,200
				By, Revaluation A/c	1,840	3,680	3,680
	47,840	95,680	122,080	-	47,840	95,680	122,080

Statement Of Financial Position as on 31.12.20X3

Liabilities	Rs.	Assets	Rs.
Sundry Creditors	20,000	Building (120,000 + 20,000)	140,000
Bank Loan	50,000	computers (80,000-30,000)	50,000
Z's Loan	110,080	Stock (20,000-4,000)	16,000
X's Capital	35,440	car (40,000-8,000-4,800)	27,200
Y'S Capital	70,880	Sundry debtor	20,000
		Cash at bank	20,000
		investment (10,000-4,000)	6,000
		Profit and loss Suspense	7,200
	286,400		286,400

Working Note

i. **Calculation of Book Value of cars as on 01.04.20X3 and 31.12.20X3**

Particular	Rs.
Original cost of car as on 01.04.20X2	40,000
Less: Depreciation at 20% for 20X2	8,000
Book values as on 31.03.20X3	32,000
Less : Depreciaiton at 20% for 9 month	4,800
Book values as on 31.12.20X3	**27,200**

ii. **Calculation of Profit or loss on revaluation**

Revaluation account

Particular	Rs.	Particular	Rs.
To, stock	4,000	By. Building	20,000
To, Computer	30,000	By, car	27,200
To, Investment	4,000		
To, Profit on revaluation transfer to			
X's Capital	1,840		
Y's Capital	3,680		
Z's Capital	3,680		
	47,200		**47,200**

iii. **Average profit** = (30,000+ 22,000 + 20,000) / 3 = 72,000/ 3
= Rs 24,000

iv. Calculation of Z's share of Goodwill

Present value of Goodwill	24,000*2	48,000
Z's Share of Goodwill	48,000 * 2/5	19,200

v. Calculation of Z's share of Profit

Estimated profit from 01.04 to 31.12	24,000 * 9/12	18,000
Z's Share of Profit	18,000 * 2/5	7,200

Summary

On the death of a partner, accounting treatment regarding revaluation of assets and liabilities, transfer of reserve to partners' Capital Accounts, raising the value of goodwill in the books of accounts are same as discussed in case of retirement of a partner. If death takes place during the accounting period, the Executor of the deceased partner is entitled to have a share of profit upto the date of death based on the profit earned in the immediately preceding year or some other agreed basis. For this purpose Profit and Loss Suspense Account is to be created and finally transferred to Statement Of Profit or Loss at the year-end.

Self-Examination Questions

1. The following figures were extracted from the Account Books of Kunal & Co, A partnership firm having partners Mr. Kunal and Mr. Vikram who were sharing profits and losses in equal ratio as on 31st March 2018.

Particular	Debit	Credit
Mr. Kunal's Capital Account		276,000
Mr. Vicar's Capital Account		156,000
Mr. Kunal's Drawings Account	54,000	
Mr. Vikram's Drawings Account	42,000	
Gross Profit		201,600
Salaries	90,000	
Rent, Rates and Taxes	24,000	
Other overheads	24,000	
Discount Received		2,400
Property, Plant & Equipment	390,000	
Current Assets	12,000	
	636,000	**636,000**

The partnership Deed provided that :

(a) Interest at 5% p.a. is to be allowed on capital, but no interest is to be charged on drawings.

(b) On the death of a partner the surviving partners shall pay out the interest of the deceased partners.

(c) The deceased partner, shall be entitled to his share of goodwill of the firm calculated at two and half years' purchase of the average profits of the preceding three years' profit prior to the date of death of a partner.

(d) Assets are to be taken at Book value on the date of death

Mr. Kunal died on 31st March 2018.

The profits of the preceding three years ending 31.12.2015, 31.12.2016 and 31.12.2017 respectively were Rs. 180,000, Rs, 150,000 and Rs. 210,000. The accounts were closed on 31st December each year.

Prepare the Statement Of Profit or Loss to be produced to the Executors of Mr. Kunal showing the amount due to his estate.

2. The Balance Sheet of Aman, Bimal and Chandra as at 31.12.2017 stood as follows:

Liabilities	**Rs.**	**Assets**	**Rs.**
Creditors	25,800	Cash & Bank	10,000
General Reserve	8,900	Debtors 20,000	
Investment Fluctuation Reserve	2,400	Less: Provision 1,600	18,400
Aman's Capital	60,000	Stock	20,000
Bimal's Capital	40,000	Land & Building	74,000
Chandra's Capital	40,000	Investments	10,000
		Goodwill	37,800
		Life Policy (At Surrender Value):	
		Aman's	2,500
		Bimal's	2,500
		Chandra's	1,000
		Advertisement Expenditure	900
	1,77,100		**1,77,100**

Chandra died on 31st March, 2018. For the purpose the following adjustments were agreed upon:

(a) Land and Building to be appreciated to Rs. 1,11,000.

(b) Investment is valued at 6% less than the cost.

(c) All Debtors (except Rs. 4,000 which are considered as doubtful) were good.

(d) Stocks are reduced to Rs. 18,800.

(e) Goodwill is valued at one year's purchased of the average profit of the past five years.

(f) Chandra's share of profit to the date of death to be calculated on the basis of average profits of the three completed years immediately preceding the year of death.

The books showed the profits of the last five years as follows:

2013 Rs. 23,000, 2014 Rs. 28,000, 2015 Rs. 18,000, 2016 Rs. 16,000 and 2017 Rs. 20,000. The life policies have been shown at their surrender values representing 10% of the sum assured in each case. The annual premium of Rs 1,000 is payable every year on 1st August.

Required: Give the necessary journal entries and the balance sheet of the reconstituted firm

THE-END