ACCOUNTANCY
PAPER - II

BLOCKS : III - IV

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PREFACE

This book deals with the topics in "Accountancy" included in the syllabus for the Second Year of the B.Com. course offered by the Andhra Pradesh Open University. These topics generally cover the 'Core' area of the subject to be studied in the Second Year of the three year Degree Course in Commerce. The syllabus is, for the sake of convenience, divided into Blocks, each of which comprises a number of Units. The Units are prepared by Specialists in accordance with a format so designed as to enable the student to read and understand them without much difficulty. Each unit begins with a statement of its objectives followed by unit contents. At the end of each unit, model examination questions are given with an intention to test the student's comprehension of its subject matter. Technical terms with which the student may not be familiar are given at the end of each unit under the head, "Glossary", besides summary of the unit.

Accountancy is the science of measurement of wealth. Accounting, deals with the identifying, measuring, classifying, recording, summarising the transactions and interpreting and reporting the results thereof. This work presents the student the whole range of accounting process, except the interpretation and reporting aspects. The purpose of introducing this course is to ensure that the student on graduating from the University will have acquired adequate familiarity in the matter of recording business transactions and be capable of performing the routine functions of an accountant. With this background the student should be able to understand the underlying principles of accounting and adopt it to different situations, if necessary.

The University hopes that this material will help the student to get acquainted with the concepts, principles and the process of accounting.

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BLOCK - III : FINAL ACCOUNTS

UNIT -12 : CAPITAL AND REVENUE

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12.10 Answers to Check Your Progress
12.11 Model Examination Questions
12.12 Glossary

12.0 AIMS AND OBJECTIVES

The Aims of this unit are to explain the difference between capital and revenue items and their importance in ascertaining the profit and preparation of final accounts.

After studied this unit, you will be able to:

- explain the distinction between capital and revenue
- distinguish between capital expenditure and revenue expenditure
- distinguish between expenditure and payment
- describe the deferred revenue expenditure
- distinguish between capital receipts and revenue receipts.

12.1 INTRODUCTION

As indicated in the previous Unit a Trial Balance is prepared to establish the arithmetical accuracy of the books of account. The next step is to know the results of business activities (i.e., profit or loss) and the financial position of the business. The Trial Balance is merely a list of balances on ledger accounts, so further processing of the information is necessary to know the profit or loss and the financial position. For this purpose, a Profit and Loss Account and a Balance Sheet are prepared. The Profit and Loss Account (also called Income Statement including Trading Account) is prepared to ascertain the profit or loss and the Balance Sheet (also known as position statement) is prepared to know the financial position of the business. The Profit and Loss Account and the Balance Sheet together are called Final Accounts. The Final Accounts are normally prepared at the end of every year.

The various accounting concepts and conventions relating to the preparation of final accounts have already been discussed in Unit 1. You are advised to go through the same again, before proceeding further.

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12.2 CAPITAL AND REVENUE

Such of those transactions the effect of which is exhausted within the accounting year are classified as 'revenue' in nature and a matching of the revenue expenditure with revenue receipts will decide the net result of the business activities. However, when the effect of the transactions continue beyond the accounting year, they are classified as 'capital' in nature, and will be influencing the financial position. Hence, a proper distinction between capital and revenue items is necessary to arrive at the correct results of the business activities.

The various items appearing in the Trial Balance constitute the basis for preparing the Final Accounts. All items of revenue nature (i.e., revenue receipts and revenue expenditure) are transferred to the Profit and Loss Account and all items of capital nature (i.e., capital receipts and capital expenditure) are transferred to the Balance Sheet. Therefore, in order to prepare correctly the final accounts of a business, it is essential that proper distinction be made between capital and revenue.

12.3 CAPITAL EXPENDITURE

Capital expenditure is that expenditure the benefit of which is available for a number of accounting years. The following types of expenditure fall under this category:

1. Expenditure which results in the acquisition of fixed assets which are meant for use in the conduct of business. Thus, the cost of land, buildings, machinery, tools, furniture etc., should be treated as capital expenditure.
2. Expenditure incurred in connection with the acquisition, receipt or installation of fixed assets. For example, legal charges and registration fees paid in connection with the acquisition of land, carriage paid on machinery and wages paid for installing of machinery fall under capital expenditure.
3. Expenditure incurred towards improvement and expanding fixed assets. Any amount spent which tends to improve or extend existing assets so as to increase their revenue earning capacity by increasing production or reducing cost of production is also treated as capital expenditure e.g., additions to buildings, costs of rebuilding old machinery.
4. Development expenses in case of Mines and Plantations are also treated as capital expenditure.

Check Your Progress -1

Give any two examples of capital expenditure.

12.4 REVENUE EXPENDITURE

Revenue expenditure is that expenditure the benefit of which is available only in the year in which it is incurred. The following are the examples of revenue expenditure:

1. Day to day expenses incurred in the conduct and administration of business, e.g., salaries, wages, rent, taxes, insurance, etc.

2. Expenditure for repairs and maintaining fixed assets for their efficient working, e.g. repairs to roof walls of buildings, machinery, etc., This expenditure does not add to the earning capacity helps in maintaining it.
3. Costs incurred towards the purchase of goods for resale and cost of raw material acquired consumption in the course of manufacturing, to the extent they are sold or used up during year, should also be treated as revenue expenditure. The value of unsold goods or material will be treated as asset.
4. Depreciation (reduction in value) of fixed assets and interest on loans borrowed for busine are also treated as revenue expenditure.

Check Your Progress - 2

Give any three examples of revenue expenditure

12.5 EXPENDITURE AND PAYMENT

The difference between expenditure and payment is a point to be noted. Expenditure refers to the amount incurred, whether paid or not ; whereas payment is the amount actually paid. Suppose furnitu is purchased from ZR Co. for Rs.30,000 by paying Rs.15,000 in cash and promising to pay the balan later. The sum of Rs.30,000 is expenditure, but only Rs.15,000 is payment.

12.6 DEFERRED REVENUE EXPENDITURE

Sometimes, heavy expenditure of a revenue nature is incurred in a particular accounting year yields benefit beyond that year. It is called deferred revenue expenditure thus, heavy advertise expenditure incurred when a new product is introduced into the market, Expenses on shifting of premises fall under Deferred Revenue expenditure, etc. It is customary to spread such expendit equitably over the number of years during which the benefit of it is likely to be available.

Check Your Progress-3

What do you understand by "Deferred Revenue Expenditure"?

12.7 CAPITAL RECEIPTS

Amounts received on account of the sale proceeds of fixed assets or on account of capital invested by businessman or on account of loans taken are called capital receipts. Such receipts are not frequ and are usually repayable.

2.8 REVENUE RECEIPTS

Amounts received from sale of goods and services and other amounts received during the course of trading operations (e.g. discount received) are treated as revenue) receipts. Such receipts are more frequent and are not repayable.

Illustration

State, by giving reasons, whether the following items of expenditure are capital or revenue:

Freight paid on goods purchased Rs. 2,500

Cost of pulling down an old building preparatory for constructing a new one Rs. 2,000

Repairs to second hand machinery purchased, Rs. 3,000

Legal expenses incurred in defending a suit for breach of contract to supply goods Rs.1,500

Rs.50,000 spent on the construction of railway siding.

Answer

Rs.2,500 paid towards freight, is revenue expenditure as it has been incurred in connection with the purchase of goods meant for resale.

The cost of pulling down an old building preparatory for constructing a new building Rs.2,000, should be treated as part of the cost of the new building and, should be treated as capital expenditure.

The cost of repairs to second hand machinery purchased Rs.3,000, should be treated as capital expenditure as it is incurred to restore the machinery to working condition.

The legal expenses incurred in defending a suit for breach of contract to supply goods, Rs.1,500 are treated as revenue expenditure because they are incurred in the ordinary course of business.

The amount of Rs.50,000 spent is capital expenditure, as it is the cost of acquiring a fixed asset, viz Railway siding.

2.9 SUMMING UP

The Trading and Profit and Loss Account and the Balance Sheet are collectively called Final Accounts. They are prepared to know the result of business activities and the financial position of the business.

All revenue items are taken to Profit and Loss Account and all capital items to the Balance Sheet. Expenditure, the benefit of which accrues over a long period is called capital expenditure, where as the expenditure whose benefit is exhausted in the same accounting year is called revenue expenditure. Deferred revenue expenditure refers to the expenditure of a revenue nature whose benefit extends beyond the year in which it is incurred. Receipts of a recurring nature are treated as revenue receipts, whereas, receipts which are not recurring are capital receipts.

2.10 ANSWERS TO CHECK YOUR PROGRESS

i) Expenditure resulting in the acquisition of fixed assets, eg., building, machinery, motor car, trade marks, etc.

ii Expenditure in connection with extension or improvement of fixed assets, eg., costs of rebuilding old machinery, etc.

i) Expenses incurred in the normal course of business, eg., administration expenses, selling expenses etc.

ii) Cost of Goods purchased for re-sale.

iii) Depreciation on fixed assets.

3) A heavy expenditure of revenue nature incurred in a particular accounting year which yields benefit beyond that year is called deferred revenue expenditure. The examples of such expenses are : heavy advertisement, preliminary expenses, etc.,

12.11 MODEL EXAMINATION QUESTIONS

A. Short Answer Questions.

1. What are Final Accounts?
2. State the object of preparing final accounts ?
3. What do you mean by deferred revenue expenditure ?
4. Explain the difference between capital and revenue receipts ?

B. Essay Answer Questions

5. Write essays on the following :
   a) Capital expenditure and revenue expenditure
   b) Capital receipts and revenue receipts
   c) Deferred revenue expenditure.

PROBLEMS

1. State which of the following items would be charged to Capital and which to revenues:
   a) Wages of workmen employed for erecting new machinery Rs.100/-
   b) Damages paid on account of the breach of contract to supply goods Rs.2,000
   c) Legal expenses incurred in purchasing land Rs.1,000/-
   d) Rs.4,200/- expended on dismantling, removing and reinstalling plant and machinery.
   e) Replacement cost of a worn-out part of machinery Rs.800

   (Answers: items (b) and (e) are revenue expenditure ; item (d) is deferred revenue expenditure and items (a) and (c) are capital expenditure).

12.12 GLOSSARY

1. Capital Expenditure	:	Capital expenditure is that expenditure the benefit of which accrues for a long period.
2. Capital Receipts	:	Capital receipts are those receipts which are not frequent and which are usually repayable.
3. Deferred Revenue Expenditure	:	It refers to the expenditure of a revenue nature whose benefit extends beyond the year in which it is incurred.
4. Revenue Expenditure	:	Revenue expenditure is that expenditure whose benefit is exhausted in the same accounting year in which it is incurred.
5. Revenue Receipts	:	Revenue receipts are those receipts which are more frequent and which are not repayable to anybody.
6. Final Accounts	:	Final Accounts are the accounts prepared to know the results of business activities and the financial position of the business. The Trading and Profit and Loss Account and the Balance Sheet are collectively called Final Accounts.

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UNIT - 13 : TRADING ACCOUNT AND MANUFACTURING ACCOUNT

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13.8 Form of Manufacturing Account
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13.10 Closing Entries for Trading Account
13.11 Advantages of Trading Account
13.12 Summing Up
13.13 Answers to Check Your Progress
13.14 Model Examination Questions
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13.0 AIMS AND OBJECTIVES

The aim of this unit is to discuss the Trading Account and closing entries required for preparing the Trading Account.

Having studied and worked through this unit you will be able to :

- prepare the Trading Account
- prepare the Manufacturing Account
- identify the difference between Trading Account and Manufacturing Account.

13.1 INTRODUCTION

To ascertain whether the business has been profitable or otherwise (i.e., profit made or loss suffered) the business man will have to prepare a Profit and Loss Account. This Profit and Loss Account is divided into two sections 1) the Trading Account and 2) the Profit and Loss Account. In this unit we will discuss the Trading Account and the closing entries required for preparing the Trading Account.

13.2 TRADING ACCOUNT

As explained in the previous unit that a Profit and Loss Account is prepared to draw the results of business activities i.e., to know whether the enterprise is earning profit or incurring loss. The Profit and Loss Account is usually prepared at the end of each accounting year. All revenue items i.e., expenses and incomes are transferred to the Profit and Loss Account. It is divided into two sections:

1. The Trading Account, and
2. The Profit and Loss Account

The Trading Account indicates the result of business activities gross profit or gross loss. It contains all the items which have direct relation to the goods dealt in by the business. In a trading concern (i.e., a concern dealing with buying and selling of goods) the gross profit or gross loss is ascertained by comparing sale of goods with the cost of goods sold. If the sale proceeds exceed the cost of the goods sold, the difference would indicate gross profit. On the other hand if the cost of the goods sold exceeds sale proceeds the difference would be gross loss.

In the case of a manufacturing concern (i.e., a concern which purchases raw materials and produces finished goods and sells them) sale proceeds are compared with the cost of manufacturing the goods to ascertain the gross profit or gross loss. If the sale proceeds exceed the cost of manufacture the difference would be called gross profit. If, on the other hand, the manufacturing cost exceeds the sale proceeds, the difference is gross loss.

We shall now discuss how the cost of goods sold is calculated.

13.3 COST OF GOODS SOLD

It is necessary to note that it is the 'cost of goods sold' (also called the cost of sale) and not the 'cost of goods purchased' (also known as the cost of purchase) that is considered to ascertain the gross profit or gross loss. 'Cost of goods purchased, includes' besides the actual price paid for the goods, all incidental expenses incurred while making purchases. Such as transport cost, freight, octroi duty, clearing charges, etc., Such expenses are called direct expenses. If all the goods are sold out, no stock is left at the end of the year. In such a case the cost of goods purchased and the cost of goods sold will be the same. If some goods remain unsold at the end of the year the value of such unsold goods (called 'closing stock') is deducted from the cost of goods purchased in order to arrive at the 'cost of goods sold'. The closing stock is usually valued at cost price or market price, which ever is lower. This closing stock becomes the 'opening stock' of the following year. The value of opening stock is added to the cost of goods purchased before adjusting the value of closing stock to ascertain the cost of goods sold.

Illustration 1

From the following figures ascertain the cost of goods sold:

Opening Stock	30,000
Purchases	2,00,000
Direct Expenses	15,000
Closing Stock	35,000

Solution

Opening Stock	30,000
Add: Purchases	2,00,000
Direct Expenses	15,000
	2,45,000
Less: Closing Stock	35,000
	2,10,000

Check Your Progress -1

i) Ascertain cost of goods sold from the following figures.

	Rs.
Purchases	21,500
Opening Stock	10,800
Closing Stock	8,300

---

ii) Ascertain cost of goods sold from the following figures:

	Rs.
Opening Stock	10,800
Purchases	21,500
Indirect Expenses	6,900
Direct Expenses	7,700
Closing Stock	10,000

13.4 FORM OF TRADING ACCOUNT OF A TRADING CONCERN

The following is the form of the Trading Account of Trading concern:

TRADING ACCOUN OF---------- for
(Name of the business or proprietor)

the---------- ended----------
(Period) (Day, Month and Year)

Dr. Cr.

Particulars	Amount	Amount	Particulars	Amount	Amount
	Rs.	Rs.		Rs.	Rs.
To Opening Stock			By Sales		
" Purchases			Less: Sales Returns (if any)		
Less: Purchases Returns (if any)			" Closing Stock		
" Direct Expenses			Gross Loss if any		
Gross Profit					

Note: The two amount columns opened on either side of the Trading Account are referred to as inner column and outer column respectively. The inner column is used for showing details or for additions and subtractions, if any. The outer column is meant for showing the final figures.

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13.5 EXPLANATION OF TRADING ACCOUNT ITEMS

The following is the explanation to the items which appear in the trading account.

13.5.1 Opening Stock

This item refers to the stock of goods unsold at the end of the previous year and brought into the current year for sale. It is usually shown in the Trial Balance.

13.5.2 Purchases

This item refers to the goods which are purchased for resale. Purchases by cash and on credit are debited to Trading Account after deducting if any purchases returns.

Goods taken by the proprietor for his personal use, goods sold to employees at cost price and goods distributed free as samples should not be treated as sales. They should be credited to Purchases Account

It may sometimes happen that goods are received before the end of the year and are included in closing stock but the relevant invoice is not received. In such a case, an entry should be passed debiting Purchases Account. In other words such goods also should be included in purchases. The balance (credit) of the Supplier's Account will be shown as a liability in the Balance Sheet.

Some times it may happen that the invoice is received before the end of the year but not the goods, such goods which remain in transit are called 'goods in transit. In such a case, an entry must be passed debiting Goods in Transit Account, and crediting the Supplier's Account. Such goods should not be included in purchases. The Goods in Transit Account will appear as an asset in the Balance Sheet. The amount due to the supplier will appear as a liability in the Balance Sheet.

13.5.3 Direct Expenses

Direct expenses are those which are incurred to bring the goods for sale. They are treated as part of the cost of goods purchased. Examples of such expenses are freight, marine insurance, carriage, import duty, clearing charges, octroi duty, etc. If some of these expenses have not yet been paid, they should be brought into books by passing appropriate entries for necessary adjustments. This will be discussed in detail in Unit 16.

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13.5.4 Sales

This item refers to sales (both by cash and credit) of the goods which are purchased for resale. Sales are shown on the credit side of the Trading Account after deduction of any sales returns. Sometimes goods are sent to customers on sale or return basis (or 'on approval basis). The customers are given an option either to retain them or to return them within a stipulated period. Such goods should not be treated as sales before the stipulated period. However, the cost of the goods should be included in the closing stock. If, for some reason, any entry was passed treating them as sales, it should be cancelled by passing a reverse entry.

13.5.5 Closing Stock

This item refers to goods remaining unsold at the end of the year. The closing stock must be taken into account to determine the cost of goods sold actually. Every article that is unsold is physically verified and a list of such unsold articles is prepared (This is called stock taking or taking the inventory). Then they are valued at cost price or market price, whichever is lower. The following adjusting entry is passed to bring the closing stock into the books of account:

Closing Stock Account Dr.
To Trading Account
(Being the value of closing stock brought into account)

The closing stock does not appear in the Trial Balance because it is not the balance of any account. It is brought into the books by means of the above entry.

13.5.6 Adjusted Purchases

Some times, purchases are adjusted for opening and closing stocks. In such a case, the opening stock is transferred to Purchases Account and not the Trading Account. The entry required for this purpose is:

Purchases Account Dr.
To Opening Stock Account

The effect of the above entry is that the Opening Stock Account is closed and purchases are increased to the extent of opening stock. The closing stock is brought into the books by means of the following entry:

Closing Stock Account Dr.
To Purchases Account

The effect of the above entry is that purchases are decreased to the extent of closing stock and closing stock is brought into the books of account. The balance of Purchases Account now indicates "Adjusted Purchases". Thus, when the above method is adopted, both adjusted purchases and closing stock will appear in the Trial Balance. (The item Opening Stock does not appear in the Trial Balance as the account has been closed). Then, the Adjusted Purchases will be taken to the debit of the Trading Account and Closing Stock will be shown in the balance sheet as asset. The closing stock will not be shown in the Trading Account as it has already been adjusted in purchases.

13.5.7 Gross Profit/Gross Loss

It is the difference between the total amounts on either side of the Trading Account. If the total of the credit side is greater than the total of the debit side, the difference would indicate gross profit. If on the other hand, the total of the debit side is greater than the total of the credit side, the difference is the gross loss. The profit (or loss) is called gross profit (or gross loss) because some more expenses (administrative expenses, selling expenses, etc.,) have to be deducted, for ascertaining the net profit. It is transferred to the second section i.e., Profit and Loss Account.

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13.6 ALTERNATIVE FORM OF TRADING ACCOUNT

The Trading Account can also be prepared in the following manner:

TRADING ACCOUNT OF ----------

Dr. for the period ended ---------- Cr.

Particulars	Amount	Amount	Particulars	Amount	Amount
	Rs.	Rs.		Rs.	Rs.
To Cost of goods sold		xxx	By Sales (net)		xxx
" Opening Stock	xx		" Gross Loss, if any		xx
Add: Purchases (net)	xx				
Add : Direct Expenses	xx				
	xxx				
Less : Closing Stock	xx	xxx			
To Gross Profit		xx			

Thus,

Purchases during the period	.....
Add : Opening Stock	.....
	.....
Less : Closing Stock	.....
Adjusted purchases	.....

Illustration - 2

The following balances were taken from the books of Ganesh on 31st December, 1989 :

	Rs.
Stock on 1st January 1989	30,000
Purchases	2,00,000
Sales	3,25,000
Purchases Returns	5,000
Sales Returns	7,000
Freight Inwards	12,000
Duty and Clearing Charges	3,000

In addition, the following Information is given :

(a) Stock on 31st December, 1989 was Rs. 25,000

(b) The stock includes goods worth Rs.7,000 for which the relevant invoice has not yet been received and therefore not recorded.

(c) Included in the sales is an amount of Rs.8,000 representing goods sent on sale or return basis, the customers still having the right to return the goods. The goods were invoiced showing a profit of 25% on sales.

Prepare Trading Account for the year ended 31st December, 1989.

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Solution

(1) Goods purchased for Rs.7,000 have not been recorded as the relevant invoice has not yet been received. Therefore, they should be included in purchases.

(2) Goods for Rs.8,000 were sent on sale or return basis and they were recorded as sales. As the customers still have the right to return goods, it is not proper to treat them as sales. Therefore, the sum of Rs.8,000 should be deducted from sales. Further, the goods should be included in closing stock at cost price of Rs.6,000 (i.e. Rs.8,000 less 25% profit).

TRADING ACCOUNT OF GANESH
for the year ended 31st December, 1989

Dr					Cr.
	Rs.	Rs.		Rs.	Rs.
To Opening Stock		30,000	By Sales	3,25,000	
" Purchases	2,00,000		Less: Returns	7,000	
				3,18,000	
Less: Returns	5,000		Less: Goods on Sales or return basis	8,000	3,10,000
	1,95,000				
Add: Unrecorded Purchases	7,000	2,02,000	" Closing Stock	25,000	
" Frieght inwards		12,000	Add: Stock with the customers	6,000	31,000
" Duty and Clearing Charges		3,000			
" Gross Profit (transferred to Profit and Loss A/c		94,000			
		3,41,000			3,41,000

Check Your Progress - 2

Calculate gross profit from the following figures:

Cost of goods sold - Rs. 80,500
Sales - Rs. 1,49,500

13.7 MANUFACTURING ACCOUNT

So far we have discussed the Trading Account applicable to a Trading concern. A Trading concern buys and sells goods whereas a manufacturing concern buys raw material, produces finished goods for sale. Hence, a manufacturing concern has to find out the cost of goods manufactured by it during the year before finding out the gross profit. In such a case an account called Manufacturing Account is prepared to ascertain the cost of manufacturing goods.

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13.8 FORM OF MANUFACTURING ACCOUNT

The following is the form of Manufacturing Account:

MANUFACTURING ACCOUNT OF ----------
for the period ended ----------

Dr. Cr.

Particulars	Amount	Amount	Particulars	Amount	Amount
To Opening work in Progress			By Sale of Scrap		
" Materials consumed			" Closing work-in-Progress		
Opening Stock of Raw Materials					
" Add: Purchase of Raw Materials (net)			" Cost of goods manufactured (transferred to Trading Account)		
" Less : Closing Stock of Raw Materials					
" Carriage on Purchases of Raw Materials					
" Duty and Clearing charges					
" Manufacturing wages (or Direct wages or Productive wages)					
" Motive Power					
" Coal, gas and water					
" Fuel, Heating and lighting					
" Factory Insurance					
" Repairs to plant and Machinery					
" Repairs to factory Building					
" Depreciation on Plant and Machinery					
" Depreciation on Factory Building					
" Other Factory Expenses					
		----------			----------
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After preparing the Manufacturing Account, the Trading Account is prepared to ascertain the gross profit.

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13.9 FORM OF TRADING ACCOUNT OF A MANUFACTURING CONCERN

The following is the form of the Trading Account of a manufacturing concern:

TRADING ACCOUNT OF ----------

Dr. for the period ended---------- Cr.

	Particulars	Amount	Amount	Particulars	Amount	Amount
		Rs.	Rs.		Rs.	Rs.
To	Opening Stock of finished goods			By Sales of finished goods (net)		
"	Cost of goods manufactured (transferred from Manufacturing Account)			" Closing Stock of finished goods		
"	Purchase of finished goods(net) if any					
"	Carriage on purchases of finished goods			" Gross Loss, if any, transferred to Profit & Loss Account		
"	Gross Profit (transferred to Profit and Loss Account)					
			---			---

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The following special points may be noted in this connection.

1. In a trading concern opening and closing stocks generally consist finished goods. In a manufacturing concern the stocks held are of three types: (a) Raw materials which are used in the manufacture of finished goods: (b) Partly finished goods (or semi-manufactured goods or work-in-progress) i.e., goods which are neither raw materials nor completely manufactured goods and in respect of which still some work remains to be done; and (c) Finished goods i.e., goods that are ready for sale. The stock of raw materials and partly finished goods are taken to the Manufacturing Account and the stocks of finished goods are taken to the Trading Account.

2. The item 'Materials Consumed' Is shown separately on the debit side of the Manufacturing Account. This is obtained by adding opening stock of raw materials and purchases of raw materials and then deducting the closing stock of raw materials. Sometimes, only the opening stock of raw materials and purchase of raw materials, are shown on the debit side of the Manufacturing Account and the closing stock of raw materials is shown on the credit side along with the closing work-in-progress.

3. Besides direct expenses like carriage, duty and clearing charges, etc., which are incurred on purchase of raw materials, all expenses incurred in the factory for converting raw materials into

finished goods such as wages, motive power, etc., are debited to Manufacturing Account. Direct expenses on purchase of finished goods, if any, are debited to the Trading Account.

4. The sale proceeds of scrap (waste material which emerges in the course of manufacturing), if any, are credited to the Manufacturing Account. The sale proceeds of finished goods will, of course, be credited to the Trading Account.

5. The Manufacturing account is closed by transferring the balance representing the cost of goods manufactured during the period to the debit side of the Trading Account.

6. The gross profit (or gross loss) revealed by the Trading Account is transferred to the Profit and Loss Account.

7. With regard to the items 'Repairs to Plant and Machinery and Factory Buildings' and 'Depreciation on Plant and Machinery and Factory Buildings, it is necessary to note that these two items are shown in the Manufacturing Account when it is prepared separately. However, sometimes, these two items are taken to the Profit and Loss Account when a question is asked in the examination on the preparation of the 'Trading and Profit and Loss Account' (i.e., when it is not necessary to ascertain the cost of goods manufactured before ascertaining the gross profit).

Illustration - 3

On 31st December, 1989, the following balances appeared in the books of Raman

	Rs.
Balances on 1st January, 1989:	
Raw Materials	15,000
Work-in-Progress	8,000
Finished Goods	25,000
Purchases of Raw Materials	90,000
Freight and Carriage on above	2,500
Manufacturing Wages	48,000
Gas and Water for Factory	2,000
Depreciation on Plant and Machinery	3,000
Repairs to Plant and Machinery	500
Factory Rent	6,000
Sales	2,00,000
Returns Inward	2,000
Returns Outward	2,500
Power Consumed	3,500

Balances on 31st December, 1989 :

Raw Materials	Rs. 12,000
Work-in-progress	Rs. 10,000
Finished goods	Rs. 30,000

Prepare the Manufacturing Account and the Trading Account for the year ended 31st December, 1989.

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Solution

MANUFACTURING ACCOUNT OF RAMAN
for the year ended 31st December, 1989

Dr. Cr.

	Rs.	Rs		Rs.	Rs.
To Work-in-Progress at Commencement		8,000	By Work-in-Progress at Close		10,000
" Materials consumed: Opening Stock	15,000		" Cost of goods manufactured (transferred to Trading Account)		1,54,000
Add: Purchases 90,000					
Less: Returns 2,500	87,500				
	1,02,500				
Less: Closing Stock	12,000				
		90,500			
" Frieght and Carriage		2,500			
" Manufacturing Wages		48,000			
" Power		3,500			
" Gas and Water		2,000			
" Factory Rent		6,000			
" Repairs to Plant and Machinery		500			
" Depreciation on Plant and Machinery		3,000			
		1,64,000			1,64,000

TRADING ACCOUNT OF RAMAN----------
for the year ended 31st December, 1989

Dr. Cr.

	Rs.		Rs.	Rs.
To Opening Stock of finished goods	25,000	By Sales	2,00,000	
		Less: Returns	2,000	1,98,000
" Cost of Goods manufactured	1,54,000	" Closing Stock of Finished goods		30,000
" Gross Profit (transferred to Profit & Loss Account)	49,000			
	2,28,000			2,28,000

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13.10 CLOSING ENTRIES FOR TRADING ACCOUNT

As already stated, the journal entries necessary to transfer the various nominal accounts (revenue items) to the Trading and Profit and Loss Accounts are called closing entries. They are so called because they serve to close these accounts. While transferring the balance of one account to another, the account with a debit balance must be credited and the one with a credit balance must be debited so as to close the accounts thus transferred.

The following are the closing entries in respect of the items that appear in the Trading Account:

1. Purchases Returns Account Dr.
To Purchases Account
(Being the transfer of purchases returns to Purchases Account)

2. Sales Account Dr.
To Sales Returns Account
(Being the transfer of sales returns to Sales Account)

3. Trading Account Dr.
To Opening Stock Account
To Purchases (net) Account
To Expenses Accounts (individually)
(Being the transfer of the above accounts to Trading Account)

4. Sales (net) Account Dr.
To Trading Account
(Being the transfer of Sales Account to Trading Account)

NOTE: Closing stock is not the balance on any account but the value of goods remaining unsold at the end of the year. It is brought into the books by means of an adjusting entry. Hence, there is no closing entry for this item.

5. Now the Trading Account will reveal the gross profit (or gross loss) which will be transferred to the Profit and Loss Account.

Entry for gross profit:
Trading Account Dr.
To Profit & Loss Account
(Being the transfer of gross profit to Profit and Loss Account)

The above entry is reversed for gross loss, if there is any.

Illustration - 4
Give the closing entries relating to items in Illustration 2

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Solution

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			Rs.	Rs.
1989	Purchases Returns Account Dr.		5,000	
Dec. 31	To Purchases Account			5,000
	(Being the transfer of purchases returns to Purchases Account)			
	Sales Account Dr.		7,000	
	To Sales Returns Account			7,000
	(Being the transfer of Sales returns to Sales Account)			
	Trading Account Dr.		2,47,000	
	To Opening Stock Account			30,000
	To Purchases Account			2,02,000
	To Freight Account			12,000
	To Duty and Clearing Charges Account			3,000
	(Being the transfer of the above accounts to Tranding Account)			
	Sales Account Dr.		3,10,000	
	To Trading Account			3,10,000
	(Being the transfer of Sales to Trading Account)			
	Trading Account Dr.		94,000	
	To Profit and Loss Account			94,000
	(Being the transfer of Gross Profit to Profit and Loss Account)			

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13.11 ADVANTAGES OF TRADING ACCOUNT

1. The trader can find out whether the expected gross profit has been realised or not by calculating the percentage of gross profit on the cost of goods sold.

2. A comparison of opening and closing stocks enables the traders to ascertain whether the purchases have been judicious.

3. The Trading Account also helps the trader to know the relationship between the cost and the revenues.

4. It facilitates comparison of sales of one year with those of the previous years.

5. The ratio of gross profit to sales measures the profitability and operating efficiency of the concern. The higher the ratio the better will be the efficiency.

13.12 SUMMING UP

The Trading Account is prepared at the end of the each accounting period with a view to ascertain gross profit (or gross loss). In the case of a trading concern, the debit side of the Trading Account will show the opening stock, purchases less returns and other direct expenses on purchases. The sales less returns and the closing stock are shown on the credit side of the Trading Account. The closing stock is valued at cost price or market price which ever is lower. The credit balance, of the Trading Account represents gross profit and the debit balance, if any, represents gross loss. The balance of the Trading Account (Gross Profit/Gross loss) is transferred to the Profit and Loss Account.

The Manufacturing Account is prepared to ascertain the cost of manufacturing goods. work in progress at commencement, materials consumed, direct charges on purchases and all expenses of manufacture are shown on the debit side of the Manufacturing Account. On the credit side are shown the sale of scrap and work-in-progress at the close. The balance on the Manufacturing Account represents cost of goods produced during the period. It is transferred to the Trading Account.

13.13 ANSWERS TO CHECK YOUR PROGRESS

1. i) Answer Rs. 24,000
   ii) Answer Rs. 30,000

2. Answer Rs. 69,000

13.14. MODEL EXAMINATION QUESTIONS

A. Short Answer Questions

1. What is a Trading Account?
2. What are direct expenses ?
3. What items would you include on the credit side of the Trading Account ?
4. What do you understand by adjusted purchases ?
5. How is the closing stock recorded in the books of account ?
6. What is Gross Profit ?
7. What is a Manufacturing Account ?
8. List the items that are debited to the Trading Account ?
9. Write the closing entries for the Trading Account.

B. Essay Answer Questions.

10. Give the Forms of Manufacturing Account and Trading Account.
11. Give the advantages secured by the preparation of Trading Account.

PROBLEMS

1. Ascertain the cost of goods sold from the following figures :

	Rs
Opening Stock	22,000
Purchases	1,75,000
Carriage Inward	5,000
Closing Stock	25,000
Sales	2,30,000

(Ans: Rs. 1,77,000)

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2. Prepare the Trading Account for the year ended 31st March, 1989 from the following :

Stock on 1st April 1988	25,000
Purchases	1,90,000
Sales	3,10,000
Freight and Carriage	10,500
Octroi Duty	300
Returns Outward	3,000
Returns Inward	2,000

Stock on 31st March, 1989 was Rs. 21,000
Also give the closing entries

(Answer : Gross Profit Rs. 1,06,200)

3. On 31st December, 1989, the following balances appeared in the books of Venkataramana:

	Rs.
Stock on 1st January, 1989 :	
Raw Materials	18,000
Work-in-Progress	9,000
Finished goods	30,000
Purchases of Raw Materials	1,00,000
Carriage on above	2,000
Wages	60,000
Power	4,000
Repairs to Machinery	500
Sales	2,50,000
Depreciation on Machinery	2,500
Depreciation on Factory Buildings	2,000
Factory Insurance	800
Sundry Factory Expenses	1,200
Sale of Scrap	1,500
Stocks on 31st December 1989 were as follows:	
Raw Materials	15,000
Work-in-Progress	10,000
Finished goods	25,000

Prepare the Manufacturing Account.

(Answer :Cost of goods manufactured Rs. 1,73,500; Gross Profit Rs. 71,500)

13.15 GLOSSARY

1.	**Cost of Goods Sold**	:	It is the difference between the cost of goods purchased and the value of unsold goods.
2.	**Trading Account**	:	The Trading Account is the account prepared to find out the gross profit or gross loss.
3.	**Manufacturing Account**	:	The Manufacturing Account is the account prepared to ascertain the cost of manufacturing goods.
4.	**Gross Profit**	:	Gross Profit is the excess of sales over the cost of goods sold.
5.	**Closing Entries**	:	Closing entries are the entries passed to transfer the nominal accounts to the Trading and Profit and Loss Accounts.

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UNIT-14 : PROFIT AND LOSS ACCOUNT

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14.0 AIMS AND OBJECTIVES

This unit aims at discussing the Profit and Loss Account and the closing entries for preparing it.

After studying this unit you will be able to :

- prepare Profit and Loss Account
- write closing entries for Profit and Loss Account

14.1 INTRODUCTION

In the previous unit we dealt with the first section of the Profit and Loss Account viz., the Trading Account. In this unit we shall discuss the second section, viz., Profit and Loss Account, and the closing entries for preparing it.

The Profit and Loss Account is intended to show the net result of business activities i.e., net profit or net

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loss. It is opened with gross profit or gross loss transferred from the Trading Account. The gross profit is shown on the credit side; if the Trading Account has disclosed gross loss, it will be shown on the debit side. All expenses and losses (other than those already debited to the Trading Account) relating to the current accounting period are transferred to the debit side of the Profit and Loss Account. Usually, administrative expenses such as salaries, rent and taxes, printing and stationery, etc., are shown first. Selling and distribution expenses such as advertising, commission, carriage on sales, etc., financial expenses, such as discount allowed, interest paid, and losses such as loss by fire, loss by theft, etc., are shown later. All incomes and gains (other than sales) such as commission, interest and discount received etc., are transferred to the credit side of the Profit and Loss Account. Now, the balance of the Profit and Loss Account represents either net profit or net loss. If the total of the credit side is more than the total of the debit side, the difference will be net profit. It will be shown on the debit side as "To Net Profit transferred to Capital Account." If the total of the debit side is greater than the total of the credit side, the difference would signify net loss. It will be shown on the credit side as "By Net Loss Transferred to Capital Account". The Profit and Loss Account is thus closed by transferring the balance, being either net profit or net loss to the Capital Account of the owner of the business.

14.2 FORM OF PROFIT AND LOSS ACCOUNT

The following is the form of the Profit and Loss Account:

PROFIT AND LOSS ACCOUNT OF ----------

Dr. for the period ended---------- Cr.

Particulars	Amount	Amount	Particulars	Amount	Amount
	Rs.	Rs.		Rs.	Rs.
To Gross Loss, if any			By Gross Profit		
" Salaries			" Commission received		
" Rent, Rates and Taxes			" Interest received		
" Printing and Stationery			" Discount received		
" Postage and Telegrams			" Other Income and gains		
" Legal Expenses			" Net loss, if any,		
" Insurance			(transferred to		
" Lighting			Capital Account)		
" Advertising					
" Commission paid					
" Carriage on sales					
" Travelling Expenses					
" Discount allowed					
" Interest paid					
" Repairs and Renewals					
" Depreciation on assets					
" Loss by fire					
" Loss by theft					
" Other expenses and losses					
" Net Profit (transferred to Capital Account)					

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Notes : (1) In addition to the items shown in the above form, certain other items like provision for Doubtful Debts, Provision for Discounts, Interest on Capital, Interest on Drawings etc., are also shown in the Profit and Loss Account. This is because of certain adjustments that have to be made before preparing the Trading and Profit and Loss Account. We shall discuss them in units 16 and 17.

(2) The Trading Account and Profit and Loss Account may be prepared either separately or in a combined manner. If a combined account is prepared, it will be headed as follows:
"Trading and Profit and Loss Account of ---------- for the period ended ----------"
(name) (date)

14.3 MODERN FORM OF PROFIT AND LOSS ACCOUNT

In the above form, the various revenue items are presented in an account form. The modern practice is to present various details in 'statement form'. The Statement is called an 'Income Statement'. The following is the form of the Income Statement.

INCOME STATEMENT OF ----------
for the period ended----------

Particulars	Amount	Amount	Amount
	Rs.	Rs.	Rs.
Sales			...
Less: Sales Returns			...
			...
Less: Cost of goods sold:			
Opening Stock		...	
Add: Purchases	...		
Less: Purchases Returns	...		
Direct Expenses	...		
		...	
Less: Closing Stock		...	
Gross Profit			...
Less: Administrative Expenses:			
Salaries	...		
Rent, Rates and Taxes, etc.,	...	...	
	...		
Selling Expenses			
Advertising	...		
Commission paid etc.	...	...	
	...		...
Net Income from Operations			...
Add: Other Incomes:			
Interest earned;	...		
Commission earned, etc.	...		
	...		
Less: Other Deductions:			
Loss by fire		...	
		...	
			...
Net Income			...

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14.4 SOME IMPORTANT POINTS

The following points need to be carefully noted while preparing the Trading and Profit and Loss Account:

14.4.1 **Wages and Salaries**: We have seen that the item wages is taken to the debit of the Trading Account (being a manufacturing expense) and the item 'salaries' to the debit of the Profit and Loss Account (being an administrative expense). Here it is necessary to note that the treatment of these two items when given as a combined item. When salaries paid to those working in the factory are clubbed with wages, the two items may be given as a combined item as 'wages and salaries'. This combined item will be taken to the debit of the Trading Account. Similarly, wages paid to non-factory workers are added to salaries in which case the combined item may be given as 'salaries and wages'. This item will be taken to the debit of the Profit and Loss Account.

14.4.2 **Unproductive or Non productive Wages**: Wages paid to those who are not concerned with manufacturing work are called unproductive or non-productive wages. They should be taken to the debit of the Profit and Loss Account.

14.4.3 **Wages for installing machinery or for making furniture or for construction of buildings:** This is a capital expenditure and therefore, should not be taken to the Trading Account. It should be added to the cost of the asset concerned. If such wages have been debited to wages account, the same must be cancelled by passing an entry debiting the relevant asset account and crediting wages account. That is, the amount must be deducted from wages in the Trading Account and added to the asset account in the Balance Sheet.

14.4.4 **Carriage**: It may be a direct expense or a selling expense. When it is paid on goods purchased, it becomes a direct expense and, therefore, it is shown in the Trading Account. Carriage paid on purchases is also known as carriage inward or carriage in or carriage. Carriage paid on sales is a selling expense and, therefore, is charged to the Profit and Loss Account. It is also called carriage outward or carriage out.

14.4.5 **Consumable Stores**: This item represents engine oil, cottonwaste etc. The value of stores actually consumed is transferred to the debit of the Trading Account (or Manufacturing Account) and the value of Stores on hand is shown as an asset in the Balance Sheet.

14.4.6 **Royalties**: The term 'Royalty' means the payment made for the use of certain classes of property which belongs to others, such as the right to extract coal from land. Such payments are made either on the basis of output or on the basis of sales. When royalties are paid on the basis of output, they are transferred to the debit of the Trading Account (being a direct expense). when they are paid on the basis of sales, they are shown in the Profit and Loss Account (being a selling expense). If the problem does not clearly state the basis, the student is advised to charge it to the Trading Account appending a note to that effect.

14.4.7 **Packing Charges**: Packing charges are shown in the Profit and Loss Account as they are related to sales. If, however, special packing is essential to bring the goods to a saleable condition, the charges are transferred to the Trading Account.

14.4.8 **Insurance**: This item refers to the premiums paid against fire and marine risks, payment made towards insurance on the transport of goods purchased and on factory buildings and machinery are treated as direct expenses and are shown in the Trading Account (or Manufacturing Account). Insurance on office building and furniture is taken to the Profit and Loss Account. When it is given merely as insurance in the problem, it is customary to show it in the Profit and Loss Account.

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14.4.9 **Trade Expenses and Office Expenses:** Usually, no distinction is drawn between these two terms. They represent all the sundry and small expenses incurred in the course of the business. They are, therefore, shown in the Profit and Loss Account. If, however, the Trial Balance contains both the terms 'Trade Expenses' and 'Office Expenses' (or Sundry Expenses or Miscellaneous Expenses or General Expenses), the former will be charged to the Trading Account (on the assumption that they cover manufacturing expenses) and the latter to the Profit and Loss Account.

14.4.10 **Samples:** Generally, samples of goods are purchased and distributed free to increase sales. In such a case, the cost of the samples distributed is charged to the Profit and Loss Account (being a selling expense). Closing stock of samples, if any, is shown as an asset in the Balance Sheet.

14.4.11. **Apprentice Premium:** This item refers to the premium collected from apprentices (persons who are given training in the business). It is treated as an income and is taken to the credit of the Profit and Loss Account. Some times, Premium is paid to the apprentices (called stipend), in which case it becomes an expense and is debited to the Profit and Loss Account.

14.4.12. **Income Tax:** Income Tax paid by a sole trader on the Profits of his business should be treated as a personal expense and charged to the Drawings Account. If it is given as a separate item in the problem, it should be deducted from capital.

14.5 CLOSING ENTRIES FOR PROFIT AND LOSS ACCOUNT

We have already seen that closing entries are passed at the end of each year where by the various nominal accounts are transferred to the Trading and Profit and Loss Account. We have already discussed in Unit 13 the entries necessary for preparing the Trading Account. We shall now discuss the closing entries with regard to the items that appear in the Profit and Loss Account.

1. Profit and Loss A/c. Dr.
   To Expenses and Losses Accounts (Individually)
   (Being the transfer of the above accounts to the profit and loss account)

2. Incomes and Gains Accounts Dr. (Individually)
   To Profit and Loss Account
   (Being the transfer of above accounts to Profit and Loss Account)

3. Now, the Profit and Loss Account will reveal the net profit (or net loss) which will be transferred to the Capital Account of the proprietor.

   Entry for net profit :

   Profit and Loss Account Dr.
   To Capital Account
   (Being the transfer of net profit to Capital Account)

   Entry for net loss :

   Capital Account Dr.
   To Profit and Loss Account
   (Being the transfer of net loss to Capital Account)

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14.6 CLOSING OF DRAWINGS ACCOUNT

It has been said already that two accounts are maintained in the name of the proprietor of the business for recording the amount of capital contributed by him and the sums withdrawn by him for personal use. They are Capital Account and Drawings Account. At the end of each year, the Drawings Account is closed by transferring it to the Capital Account. The entry is

Capital Account Dr.
To Drawings Account
(Being the transfer of Drawings Account to Capital Account)

Usually, the items, Capital and Drawings are given as two separate items in the Trial Balance. In such a case, the item Drawings is shown by way of deduction from Capital Account on the Liabilities side of the balance sheet.

Illustration

From the following balances of R. Ratnakar prepare the Trading and Profit and Loss Account for the year ended 31st December, 1989. Pass the necessary closing entries.

	Rs.
Stock at Commencement	15,000
Salaries	24,000
Sundry Expenses	1,800
Rent and Taxes	3,000
Purchases	92,000
Freight Inward	2,500
Advertising	1,500
Sales	1,85,800
Discount Allowed	1,200
Discount Received	1,000

The closing stock was valued at Rs.18,500.

Solution

TRADING AND PROFIT AND LOSS ACCOUNT OF R.RATNAKAR
for the year ended 31st December, 1989

Dr.	Rs.		Cr. Rs.
To Stock at commencement	15,000	By Sales	1,85,800
" Purchases	92,000	" Closing Stock	18,500
" Freight Inward	2,500		
" Gross Profit c/d	94,800		
	2,04,300		2,04,300
To Salaries	24,000	By Gross Profit b/d	94,800
" Rent and Taxes	3,000	" Discount Received	1,000
" Sundry Expenses	1,800		
" Advertising	1,500		
" Discount Allowed	1,200		
" Net Profit (transferred to Capital A/c)	64,300		
	95,800		95,800

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CLOSING ENTRIES

Date	Particulars		L.F	Debit	Credit
				Rs.	Rs.
1989 Dec.31	Trading Account	Dr.		1,09,500	
	To Opening Stock A/c				15,000
	To Purchases A/c				92,000
	To Freight Inward A/c				2,500
	(Being the transfer of the above accounts to Trading Account)				
	Sales A/c	Dr.		1,85,800	
	To Trading Account				1,85,800
	(Being the transfer of Sales to Trading Account)				
	Profit and Loss Account	Dr.		31,500	
	To Salaries A/c				24,000
	To Rent and Taxes A/c				3,000
	To Sundry Expenses A/c				1,800
	To Advertising A/c				1,500
	To Discount Allowed A/c.				1,200
	(Being the transfer of the above items to Profit and Loss Account)				
	Discount Received A/c	Dr.		1,000	
	To Profit and Loss Account				1,000
	(Being the transfer of Discount received to Profit and Loss Account)				
	Porfit and Loss Account	Dr.		64,300	
	To Capital A/c				64,300
	(Being the transfer of Net Profit to Capital Account)				

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Check Your Progress - 1

Calculate net profit from the following figures.

Gross Profit	Rs. 80,000
Sales	Rs. 1,30,500
Sundry Expenses	Rs. 60,500

Check Your Progress - 2

From the following information ascertain gross profit and net profit.

	Rs.
Opening Stock	20,500
Purchases	45,000
Carriage in	500
Sales	65,500
Indirect Expenses	6,500
Returns Outwards	1,000

Returns Inwards	.....	500
Closing Stock	.....	30,500

14.7 SUMMING UP

The Profit and Loss Account is prepared to find out the net profit or net loss. The gross profit brought from the Trading Account is shown on the credit side of the Profit and Loss Account. (The Gross Loss is shown on the debit side). All expenses and losses, other than those already debited to Trading Account and all incomes and gains, other than sales, are shown on the credit side.

The balance of the Profit and Loss Account represents net profit (credit balance) or net loss (debit balance). It is transferred to the Capital Account.

Modern practice is to prepare the Trading and Profit & Loss Account in a vertical form.

14.8 ANSWERS TO CHECK YOUR PROGRESS

1. Answer - Rs.19,500

2. Answers : Gross Profit Rs. 30,500
   Net Profit Rs. 24,000

14.9 MODEL EXAMINATION QUESTIONS

A. Short Answer Questions

1. What is Profit and Loss Account ?
2. What is net profit ?
3. Give the form of Profit and Loss Account.

B. Essay Answer Questions

4. Write the closing entries for the Profit and Loss Account.

PROBLEMS

1. The following particulars relate to Mr. Sanjeev Enterprises for the year 1987. Prepare Trading and Profit and Loss Account.

Stock on 1-1-87	3,900	Office Expenses	275
Purchases	6,425	Sales	15,800
Discount allowed	90	Salaries	347
Carriage	248	Repairs	215
Freight	45	Wages	2,840
Discount received	85	Commission earned	50

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Returns outwards 200

(Answer : Gross Profit Rs. 2,242, Net profit Rs. 1,750)

2. From the particulars given below prepare the Trading and Profit and Loss Account of Mr. Ramakrishna for the year ended 31st March, 1987

Opening Stock	Rs. 2,720	Discounts received	Rs. 627
Capital	18,000	Postage	132
Sales	19,439	Insurance	119
Returns (Cr.)	1,200	Commision earned	390
Wages	1,510	Interest received	60
Returns (Dr.)	1,000	Depreciation on assets	600
Carriage	400		
Purchases	10,492		
Salaries	1,400		
Freight	120		

(Answer : Gross Profit Rs. 4,397, Net Profit Rs. 3,223.)

14.10 GLOSSARY

1. **Profit and Loss Account** : Profit and Loss Account is the account prepared to find out the net profit or net loss.

2. **Net Profit** : It is the excess of total revenues over the total expenses of the business.

3. **Net Loss** : It is the excess of total expenses over the total revenues of the business.

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UNIT–15 : BALANCE SHEET

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15. 0 AIMS AND OBJECTIVES

This unit aims at discussing the Balance Sheet which reveals the financial position of the business. Having studied this unit you will be able to:

— prepare Balance Sheet
— classify the assets and liabilities

15. 1 INTRODUCTION

The Trading and Profit and Loss Account enables a businessman to determine the net result of his business activities during a certain period. He should know not only this information but also the financial position of his business. In other words, he is anxious to know the various sources of funds which are used to carry out the business operations and how these funds are represented. Therefore, after preparing the Trading and Profit and Loss Account the businessman proceeds to prepare a statement called the 'Balance Sheet' in order to derive this additional information. It is also known as 'Position Statement' as it reveals the financial position of the business. A Balance Sheet may, therefore, be difined as a statement showing the financial position of a business on a certain date. It shows what a business owns and what it owes.

We have seen earlier that all the accounts relating to the trading goods, viz., Opening Stock, Purchases and Sales, along with all the nominal accounts are shown in the Trading and Profit and Loss Account in order to ascertain the net profit or net loss. The net profit/net loss is transferred to the Capital Account of the proprietor. The accounts now left in the Trial Balance are either personal accounts or real accounts. They represent either assets or liabilities existing on the last day of accounting period. All such assets and liabilities along with capital are shown in the Balance Sheet in a classified manner.

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The Balance Sheet is vertically divided into two parts. The left-hand side is called 'Liabilities' side and the right-hand side is called 'Assets' side. It is customary to show capital and liabilities on the left-hand side and the various assets on the right hand side. The Balance Sheet also includes certain other items like deferred revenue expenditure. A point to note here is that the Balance Sheet is nothing but a detailed presentation of the accounting equation (which you have learnt in the beginning) viz., Capital + Liabilities = Assets. Since the assets owned by the business equal the liabilities (including capital) owed by the business, the two sides of the Balance Sheet tally.

Another point to note is that the Balance Sheet is not an account in the ledger. But it is a statement which shows the financial position on a particular date (i.e. at a certain point of time) because even a single transaction will affect the assets and/liabilities. That is the reason why the Balance Sheet is headed as Balance Sheet as on (a particular date) and not for the period ended.

15.2 CLASSIFICATION OF ASSETS AND LIABILITIES

Assets can be divided into various kinds according to their nature.

15.2.1. Fixed Assets :These are assets of a permanent nature and are used in conducting the business. They are acquired for earning revenue and not for resale. Examples of this kind are : land, buildings, plant and machinery, vehicles, furniture, etc. Fixed assets of a business are sometimes collectively called 'Block'. The term 'Gross Block' refers to fixed assets stated at their original cost, While 'Net Block' means the gross block minus the total depreciation written off.

15. 2. 2. Intangible Assets : Intangible assets are those fixed assets which can not be seen or felt or touched e.g., good will (value of business reputations), patents, copyrights, etc., These assets have value although they do not have any physical form.

15. 2. 3. Wasting Assets: Wasting assets are those fixed assets which get exhausted and lose their value as a result of extraction of their contents such as mines, oil-wells etc.

15. 2. 4. Current Assets :These are assets which are expected to be realised in cash or sold or consumed during the normal course of business. Stock of goods, Book Debts (amounts due from customers), Bills Receivable, etc. are examples of current assets, They are also called 'Floating' Assets, since they frequently change according to business activities.

15. 2. 5. Liquid Assets: Liquid assets are those current assets which exist in the form of cash or which can be readily converted into cash, such as cash in hand, cash at Bank, government securities, etc.

15. 2. 6. Fictitious Assets :Losses not written off or non - recoverable costs or obsolete assets are called fictitious assets. Formation expenses of a company, etc. are examples.

The liabilities of a business may be classified into (i) Liabilities to proprietor (or internal liabilities) and (ii) Liabilities to outsiders (or external liabilities). The former refers to proprietor's equity in the form of capital and reserves (accumulated profits), if any. The latter refers to outsiders' equity. e.g., amounts due to suppliers of goods, Bank loan, expenses payable, etc.

Liabilities to outsiders may be sub-divided into long-term liabilities and short-term liabilities. Long-term liabilities, also called fixed liabilities, are those liabilities which are payable after a long period of time such as Debentures (issued by companies), loan on mortgage of properties etc. Short-term liabilities are liabilities that are payable immediately or in the near future, usually within one year. They are also called current liabilities and are normally paid from current assets. These include creditors for goods and services, bills payable, etc.

Liabilities which may arise in future due to the occurance of certain events are called contingent liabilities.

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They are shown by way of foot notes to the Balance Sheet as they have not actually become liabilities as on date. For instance liability in respect of a pending suit against the business (it becomes an actual liability only when the judgement of the court goes against the business), guarantee to a bank for loan advanced to a third party (it becomes an actual liability only when the third party fails to repay the loan), becomes a contingent liability at a later date.

15.3 MARSHALLING OF ASSETS AND LIABILITIES IN THE BALANCE SHEET

The items in the Balance Sheet should be arranged in a proper order. The arrangement of the assets and liabilities in the Balance Sheet is called "Marshalling". The assets may be arranged in order of either (a) Liquidity, or (b) Permanence. In the former case, the most liquid asset is shown at the top and the least liquid asset is shown at the bottom. In other words the assets which are already in the form of cash or which can be readily converted into cash are mentioned first and those which are most difficult to convert into cash are mentioned in the last.

In the case of order of permanence, the above order is reversed, that is, assets which are meant to be used permanently are shown first and those which are most temporary are shown in the last.

The various assets, when arranged according to the two orders as explained above would appear as follows :

(a)	**Order of Liquidity**	(b)	**Order of Permanence**
	Cash in Hand		Goodwill
	Cash at Bank		Land and Buildings
	Bills Receivable		Plant and Machinery
	Sundry Debtors		Furniture
	Stock of Goods		Stock of Goods
	Furniture		Sundry Debtors
	Plant and Machinery		Bills Receivable
	Land and Buildings		Cash at Bank
	Goodwill		Cash in Hand

Similarly, liabilities can be arranged in two ways from the view point of urgency of payment. (a) order of dischargeability, and (b) order of permanence. In the former case, short-term liabilities are mentioned first and long term liabilities are mentioned in the last. In other words, liabilities are shown in the order in which the payment has to be made according to time. In the case of order of permanence, long-term labilities are shown first and short term liabilities are shown next.

The following are the lists of liabilities, when arranged according to the above two orders :

(a)	**Order of Dischargeability**	(b)	**Order of Permanence**
	Bills payable		Capital
	Creditors		Reserves
	Loans		Loans
	Reserves		Creditors
	Capital		Bills Payable

Check Your Progress – 1

i) Re arrange the following current assets in order of liquidity :

a)	Cash in hand :	b)	Investments :
c)	Cash at Bank :	d)	Prepaid Advertising :
e)	Debtors :	f)	Stock in Trade :

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ii) Identify the following as either current assets, intangible assets or current liabilities.

a)	Cash,	b)	Goodwill,
c)	Trade mark,	d)	Patent rights,
e)	Bills Receivable,	f)	Bills Payable,
g)	Prepaid Advertising,	h)	Accrued Wages and Salaries payable.

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15. 4 FORM OF BALANCE SHEET

The following is the form of the Balance Sheet :

BALANCE SHEET OF ——————
(Name)

as on ——————
(Day, Month and Year)

Liabilities	Rs.	Rs.	Assets	Rs.	Rs.
Bills Payable Sundry Creditors (or creditors on open accounts) Loans Reserve Capital : Opening Balance Add : Net Profit for the period Less : Drawings			Current Assets : Cash in hand Cash at Bank Bills Receivable Sundry Debtors (or Book Debts) Closing Stock Fixed Assets : Motor Vehicles Patents and Trade Marks Furniture and Fittings Loose Tools Plants and Buildings Good Will		

Note : In the above form the assets have been arranged in the order of liquidity and the liabilities in the order of dischargeability. This order is usually followed by sole trading concerns and partnership firms. The reverse order i.e., the order of permanence, can also be followed to present the assets and liabilities. But, companies have to follow the order of permanence only.

15.5 MODERN FORM OF BALANCE SHEET

In the above form, the assets and liabilities appear horizontally. The modern tendency is to present them vertically. The following is the modern form of presenting assets and liabilities :

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BALANCE SHEET OF ---------- as on ----------
(Name) (Day, Month and year)

Current Assets :			
Cash		...	
Bank		...	
Marketable Securities		...	
Bills Receivable		...	
Accrued Income		...	
Trade Debtors		...	
Inventories		...	
Supplies		...	
Pre-Payments		...	...
Less: Current Liabilities :			
Bills Payable		...	
Accrued Expenses		...	
Trade Creditors		...	
Bank Overdraft		...	
Estimated Income-tax on firm (if any)		...	
Deferred Income		...	
Total Current Liabilities		...	...
Net Working Capital			...
Fixed Assets :			
Vehicles		...	
Patents		...	
Furniture and Fittings		...	
Long-term Investment (in securities)		...	
Plant and Machinery		...	
Leaseholds		...	
Buildings		...	
Land		...	
Goodwill		...	
		...	...
Total Fixed Assets			...
Capital Employed (both owner's and outsiders')			
Less: Long–term Liabilities :			
Loans (unmortgaged)		...	
Fixed Deposits		...	
Mortgages		...	...
			...
Net Assets			
Derived From :			
Capital (proprietors)		...	
Reserves		...	...
Proprietorship			

Illustration

From the following Balance of Ramdas, prepare the Trading and Profit and Loss Account for the year ended 31st December, 1989 and Balance Sheet as on that date.

Trial Balance as on 31st December, 1989	Rs.	Rs.
Capital ----------		1,28,500
Stock, 1st January, 1989 ----------	25,000	

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Purchases	1,30,500	
Sales		2,45,000
Returns in and Out	3,000	2,000
Bills Receivable and Payable	50,000	6,000
Carriage in	7,500	
Plant and Machinery		60,000
Office Furniture	3,500	
Sundry Debtors and Creditors	70,000	46,000
Coal, Gas and Water	1,500	
Wages	12,500	
Duty and Clearing Charges	1,500	
Office Rent	4,800	
Printing and Stationery	1,000	
Insurance	400	
Carriage Out	6,200	
Salaries	27,000	
Factory Rent	2,400	
Electricity and Telephone	1,200	
Bank Charges	90	
Drawings	12,000	
Cash in hand	1,610	
Cash at Bank	5,800	
	4,27,500	4,27,500

The Closing Stock was valued at Rs. 50,000

Solution

TRADING AND PROFIT AND LOSS ACCOUNT OF RAMDAS
for the year ended 31st December, 1989.

Dr. Cr.

	Rs.	Rs.		Rs.	Rs.
To Opening Stock		25,000	By Sales	2,45,000	
" Purchases	1,30,500		Less : Returns inwards	3,000	2,42,000
" Less : Returns Outwards	2,000	1,28,500	" Closing Stock		50,000
" Carriage in		7,500			
" Duty and Clearing charges		1,500			
" Wages		12,500			
" Coal, Gas and Water		1,500			
" Factory Rent		2,400			
" Gross Profit c/d		1,13,100			
		2,92,000			2,92,000
			By Gross Profit b/d		1,13,100
To Salaries		27,000			
" Office Rent		4,800			
" Printing and Stationery		1,000			
" Insurance		400			
" Electricity and Telephone		1,200			
" Bank charges		90			
" Carriage Out		6,200			
" Net Profit (transferred to Capital Account)		72,410			
		1,13,100			1,13,100

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BALANCE SHEET OF RAMDAS
as on 31st December 1989

Liabilities	Rs.	Rs.	Assets	Rs.	Rs.
Bills Payable		6,000	Current Assets :		
Sundry Creditors		46,000	Cash in hand		1,610
Capital :			Cash at Bank		5,800
Balance on 1st Jan. 1989	1,28,500		Bills Receivable		50,000
Add : Net Profit			Sundry Debtors		70,000
for the year	72,410		Closing Stock		50,000
	2,00,910		Fixed Assets :		
Less : Drawings	12,000		Office Furniture		3,500
		1,88,910	Plant and Machinery		60,000
		2,40,910			2,40,910

15.6 SUMMING UP

The Balance Sheet shows the financial position of a concern on a certain date. The various assets are shown on the right-hand side of the Balance Sheet and the liabilities and capital on the left-hand side. The two sides of Balance Sheet must always tally.

Assets are classified into i) Fixed Assets ; ii) Intangible assets ; iii) Wasting assets ; iv) Current assets ; v) Liquid assets and ; vi) Fictitious assets. Liabilities are classified into i) Internal Liabilities and ii) External liabilities. External liabilities are subdivided into a) Long term liabilities and b) Short - term liabilities. Liabilities which may arise in the future on the occurance of a certain event are called contingent liabilities.

The assets may be arranged in the Balance Sheet in order of either a) liquidity, or b) permanence. And the liabilities may be arranged in order of either a) dischargeability or b) permanence. The modern practice is to present assets and liabilities in the vertical form.

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15.7 ANSWERS TO CHECK YOUR PROGRESS

1. i) Order of Liquidity :
   Cash
   Cash at Bank
   Investments
   Debtors
   Stock in Trade
   Pre-paid Advertising

   ii) Current Assets :
   Cash
   Bills Receivable
   Pre-paid Advertising

Current Liabilities :
- Bills Payable
- Accrued wages and Salaries payable

Intangible Assets :
- Good will
- Trade Marks
- Patent Rights.

15.8 MODEL EXAMINATION QUESTIONS

A. Short Answer Questions

1. What is Balance Sheet ?
2. Why is a Balance Sheet prepared ?
3. Distinguish between long term and short term liabilities.
4. Give the form of Balance Sheet.

B. Essay Answer Questions

5. What are the different methods of arranging the assets and liabilities in the balance sheet.

Problems

1. From the following information draw up a Balance Sheet of M/s. Devi Enterprises as on 30th June, 1989 presenting the assets in the order of i) liquidity and ii) permanence.

	Rs.		Rs.
Cash in hand	100	Cash at bank	1,000
Bills receivable	2,000	Bills Payable	1,600
Sundry Creditors	4,000	Sundry Debtors	10,000
Closing Stock	5,000	Bank Loan	5,000
Capital	25,000	Drawings	5,000
Investments	6,000	Net Profit	14,000
Land & Building	20,000	Furniture	500

(Answer : Balance Sheet Rs.44,600)

2. From the following information, draw up the balance sheet of Reddy Traders as on 31st December, 1989.

	Rs.		Rs.
Capital	18,000	Bills payable	1,160
Cash in hand	620	Sundry Creditors	3,570
Stock (31-12-89)	4,650	Sundry Debtors	3,820
Furniture	2,100	Drawings	1,050
Cash at Bank	3,900		
Building	3,809		
Bills receivable	2,790		

(Answer : Balance Sheet Rs.21,680)

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15.9 GLOSSARY

1.	**Balance Sheet**	:	Balance Sheet is the statement prepared to assess the financial position of concern on a certain date.
2.	**Block**	:	It is the collective name for the fixed assets of a business.
3.	**Contingent Liabilities**	:	Thses are liabilities which may arise in future on the occurance of a certain event.
4.	**Current Assets**	:	These are assets which are expected to be realised in cash or sold or consumed during the normal course of the business.
5.	**Current Liabilities**	:	These are liabilities that are payable immediately or in the near future.
6.	**Fictitious Assets**	:	These are valueless assets or not written off expenses and losses.
7.	**Fixed Assets**	:	Fixed assets are assets which are used in the conduct of the business.
8.	**Fixed Liabilities**	:	These are liabilities that are payable after a long period of time, i.e., more than one year.
9.	**Intangible assets**	:	Intangible assets are those fixed assets which cannot be felt or seen or touched, e.g., good will
10.	**Liquid Assets**	:	Liquid assets are those current assets which are already in the form of cash or which can be readily converted into cash.
11.	**Marshalling**	:	Marshalling is the order in which the assets and liabilities are arranged in the Balance Sheet.
12.	**Wasting Assets**	:	Wasting assets are those fixed assets that get exhausted or lose their value as a result of extraction of their contents.

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UNIT - 16 : ADJUSTMENTS - 1

Contents

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16.12 Answers to Check Your Progress
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16.0 AIMS AND OBJECTIVES

The aim of this unit is to discuss about the adjustments pertaining to outstanding expenses, outstanding income, prepaid expenses and income received in advance. Further it presents relating to bad debts, provision for doubtful debts, and provision for discounts.

On having studied and worked through this unit you would be able to:

- make the above adjustments in final accounts.
- pass required adjustment entries for the above adjustments.

16.1 INTRODUCTION

In the previous three units you have become familiar with the method of preparing the final accounts of a concern. The next two units dwell upon the adjustments that have to be made in final accounts. In the absence of adjustment entries, the profit or loss shown by the final accounts is not true. Hence, in order to arrive at the true profit or loss of a concern, it is essential to make concerned adjustments in final accounts. In this unit the adjustments pertaining to outstanding expenses, out standing income, pre-paid expenses, income received in advance, bad bebts, provision for doubtful debts and provision for discounts on debtors and creditors are discussed in detail. Entries passed for adjusting all these accounts are called "adjustment entries".

In practice, the Trial Balance is prepared after making all the adjustments. in the examination, however, the student is asked to prepare the final accounts from a given Trial Balance which has been prepared before making the adjustments (at least some, if not all). The adjustments to be made are stated outside the Trial Balance. In case some adjustments appear in the Trial Balance, it indicates that the amounts have already been adjusted.

We shall now discuss aforesaid adjustments in detail.

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16.2 OUTSTANDING EXPENSES

Expenses remaining unpaid at the end of the accounting period are called outstanding expenses or expenses accrued due. It is usual to pay certain expenses like salaries, wages, etc., of each month in the next month. Suppose a concern closes its books on 31st December. Salaries, Wages, etc., for the month of December will not appear in the books for the period ended 31st December as they have not been paid in that month. Yet, they should be shown in the Trading and Profit and Loss Account for the period ended 31st December since they have been incurred, that is to say, their benefit has been already received, and they belong to that accounting period. For this purpose, the following adjustment entry is made :

Concerned Expense Account Dr.
To Outstanding Expense Account
(Being the outstanding expense)

In this connection it is necessary to note the difference between the two expressions outstanding expense' and 'accruing expense'. An expense that has fallen due in the current accounting period but has not yet been paid is called 'outstanding expense'. An expense that relates to the current accounting period but is due and will be paid in the next accounting period is called 'accruing expense' (also called expense accrued). Suppose interest at 10% p.a. is payable quarterly on a loan of Rs.60,000 borrowed on 1st August and the date of closing the books of account is 31st December. Then, interest of Rs. 1,500 for the quarter ended 31st October will be outstanding ; and that of Rs.1,000 for the two months ending 31st December will be accruing interest, in case nothing is paid upto 31st December

The adjustment for an accruing expense is made by means of the following entry :

Concerned Expense Account Dr.
To Expense Accuring but not Due Account
(Being the expense accruing but not due)

Treatment in the Final Accounts

Every adjustment (given outside the Trial Balance) will be shown at two places in the final accounts in order to complete the double entry. In the case of outstanding or accruing expense, it will be shown, in the first instance, on the debit side of the Trading Account or the Profit and Loss Account, as the case may be, by way of addition to the concerned expense (as it relates to the current period). It will also appear on the liabilities side (as the amount remains payable) of the Balance Sheet as a separate item.

Illustration 1

A trader, on balancing his books on 31st December 1989, found that the salary amounting to Rs.2,000 for the month of December has not been paid. The salary paid in the year was Rs.22,000. Pass the required adjustment entry and show how the ledger accounts would appear after the adjustment. Also show how the outstanding salary will appear in the final accounts.

Solution

The following is the adjustment entry for bringing into account the outstanding salary for the month of December, 1989.

			Rs.	Rs.
1989 Dec 3	Salaries Account Dr. To Outstanding Salaries Account (Being the outstanding salary for the month of December, 1989)		2,000	2,000

The effect of the above adjustment is that the Salaries Account will not contain the total salaries (paid and outstanding) for the year and the fact that there is a liability in respect of the salary for the month of December is brought into the books. The ledger accounts, after this adjustment, will appear as follows :

Dr. SALARIES ACCOUNT Cr.

	To Cash		22,000	1989 Dec. 31	By Profit and Loss A/c (Transfer)		24,000
1989 Dec.31	To Outstanding Salaries Account		2,000				
			24,000				24,000

Dr. OUTSTANDING SALARIES ACCOUNT Cr.

			Rs.				Rs.
1989 Dec.31	To Balance c/d		2,000	1989 Dec.31	By Salaries A/c		2,000

The figure of the outstanding salaries will appear in the final accounts as follows :

(1) Profit and Loss Account debit side by way of addition to the salaries already paid (given in the Trial Balance).

Dr. PROFIT AND LOSS ACCOUNT Cr.

	Rs.	Rs.		Rs.	Rs.
To Salaries	22,000				
Add: Outstanding	2,000				
		24,000			

2) Balance Sheet liabilities side as a separate item

BALANCE SHEET

Liabilities	Rs.	Rs.	Assets	Rs.	Rs.
Outstanding Salary		2,000			

The balancing of Outstanding Salaries Account will be carried forward. In the beginning of the next accounting year, this account will be closed by debiting it and crediting the Salaries Account. The treatment shown above is similar for all outstanding expenses.

Check Your Progress - 1

Pass the adjustment entry for the following :

i) Salary amounting to Rs.3,000 for the month of December has not been paid.

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16.3 OUTSTANDING INCOME

Like expenses due but not paid there may be incomes due but not received. Such incomes earned during the current accounting period but not received during that period are called outstanding incomes outstanding income is also called income accrued due or income earned but not yet received. Suppose a businessman has invested a sum of Rs.10,000 at 6 percent per annum in Government Securities on 1st January, 1989 on which interest is receivable half yearly and his books are closed on 31st December each year. If we assume that the interest due on 30th June, 1989 has been received, and the interest due on 31st December, 1989 has not been received then, the interest due on 31 Dec. 1989 is called 'outstanding interest'. The outstanding interest must be brought in before the preparation of Final Accounts so that the entire income relating to the current period may be shown in the accounts.

The required adjustment entry for outstanding income is :

Outstanding Income Account Dr.
To Concerned Income Account
(Being the Outstanding Income)

Similarly, an income that relates to the current accounting period but would be due and received in the next accounting period must be brought into account. It is called accruing income' or 'income accruing but not due'. The entry required for this purpose is :

Income Accruing but not Due Account Dr.
To Concerned Income Account
(Being the income accruing but not due)

Treatment in the Final Accounts

The figure of the outstanding or accruing income will be shown (1) on the credit side of the Profit and Loss Account by way of addition (as it relates to the current period) to the income concerned and (2) on the assets side (because it is receivable) of the Balance Sheet as a separate item.

Illustration 2

Interest received during the year 1989 was Rs.300 and outstanding interest at the end of the year was Rs.300. Pass the required adjustment entry and show the position of the accounts after the adjustment. Also show how the outstanding interest will appear in the final accounts.

Solution

The adjustment entry required for bringing into account the outstanding interest will be:

1989				Rs.	Rs.
Dec.31	Outstanding Interest Account	Dr.		300	
	To Interest Account				300
	(Being the outstanding interest)				

The effect of the above adjustment is that the Interest Account will now show the interest actually received and the interest outstanding. The fact that interest outstanding is also brought into account. The item interest outstanding is an asset to the business.

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The position of the concerned accounts will be as follows:

Dr. INTEREST ACCOUNT Cr.

1989			Rs.	1989			Rs.
Dec.31	To Profit and Loss A/c		600	Dec. 31	By Cash		300
					" Outstanding Interest A/c		300
			600				600

Dr. OUTSTANDING INTEREST ACCOU NT Cr.

1989			Rs.	1989			Rs.
Dec.31	To Interest A/c		300	Dec.31	By Balance c/d		300

The item outstanding interest will be shown in the final accounts in the following way :

1) Profit and Loss Account credit side by way of addition to the interest already received.

Dr. PROFIT AND LOSS ACCOUNT Cr.

	Rs.	Rs.		Rs.	Rs.
			By Interest	300	
			Add : Outstanding	300	
					600

2. Balance Sheet Assets side as a separate item.

BALANCE SHEET

	Rs.	Rs.		Rs.	Rs.
			Outstanding Interest		300

The Balance of outstanding Interest Account will be carried forward. This account will be closed by transfer to Interest Account in the beginning of the next year by passing a reverse entry. The treatment shown above is to be followed in respect of all outstanding incomes.

Check Your Progress - 2

Pass the required adjustment entry for the following :
i) Interest to be received for the year was Rs.1,000

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16.4 PREPAID EXPENSES

Sometimes, the benefit of expenses like insurance premium` rates, etc. paid in the current period extends beyond that period. Such an expense the benefit of which is yet to be received is called prepaid or unexpired expenses. In such a case, the expense accounts concerned should be adjusted so that the proportionate amount relating to the current period only may be charged to the Profit and Loss Account. The prepaid expense is treated as an asset. Suppose accounts are closed on 31st December and Insurance premium of Rs.1,200 is paid on 1st April, 1989 for the following one year. The premium for the first nine months (Rs.900) i.e. from 1st April , 1989 to 31st December, 1989 belongs to the current year and the premium for the remaining three months (Rs.300) i.e. from 1st January,1990 to 31st March,1990 belongs the next accounting year. The premium paid for the 3 months should, therefore, be treated as prepaid and should not be shown in the Profit and Loss Account of the current year.

The adjustment for prepaid expense will be made by passing the following journal entry :

Prepaid Expense Account Dr.
To Concerned Expense Account
(Being the adjustment of prepaid expense)

Treatment in the final Accounts

The amount of the prepaid expense will be shown (1) on the debit side of the Trading Account or the Profit and Loss Account by way of deduction (since it relates to the next period) from the expenses concerned and (2) on the asset side of the Balance Sheet as a separate item (It is an asset in as much as it represents a pre-payment in respect of which some benefit has yet to be received).

Illustration - 3

On 31st October, 1989, a sum of Rs.600 had been paid as premium towards a fire insurance policy for the year ended 31st September, 1990. The books of the business are closed on 31st December every year. Show what adjustment would be necessary on 31st December, 1989, and how the ledger accounts would be after the adjustment. Also show how the prepaid insurance will appear in final accounts.

Solution

Insurance premium for nine months (1st January, 1989 to 30th September, 1989) amounting to Rs.450 has been paid in advance and consequently this amount will have to be treated as prepaid. The adjustment will be made by passing the following journal entry :

1988 Dec.31	Prepaid insurance Account Dr. To Insurance Account (Being the adjustments of prepaid insurance)	Rs. 450.	Rs. 450

The effect of the above adjustment is that the amount of insurance premium is reduced to the extent of unexpired portion. The same stands debited to a new account called prepaid insurance account which will be shown as an asset in the Balance Sheet.

The account, after the adjustment, will be as follows :

PROOF

Dr. INSURANCE ACCOUNT Cr.

1988		Rs.	1988		Rs.
Oct.1	To Cash A/c	600	Dec.31	By Prepaid Insurance A/c	450
			"	" Profit and Loss A/c	150
		600			600

Dr. PREPAID INSURANCE ACCOUNT Cr.

1988		Rs.	1988		Rs.
Dec.31	To Insurance A/c	450	Dec.31	By Balance c/d	450

The prepaid insurance will appear in the final accounts as follows :
1) Profit and Loss Account debit side by way of deduction from the item Insurance given in the Trial Balance.

Dr. PROFIT AND LOSS ACCOUNT Cr.

	Rs.	Rs.		Rs.	Rs.
To Insurance	600				
Less: Prepaid	450				
		150			

2) Balance Sheet Asset side as a separate item

BALANCE SHEET

	Rs.	Rs.		Rs.	Rs.
			Prepaid Insurance		450

The Prepaid Insurance Account will be transferred to the insurance Account of the next year by passing a reverse entry.

The treatment shown above is to be followed in respect of all prepaid expenses.

Check Your Progress - 3

Pass adjustment entry for the following :

i) Rent for 3 months amounting to Rs.1500 has been paid in advance.

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16.5 INCOME RECEIVED IN ADVANCE

Sometimes, the entire amount of a certain income received during a particular period may not belong to that period as a portion of that relates to the next period. Such a portion is known as unearned or enexpired income. The same cannot be shown as income in the Profit and Loss Account for the period as the service in respect of that income is yet to be rendered. Suppose a businessman has let out a part of his building on 1st July, 1989 at an annual rent of Rs.6,000 payable in advance. If he closes his accounts on 31st December the rent for the first six months (1st July 1989 to 31st December 1989) only has been earned and the balance has been received in advance. Therefore, on 31st December, 1989 Rs.3,000 is unearned income. This unearned income cannot be treated as income for the current period and has to be adjusted.

The adjustment for unearned income is made by passing the following journal entry :

Concerned Income Account Dr
To Income Received in Advance Account
(Being the adjustment of income received in advance)

Treatment in the Final Accounts

The unearned income will be shown in the final accounts as follows :

(1) Profit and Loss Account credit side by way of deduction (as it does not belong to the current period) from the income concerned.

(2) Balance Sheet liabilities side (as the service in respect of the unearned income has not been rendered) as a separate item.

Illustration - 4

Rent received in 1989 was Rs.6,000 which includes Rs.3,000 for the following year. Pass the required adjusting entry and prepare the necessary accounts. Also show how the pre-received rent will be shown in the final accounts.

Solution

The adjustment for the unearned rent of Rs.3,000 will be made by means of the following journal entry:

			Rs.	Rs.
1989 Dec.31	Rent Account Dr. To Rent Received in Advance Account (Being the adjustment entry for rent received in advance)		3,000	3,000

The effect of the above entry is that the amount of rent is reduced to the extent of unexpired portion. The same amount stands credited to a new account called Rent Received in Advance Account which will appear as a liability in the Balance Sheet.

The ledger accounts will appear as follows :

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Dr. RENT ACCOUNT Cr.

1989		Rs.	1989		Rs.
Dec.31	To Rent Received in Adv. A/c	3,000	Dec.31	By Cash A/c	6,000
	" Profit & Loss A/c	3,000			
		6,000			6,000

Dr. RENT RECEIVED IN ADVANCE ACCOUNT Cr.

1989		Rs.	1989		Rs.
Dec.31	To Balance c/d	3,000	Dec.31	By Rent A/c	3,000

The amount of rent received in advance will be shown in the final accounts as follows :

1) Profit and Loss Account credit side by way of deduction from the item rent given in the Trial Balance.

Dr. PROFIT AND LOSS ACCOUNT Cr.

	Rs.	Rs.		Rs.	Rs.
			By Rent	6,000	
			Less : Received in Advance	3,000	
					3,000

2) Balance Sheet Liabilities side as a separate item

BALANCE SHEET

	Rs.	Rs.		Rs.	Rs.
Rent Received in Advance		3,000			

The Rent received in advance account will be transferred to the Rent Account by passing a reverse entry in the next year.

Similar treatment is to be given in case of all other pre-received incomes.

Check Your Progress - 4

Pass the required entry for the following :

i) Interest received in advance for the year was Rs.2,000/-

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16.6 BAD DEBTS

When a credit sale is made the buyer becomes a debtor and his personal account is debited with the amount of the transaction. Subsequently, when the debtor pays the amount promptly on the due date, the debt is settled and his personal account is closed. Sometimes, the debt due from a particular customer may not be recovered (usually due to insolvency). Such a debt which cannot be recovered is called' a bad debt'. It is a loss to the business. As there is no hope of recovering it in future the debtor's personal account has to be closed and the fact that it has become a loss has to be recorded. Otherwise the profit shown by the Profit and Loss Account and the sundry debtors (i.e., debts due from various customers in respect of credit sales made) shown by the Balance Sheet will be incorrect. The bad debt is written off by making the following entry :

Bad Debts Account	Dr.
To Debtor's Account	
(Being bad debt written off)	

The effect of the above entry is that the debtor's personal account is closed and the loss is debited to Bad Debts Account which is a nominal account. If the entry is passed during the accounting period, the Bad Debts Account will be included in the Trial Balance (along with other items) and the figure of Sundry Debtors in the Trial Balance will represent the reduced amount of debts. In such a case, the Bad Debts Account will be transferred to the Profit and Loss Account by making the following closing entry.

Profit and Loss Account	Dr.
To Bad Debts Account	
(Being the transfer of bad debts	
to Profit and Loss Account)	

The item 'Sundry Debtors' will be shown on the assets side of the Balance Sheet.

If the Trial Balance has been extracted before writing off bad debts, it will be mentioned outside the Trial Balance as one of the adjustments. In such a case, it is necessary to pass the entry for bad debts and to consider the effect of the entry at the time of preparing the final accounts. Such bad debts now written off will be shown in the final accounts in the following way :

1) Profit and Loss Account debit side as a separate item.

Dr. PROFIT AND LOSS ACCOUNT Cr.

	Rs.	Rs.		Rs.	Rs.
To Bad Debts (already written off)		.....			
Add : Further Bad Debts written off		.....			

ii) Balance Sheet Asset side by way of deduction from Sundry Debtors

BALANCE SHEET

	Rs.	Rs.		Rs.	Rs.
			Sundry Debtors		
			Less : Bad Debts (now written off)		

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Notes

i) It is necessary to note the difference in the treatment between the bad debts mentioned in the Trial Balance (i.e., bad debts already written off during the accounting period) and the bad debts mentioned outside the Trial Balance in the adjustments. The bad debts mentioned in the Trial Balance should not be deducted from Sundry Debtors in the Balance Sheet, as the figure of Sundry Debtors stands already reduced. The bad debts stated in the adjustments have to be deducted from Sundry Debtors in the Balance Sheet as the amounts due from some of those debtors are now written off. However, both the bad debts should be shown in the Profit and Loss Account.

ii) The above treatment (in the Profit and Loss Account) for bad debts is to be followed when the Provision for Doubtful debts does not exist in the books. The treatment of bad debts when such a provision exists will be discussed later.

iii) Sometimes, a debt which has been written off as bad may be recovered (wholly or partly) later. In such a case, the customer's account should not be credited as it has already been closed. The amount received will be debited to Cash Account and will be credited to Bad Debts Recovered Account. This is a gain to the business and is transferred to the credit of the Profit and Loss Account.

Check Your Progress - 5

Pass the required entry for the following :

i) Out of sundry debtors which stood at Rs.50,000, Rs.2,000 had to be written off as bad debts.

ii) Transfer the above bad debts account to Profit & Loss Account

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16.7 PROVISION FOR DOUBTFUL DEBTS

At the end of a trading period, a businessman may find that the recovery of some debts is doubtful due to the fact that there is likelihood of a debtor becoming insolvent or that a debtor has already been declared insolvent and only a part of the bedt is likely to be recovered from him. Such debts are called doubtful debts (likely bad debts). In order to meet such an anticipated loss, a suitable provision is made at the end of the current trading period. This is known as provision for doubtful debts or provision for bad debts. The provision is made by means of the following entry :

Profit and Loss Account		Dr.
To Provision for Doubtful Debts Account		
(Being the Provision for doubtful debts)		

Usually, a fixed percentage of the total debtors' balances outstanding (i.e., total book debts minus actual bad debts) at the end of the trading period is taken as the amount of the provision for doubtful debts.

There are two reasons for making the provision for doubtful debts in the current period even though the business has not actually suffered any loss in that period. Firstly, loss due to bad debts (actual or estimated) results from credit sales made. Such a loss, therefore, relates to the period in which the sales are made and should be charged to the profit and loss account of that period. Secondly, the sundry debtors must be shown in the Balance Sheet at their expected realisable value. Consequently, if the recovery of some debts is doubtdul, it will be incorrect to show the debtors at their book value without deducting the expected loss.

The provision for doubtful debts is shown in the final accounts as follows :

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(1) Profit and Loss Account debit side as a separate item.

Dr.	PROFIT AND LOSS ACCOUNT				Cr.
	Rs.	Rs.		Rs.	Rs.
To Provision for Doubtful Debts					

ii) Balance Sheet asset side as a deduction from Sundry Debtors.

BALANCE SHEET

	Rs.	Rs.		Rs.	Rs.
			Sundry Debtors Less : Provision for Doubtful Debts		

The balance of the provision for Doubtful Debts Account will be carried forward to the next period.

Check Your Progress - 6

What is the adjustment entry for provision for doubtful debts ?

16.8 TREATMENT OF BAD DEBTS ACCOUNT AND PROVISION FOR DOUBTFUL DEBTS ACCOUNT

We have learnt that bad debts should be transferred to the debit of Profit and Loss Account when the provision for doubtful debts does not exist in the books. We shall now discuss the treatment when both 'Bad Debts' and 'Provision for Doubtful Debts' are given together.

1. When Provision for Doubtful Debts is made for the first time at the end of a particular trading period.

In this case, it will be stated in the adjustments that a provision should be made for doubtful debts. The following procedure should be adopted while making the provision :

(a) The bad debts stated in the adjustments should be written off by means of the following entry :

Bad Debts Account Dr.
To Sundry Debtors A/c
(Being bad debts written off)

(b) The Bad Debts Account (showing the bad debts mentioned both inside and outside the Trial Balance) is then transferred to the Profit and Loss Account by means of the following closing entry :

Profit and Loss Account Dr.
To Bad Debts Account
(Being the transfer of bad debts to Profit and Loss Account)

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(c) The provision for doubtful debts is now calculated on the sundry debtors after deducting the bad debts mentioned outside the Trial Balance in the adjustments. The following entry is passed for creating the provision :

Profit and Loss Account Dr.
To Provision for Doubtful Debts Account
(Being the provision made for doubtful debts)

The items 'Bad Debts and, provision for Doubtful Debts, will be shown in the final accounts in the following way :

(1) (i) Profit and Loss Account Debit side :

Dr. PROFIT AND LOSS ACCOUNT Cr.

	Rs.	Rs.		Rs.	Rs.
To Bad Debts	.....				
Add: Further Bad Debts	.....	.....			
To Provision for Doubtful Debts		.....			

(ii) Balance sheet Asset side :

BALANCE SHEET

	Rs.	Rs.		Rs.	Rs.
			Sundry Debtors		.....
			Less: Bad Debts (mentioned in the adjustments)	....	
			Less: Provision for Doubtful Debts	....	....

2. When the balance of Provision for Doubtful Debts Account from the Previous period is given in the Trial Balance and when the provision is necessary for the current period also.

We have learnt that the provision made in a particular trading period will be carried forward to the next period. Thus when the provision exists the actual bad debts written off during the current year should be transferred to the provision for Doubtful Debts Account (as the provision is meant for meeting such a loss) and not the the Profit and Loss Account. The provision will then be made for the current year.

The following steps are necessary when both the provisions (i.e., 'old' provision brought from the previous period and 'new' provision for the current year) are given in the problem :

(a) The bad debts mentioned in the adjustments should be written off by means of the following entry:

Bad Debts Account Dr.
To Sundry Debtors A/c
(Being bad debts written off)

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(b) The bad debts (stated both inside and outside the Trial Balance) should be transferred to the Provision for Doubtful Debts Account. The entry required for this purpose is :

Provision for Doubtful Debts Account Dr.
To Bad Debts Account
(Being the transfer of bad debts to Provision
for Doubtful Debts Account)

(c) Now, find out whether the old provision (appearing on the credit side of the Provision for Doubtful Debts Account) is sufficient to meet the loss due to bad debts (appearing on the debit side of the Provision for Doubtful Debts Account) or not. In case the Loss due to bad debts is more than the old provision, the excess loss should be debited to the Profit and Loss Account. The amount of new provision to be made will also be debited to the profit and Loss Account. The following entry is passed with the total of the excess loss and the new provision required :

Profit and Loss Account Dr.
To Provision for Doubtful Debts A/c
(Being the additional provision made)

If, on the other hand, the old provision is more than the loss due to bad debts, the surplus is compared with the new provision and adjustment is made in the Profit and Loss Account for the difference. In case the surplus is less than the new provision, the difference between the two should be debited to the Profit and Loss Account by means of the above entry. When the surplus is more than the new provision required, the excess amount (i.e., the amount by which the surplus exceeds the new provision) should be credited to the Profit and Loss Account. The entry for this will be :

Provision for Doubtful Debts Account Dr
To Profit and Loss Account
(Being the transfer of surplus provision
for doubtful debts to Profit and Loss Account)

A summary of the above points relaing to the treatment of bad debts and provision for doubtful debts is given below :

i) Ascertain the actual loss due to bad debts
(i.e., the total of bad debts given both inside and outside the Trial Balance)
ii) Calculate the new provision for doubtful debts as mentioned in the adjustments (i.e., the provision required for expected loss).
iii) Add (i) and (ii) and compare the resultant figure of the total loss with the old provision for doubtful debts. (The old provision appears in the Trial Balance).
iv) (a) If the total loss is more than the old provision, the difference between the two should be debited to the Profit and Loss Account in the following way :

Dr. PROFIT AND LOSS ACCOUNT Cr.

	Rs.	Rs.		Rs.	Rs.
To Provision for doubtful debts :					
Provision required (New)	.....				
Add: Bad Debts					
(total bad debts)	.....				

	.....				
Less : Existing					
Provision (old)	.....	.....			

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(b) If the total loss is less than the old provision, the difference between the two should be credited to the Profit and Loss Account in the following way :

Dr. PROFIT AND LOSS ACCOUNT Cr.

	Rs.	Rs.		Rs.	Rs.
			By Provision for Doubtful Debts :		
			Existing Provision (old)	.....	
			Less : Bad Debts..		
			(total bad debts)		
			Less:Provision required		
			(new)	.....	.....

It is necessary to note that only the new provision for doubtful debts (along with the bad debts stated in the adjustments) should be deducted from the Sundry Debtors in the Balance Sheet and not the amount shown in the Profit and Loss Account.

BALANCE SHEET

	Rs.	Rs.		Rs.	Rs.
			Sundry debtors		.....
			Less : Bad Debts		
			(mentioned in the		
			adjustments)	.....	

			Less:Provision for		
			doubtful debts (new)	.....	.....

Illustration - 5

The Provision for Doubtful Debts stood at Rs.1,800 on 1st January, 1988. During the year the bad debts amounted to Rs.500. On 31st December, 1988 the Debtors stood at Rs.41,000 out of which Rs.1,000 had to be written off as bad debts and it is required to make a provision for dobtful debts at 5% on debtors. On 31st December, 1989 the Debtors were Rs.26,400 out of which Rs. 400 had to be written off as bad debts. The concern desired to continue to make a provision for doubtful debts to the extent of 5% on the debtors.

Give Journal entries and show the Bad Debts Account and the Provision for Doubtful Debts Account for 1988 and 1989. Show also how these items will appear in the Profit and Loss Account and the Balance Sheet of each year.

Solution

JOURNAL

			Rs.	Rs.
1988				
Dec.31	Bad Debts Account Dr.		1,000	
	To Sundry Debtors			1,000
	(Being bad debts written off)			
"	Provision for Doubtful Debts A/c Dr.		1,500	
	To Bad Debts Account			1,500
	(Being the transfer of bad debts to Provision for D.D)			
"	Profit and Loss Account Dr.		1,700	
	To Provision for Doubtful Debts Account			1,700
	(Being the amount required for the creation of provision for the coming year.)			

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1989 Dec.31	Bad Debts Account Dr.		400	
	To Sundry Debtors Account			400
	(Being bad debts written off)			
"	Provision for Doubtful Debts A/c Dr.		400	
	To Bad Debts Account			400
	(Being the transfer of bad debts to provision for D D)			
"	Provision for Doubtful Debts A/c Dr.		300	
	To Profit and Loss Account			300
	(Being the transfer of surplus provision to Profit and Loss Account)			

LEDGER

Dr. BAD DEBTS ACCOUNT Cr.

1988			Rs.	1988			Rs.
Dec.31	To Sundry Debtors		500	Dec.31	By Provision for Doubtful Debts Account		1,500
	To Sundry Debtors		1,000				
			1,500				1,500
1989							
Dec.31	To Sundry Debtors		400		By Provision for Doubtful Debts Account		400

Dr. PROVISION FOR DOUBTFUL DEBTS A/C Cr.

1988			Rs.	1988			Rs.
Dec.31	To Bad Debts Account		1,500	Jan.1	By Balance b/d		1,800
" "	To Balance c/d		2,000		By Profit and Loss A/c		1,700
			3,500				3,500
1989	To Bad Debts Account		400		By Balance b/d		2,000
Dec.31	To Profit and Loss A/c		300				
" "	To Balance c/d		1,300				
			2,000				2,000
				1990			
				Jan.1	By Balance b/d		1,300

PROFIT AND LOSS ACCOUNT

Dr. for the year ended 31st December 1988 Cr.

	Rs.	Rs.		Rs.	Rs.
To Provision for doubtful Debts :					
Provision required	2,000				
Add : Bad Debts	1,500				
	3,500				
Less: Existing Provision	1,800				
		1,700			

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BALANCE SHEET
as on 31st December 1988

	Rs.	Rs.		Rs.	Rs.
			Sundry Debtors	41,000	
			Less: Bad Debts	1,000	
				40,000	
			Less: Provision for Doubtful Debts	2,000	
					38,000

PROFIT AND LOSS ACCOUNT
for the year 31st December, 1989

Dr. Cr.

	Rs.	Rs.		Rs.	Rs.
			By Provision for Doubtful Debts : Existing Provision	2,000	
			Less: Bad Debts 400 Provision Required 1300	1,700	
					300

BALANCE SHEET
as on 31st December 1989

	Rs.	Rs.		Rs.	R
			Sundry Debtors	26,400	
			Less : Bad Debts	400	
				26,000	
			Less : Provision for Doubtful Debts	1,300	
					24,700

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16.9 PROVISION FOR DISCOUNT ON DEBTORS

When credit sales are made, the businessman usually offers cash discount to his debtors. He allows the discount when cash is promptly received from them. The discount allowed during the accounting period is recorded in the Cash Book and posted to the credit side of the debtor's personal accounts. At the end of the accounting period, the businessman estimates the amount of discounts which may have to be allowed to the debtors outstanding on prompt payment of their debts in the course of the subsequent period and makes a provision for the same. Such a provision is called the provision for Discount on Debtors. The amount of discounts allowable is usually calculated by way of a percentage on the amount of the debtors outstanding after deducting the provision for doubtful debts. Then, the necessary provision is made by means of the following entry :

Profit and Loss Account Dr.
To Provision for Discount on Debtors A/c
(Being the provision made for discounts on debtors)

Since the discount is allowable in respect of credit sales made during the current period, it is treated as loss for the current period and debited to the Profit and Loss Account. But, it should not be credited to the debtors' personal accounts as it has not yet been allowed to them.

The provision for discount will be shown in the final accounts in the following way :

i) Profit and Loss Account debit side as a separate item.

Dr. PROFIT AND LOSS ACCOUNT Cr.

	Rs.	Rs.		Rs.	Rs.
To Provision for Discount on Debtors		.....			

ii) Balance Sheet asset side by way of deduction from Sundry Debtors.

BALANCE SHEET

	Rs.	Rs.		Rs.	Rs.
			Sundry Debtors	.....	
			Less : Provision for discount on debtors	.....	
				-----	.....

The provision for discount on debtor$ will be carried forward to the next period. In the next period the method of dealing with discounts allowed and provision for discount on debtors will be similar to the followed in case of bad debts and provision for bad debts.

Check Your Progress - 7

What is the adjustment entry, for "provision for discount on debtors" ?

.....

.....

.....

16.10 PROVISION FOR DISCOUNT ON CREDITORS

Just as discount is allowed to debtors for prompt payment, discount is received from creditors for prompt payment made to them. The discount received during the accounting period is recorded in the Cash Book and posted therefrom to the debit of the creditors' personal accounts. At the end of the accounting period, the businessman may like to create a provision for discounts receivable from creditors in the next period in the same manner as in the case of provision for discount on debtors. This is done by means of the following entry :

Provision for Discount on Creditors Account Dr.
To Profit and Loss Account
(Being the provision made for discounts on creditors)

The provision for discount will be ascertained by way of a percentage on the amount of creditors balances outstanding at the end of the trading period. It will be shown in the final accounts in the following manner :

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i) Profit and Loss Account credit side as a separate item.

Dr. PROFIT AND LOSS ACCOUNT Cr.

	Rs.	Rs.		Rs.	Rs.
			By Provision for Discount on Creditors		.....

ii) Balance Sheet liabilities side as a deduction from Sundry Creditors.

BALANCE SHEET

	Rs.	Rs.		Rs.	Rs.
Sundry Creditors	.....				
Less : Provision for Discount on Creditors	.....	.....			

The provision for discount on creditors will be carried forward to the next period. Discounts received in the next period will be set off against the existing provision.

Check Your Progress - 8

i) What is the required adjustment entry for "Provision for discount on creditors"?

ii) Classify the following under personal, real and nominal accounts.

a) Trading account ; b) Profit and Loss Account
c) Reserve for doubtful debts
d) Reserve for discount on debtors
e) Unexpired insurance account
f) Discount account
g) Purchases account ; h) Sales account
i) Bills receivable account.

16.11 SUMMING UP

While preparing the final accounts certain additions and subtractions have to be made to arrive at the true profit for the period. These are called adjustments. In this unit adjustments pertaining to outstanding expenses, outstanding income, prepaid expenses, income received in advance, bad debts, provision for doubtful debts and provision for discounts on debtors and creditors are explained. The adjustments at a glance are presented below :

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Items	Trading Account or Profit & Loss Account	Balance Sheet
1. Outstanding or accrued expenses	Show it on the Debit side of the Trading A/c or Profit & Loss A/c, as the case may be by way of addition to the concerned expenses.	Show it on the Liabilities side
2. Outstanding income or' Income accrued	Show it on the Credit side of the P&L Account	Show it on the Assets side
3. Prepaid or unexpired expenses	Show it on the Debit side of Trading A/c, or P&L A/c by way of deduction from the expenses concerned.	Show it on the Assets side.
4. Income received in advance or unearned income	Show it on the credit side of P&L A/c by way of deduction from the income concerned.	Show it on the Liabilities side.
5. Bad Debts	Show it on Debit side of Profit & Loss Account. (When the provision for doubtful debts does not exist).	Show it on assets side by way of deduction from Debtors.
6. Provision for doubtful debts (made for the first time)	Show it on debit side of Profit & Loss Account	Show it on assets side by way of deduction from debtors after deducting the bad debts meationed in adjustments.
7. Provision for doubtful debts. (When the balance of the provision for doubtful debts already exists).	i) If the old provision is less than the total bad debts, debit the deficit to P&L A/c in addition to new provision. ii) a) If the old provision is more than the total bad debts, but less than the new provision, debit that dificit to P & L Account. b) If the surplus is more than the new provision, credit the excess to P & L Account.	Show the new provision on the Assets side by way of deduction from debtors after deducting the bad debts mentioned in adjustments.
8. Provision for discount on debtors	Show it on debit side of the P & L Account	Show it on Assets side by way of deduction from debtors.
9. Provision for discount on creditors	Show it on credit side of P & L Account	Show it on Liabilities side by way of deduction from creditors.

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2) Explain the following :
   a) Prepaid expenses
   b) Income received in-advance

3. Distinguish between outstanding expenses and prepaid expenses.
4. Distinguish between income receivable and income received in advance.
5. Explain the following :
   a) Bad Debts
   b) Provision for Doubtful Debts
   c) Bad debts recovered.
6. Distinguish between provision for 'Discount on Debtors and Provision for Discount on Creditors.

B. Essay Answer Questions :

7. Explain the following adjustments and show their treatment in the final accounts.
   a)Outstanding expenses
   b) Prepaid expenses.

8. Explain the following and show their accounting treatment in final accounts.
   a) Bad Debts
   b) Provision for Doubtful Debts.

PROBLEMS

1) On 1st January, 1989 the Provision for Doubtful Debt stood at Rs.1,000. The total debtors on 31st December, 1989 were Rs.23,500 but out of these Rs.500 were bad and had to be written off. The provision is to be maintained at 5% on the debtors. Give Journal entries and show the Provision for the Doubtful Debts Account.

   (Debit Profit and Loss Account Rs. 650).

2) On 1st January, 1987, the provision for the Doubtful Debts Account showed a credit balance of Rs.1,800. During the year the bad debts amounted to Rs.1,500 the debts on 31st December 1987 were Rs.40,000 and provision of 5% for Doubtful Debts was required to be maintained. The bad debts during the year 1988 were Rs.1,900. On 31st December 1988, the debts were Rs.45,0[illegible] a 5% provision for doubtful debts was required to be kept. In 1989, the bad debts were R[illegible] the debts at the end of the year were Rs.24,000 on which a 5% provision for doubtfu[illegible] a 2% provision for discount were required to be maintained.

   Show the Ledger Accounts and show also how these items will appear in the Account and Balance Sheet of each of these three years.

   (Answer: In 1987 the debit Profit and Loss Account Rs.1,700, in 1988 debit Pr[illegible] Rs.2,150, in 1989 the debit Profit and Loss Account Rs.456 for Provisio[illegible] Profit and Loss Account Rs.300 for Provision for D[illegible]bts.)

16.14 GLOSSARY

1. Adjustment : Adjust[illegible]

2. Adjustment Entries :

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16.12 ANSWERS TO CHECK YOUR PROGRESS

1. Dec.i) Salary A/c Dr. Rs.3,000
To Outstanding Salary A/c R.s 3,000
(Being the outstanding salary for the month of December)

2. i) Outstanding Interest A/c Dr. 1,000
To Interest A/c Rs.1,000
(Being the outstanding interest for the year).

3. i) Prepaid Rent A/c Dr. Rs.1,500
To Rent A/c Rs.1,500
(Being the adjustment entry for prepaid rent).

4. i) Interest A/c Dr. Rs.2,000
To Interest Received in Advance A/c Rs. 2,000
(Being the adjustment entry for interest received in advance).

5. i) Bad Debts A/c Dr. Rs.2,000
To Sundry Debtors A/c Rs.2,000
(Being the bad debts written off)

ii) Profit and Loss A/c Dr. Rs.2,000
To Bad Debts A/c Rs.2,000
(Being the transfer of bad debts to P&L A/c)

6. Profit and Loss A/c Dr.
To Provision for Doubtful Debts A/c.
g the adjustment entry for provision
ubtful debts).

it and Loss A/c.
ision for Discount on Debtors A/c.

on for Discount on Creditors A/c
Loss A/c.

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UNIT - 17 : ADJUSTMENTS - II

Contents

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17.0 AIMS AND OBJECTIVES

The aim of this unit is to discuss the remaining usual adjustments besides certain other items that may be given alongwith adjustments.

On having studied and worked through this unit, you would be able to :

— prepare final accounts by making adjustments that are given in the problem.
— pass the required adjustment entries

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17.1 INTRODUCTION

In the previous 4 units we have discussed i) the method of preparing final accounts, ii) some adjustments and their accounting treatment in final accounts. In this unit we will discuss the remaining usual adjustments and certain other items that may be given along with adjustments.

On having studied and worked through this unit, the student is expected to prepare final accounts, viz., Trading Account, Profit and Loss Account, and Balance Sheet, by making required adjustments that are given in the problem.

17.2 CLOSING STOCK

The stock of goods remaining unsold or unused at the end of the accounting period is known as 'Closing Stock'. As explained in unit 13, it is necessary to bring into account the value of closing stock in order to find out the true gross profit or gross loss. This is done by means of the following adjusting entry :

Closing Stock Account Dr
To Trading Account
(Being the value of Closing Stock brought into account)

The closing stock will appear in the final accounts as follows :

i) Trading Account credit side as a separate item.

Dr. TRADING ACCOUNT Cr.

	Rs.	Rs.		Rs.	Rs.
			By Closing Stock		

ii) Balance Sheet asset side as a separate item.

BALANCE SHEET

	Rs.	Rs.		Rs.	Rs.
			Closing Stock		

Sometimes, in the examination the given Trial Balance may contain, among other items, gross profit/gross loss and closing stock. It means that the Trading Account has already been prepared (The student has to prepare the Profit and Loss Account, Balance Sheet only) Therefore, the closing stock will be shown directly in the Balance Sheet.

17.3 DEPRECIATION

Depreciation (or expiration of cost) denotes permanent decrease in the value of an asset (fixed asset) due to its continuous use or for any other reason. In order to find out the true profit or loss, it is necessary that depreciation is considered as an expense and charged against the income of the period. The following entry is required for recording the depreciation :

Depreciation Account Dr.
To Asset Account
(Being depreciation written off)

The effect of the above entry is that the value of the asset stands reduced and our expens (depreciation) is brought into the books of account.

The item depreciation will be shown in the final accounts as follows :

i) Profit and Loss Account debit side as a separate item.

Dr. PROFIT AND LOSS ACCOUNT Cr.

	Rs.	Rs.		Rs.	Rs.
To Depreciation on (name of asset)		.....			

ii) Balance Sheet asset side as a deduction from the concerned asset.

BALANCE SHEET

	Rs.	Rs.		Rs.	Rs.
			Asset (Balance in the beginning of the period)		.....
			Less : Depreciation		.....

Notes :

1) Depreciation is calculated with reference to time i.e. for the period for which the asset has been used. If the value of Machinery on 1st January, 1989 was Rs.60,000 and additional machinery worth Rs.40,000 was purchased on 1st July, it is to be depreciated at 10% p.a. If the accounts are closed on 31st December, depreciation for the year will be Rs.8,000 as calculated below :

On Rs. 60,000 for one year	6,000
On Rs. 40,000 for 6 months	2,000
	8,000

In case the date on which the additions were made to an asset is not given in the problem, the student is advised to calculate depreciation only on the opening balance of the asset account ignoring the question of depreciation on the additions.

2) Sometimes, the item depreciation may be given in the Trial Balance. It means that the entry for depreciation has already been passed and the book value of the asset is reduced. In such a case, depreciation will be shown only in the Profit and Loss Account.

3) In case of some assets the value may increase eg., land. The increase in the value of an assset is called 'Appreciation'. The following entry will be passed for appreciation :

Asset Account Dr.
To Appreciation Account
(Being appreciation in the value of the asset)

The appreciation may be credited to the Profit and Loss Account.

Check Your Progress - 1

Give the adjustment entries for the following :

i) Stock at the end
ii) Depreciation on building

17.4 INTEREST ON CAPITAL

Sometimes, the businessman would like to ascertain the profit after considering the interest on his capital which would have been received if the capital were invested elsewhere. Therefore, in order to find out whether the business has really made any profit in excess of the expected interest, he charges that interest to the Profit and Loss Account. The entry for interest on capital is passed as follows :

Interest on Capital Account Dr.
To Capital Account
(Being interest on capital)

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The credit to capital account will increase the capital of the businessman.
The interest on capital will be shown in the final accounts as follows :

1) Profit and Loss Account debit side as a separate item.

Dr. PROFIT AND LOSS ACCOUNT Cr.

	Rs.	Rs.		Rs.	Rs.
To Interest on Capital		.....			

2) Balance Sheet liabilities side as an addition to Capital.

BALANCE SHEET

	Rs.	Rs.		Rs.	Rs.
Capital	.....				
Add : Interest on Capital	.....				
		.....			

Interest on Capital is calculated on the balance of the Capital Account in the beginning of the accounting period. Interest on additional capital introduced, if any, during the accounting period will be calculated from the date on which such additional capital was introduced to the end of the accounting period.

Check Your Progress - 2

i) What is the entry for interest on capital ?

.....

.....

.....

17.5 INTEREST ON DRAWINGS

Where interest is allowed on capital, it is also usual to charge interest on the drawings made by the businessman because the business losses interest on the money drawn for personal use. The following journal entry is passed for interest on drawings :

Capital Account or Drawings Account	Dr.	
To Interest on Drawings Account		
(Being interest on drawings)		

The interest on drawings will decrease the capital of the businessman. It will be shown in the final accounts as follows :

i) Profit and Loss Account credit side as a separate item.

Dr. PROFIT AND LOSS ACCOUNT Cr.

	Rs.	Rs.		Rs.	Rs.
			By Interest on Drawings		.....

ii) Balance Sheet liabilities side by way of deduction from Capital.

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BALANCE SHEET

	Rs.	Rs.		Rs.	Rs.
Capital	.....				
Less : Interest on Drawings	.....	.....			

Note : Interest on drawings is calculated from the date of withdrawal to the end of the accounting period. However, when the dates of drawings are not given in the problem, interest should be charged for six months on the total drawings on the assumption that the drawings were made evenly throughout the period.

Check Your Progress - 3

i) What is the entry for interest on drawings ?

. . . . . .

. . . . . .

. . . . . .

. . . . . .

17.6 ACCIDENTAL LOSSES

1) Loss of Stock : Sometimes the stock of goods may be destroyed or damaged by fire or stolen during the year. Consequently, the closing stock will decrease. The gross profit also will decrease. Therefore, in order to ascertain the result of trading activities properly, the value of such goods should be either deducted from purchases or credited to the Trading Account. Further, the loss should be debited to the Profit and Loss Account. If the goods are insured the amount of the insurance claim admitted will be deducted from the total loss and the net loss only will be debited to the Profit and Loss Account.

The entries required are as follows :

(a) When the goods are not covered by insurance

i. Loss by Fire/Theft Account Dr.
To Trading Account
(Being the value of stock destroyed by fire/theft)

ii. Profit and Loss Account Dr.
To Loss by Fire/Theft Account
(Being transfer of Loss by fire/theft to the Profit and Loss Account)

(b) When the goods are covered by insurance

i. Loss by Fire/Theft Account Dr.
To Trading Account
(Being the value of stock destroyed by fire/theft)

ii. Insurance Claim Account Dr.
(with the amount of insurance claim admitted)
Profit and Loss Account Dr.
(with the net loss)
To Loss by Fire/Theft Account
(Being the amount of insurance claim admitted and transfer of the net loss to Profit and Loss Account)

Notes : (i) The full value of stock, whether covered by insurance or not should be credited to the Trading Account.

(ii) The loss by fire/theft may be treated as deferred revenue loss and it may be spread over three or four years.

(iii) The Insurance claim will appear as an asset in the Balance sheet.

2) **Loss of Other Assets** : Similarly, some fixed assets of the concern may be destroyed by fire or other accidents. In such cases the following entries are passed :

i) Loss by Fire Account/Accidental Loss Account Dr
To Asset Account
(Being Loss by fire/accidental loss)

---

ii) Insurance Claim Account Dr. (if any)
Profit and Loss Account Dr.
To Loss by Fire Account/Accidental Loss Account
(Being loss by fire/accidental loss transferred to Profit and Loss Account)

17.7 TRANSFERS TO GENERAL RESERVE

Sometimes, a portion of the net profit is set aside by way of provision for unforeseen contingencies. It is known as General Reserve. In such a case the balance of net profit only will be transferred to Capital Account. The necessary journal entry for transferring Profit to General Reserve is as follows :

Profit and Loss Account Dr.
To General Reserve Account
(Being the transfer of Profit to General Reserve Account)

General Reserve will be shown in the final accounts as follows :

1) Profit and Loss Account debit side as a separate item.

It is necessary to note that General Reserve is not an expense and, therefore, it will not be shown in the Profit and Loss Account along with expenses and losses. The net profit is calculated in the usual way. But, the Profit and Loss Account is not closed by transfer to the Capital Account. It is continued and the net profit is brought down. The transfer to reserve is shown in the next section of the Profit and Loss account as follows :

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Dr. PROFIT AND LOSS ACCOUNT Cr.

	Rs.	Rs.		Rs.	Rs.
To Expenses and Losses		....	By Gross Profit b/d		....
To Net Profit c/d		.....	By Incomes		.....
		.....			.....
To Transfer to General Reserve		.....	By Net Profit b/d		
To Net Profit (balance transferred to Capital Account)		.....			
		.....			

ii) Balance Sheet liabilities side as a separate item.

BALANCE SHEET

	Rs.	Rs.		Rs.	Rs.
General Reserve					

Note: General Reserve given in the Trial Balance is taken directly to the Balance Sheet. If it is stated in the adjustments that a portion of the current year's profit should be transferred to general reserve, then the amount transferred will be shown by way of additon to the opening balance of General Reserve on the liabilities side of the Balance Sheet.

17.8 COMMISSION PAYABLE ON NET PROFIT

Sometimes, the Manager of the business is entitled to commission on Profits, in addition to salary. Such commission may be paid as a certain percentage on net profit (i) before charging such commission or, (ii) after charging such commission.

When commission is to be paid on profits before charging such commission, the following formula is applied to find out the commission ;

$$\text{Commission} = \text{Profit (before charging commission)} \times \frac{\text{Rate}}{100}$$

Note :

The Profit for the period is ascertained after taking into consideration all the expenses except the commission.

If commission is to be paid on profits after charging such commission, the following formula will be applied to find out the commission :

$$\text{Commission} = \text{Profit (before charging commission)} \times \frac{\text{Rate}}{100+\text{Rate}}$$

Note :

In this case, the commission is to be calculated on profits arrived at after charging all expenses including the commission. If the rate of commission is 10%, then the profit remaining after taking into account such commission should be Rs. 100 and the profit, before taking into account the commission, should be Rs.110 (Profit 100 + Commission 10%).

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The Commission payable will be shown in the final accounts as follows :

i) Profit and Loss Account debit side as a separate item

Dr. PROFIT AND LOSS ACCOUNT Cr.

	Rs.	Rs.		Rs.	Rs.
To Commission to Manager		.....			

ii) Balance Sheet liabili'es side as a separate item.
(It is a liability as it has not been paid)

BALANCE SHEET

	Rs.	Rs.		Rs.	Rs.
Commission payable to Manager		.....			

You have learnt that every adjustment appears twice in the final accounts. Sometimes, some of the adjustments may appear in the Trial Balance. This indicates that the relevant adjusting entries have already been passed and the concerned accounts stand adjusted. Therefore, no further adjustment in the form of addition or deduction need be made. Thus, if depreciation is written off before preparing the Trial Balance, the Trial Balance will include the item depreciation. Then, depreciation will be transferred to the debit side of the Profit and Loss Account. Since the value of the concerned asset has already been reduced, the asset will appear in Balance Sheet at the net figure (as given in the Trial Balance) and depreciation must not be deducted from it.

Similarly, outstanding expenses, prepaid expenses, outstanding incomes, and incomes received in advance may appear in the Trial Balance when the adjustments have been made before preparing the Trial Balance. In such a case, the items 'Outstanding Expense' and Income received in advance' will be shown directly on the liabilities side of the Balance Sheet. The items 'Prepaid Expense' and 'Outstanding Income' will be shown on the assets side of the Balance Sheet.

17.9 SUMMARY OF ADJUSTMENT ENTRIES

The summary of all adjustment entries of Units 16 and 17 is given below :

Unit - 16

1. For outstanding expenses :
   Expenses Account Dr.
   To Expenses Outstanding A/c.

2. For Outstanding income :
   Outstanding Income Account Dr.
   To Income Account

3. For prepaid expenses :
   Prepaid Expenses Account Dr.
   To Expenses Account

4. For income received in advance :
   Income Account Dr.
   To Income Received in Advance A/c

5. For Bad Debts :
   Bad Debts Account Dr.
   To Debtors Account.

6. For Provision for doubtful debts :
   Profit and Loss Account Dr.
   To Provision for Doubtful Debts A/c.

7. For Provision for discount on debtors :
   Profit and Loss Account Dr.
   To Provision for Discount on Debtors A/c.

8. For provision for discount on creditors :
   Provision for Discount on Creditors A/c. Dr.
   To Profit and Loss Account.

Unit - 17

9. For Closing Stock :
   Closing Stock Account Dr.
   To Trading Account.

10. For Depreciation :
    Depreciation Account Dr.
    To Asset Account

11. For Interest on Capital :
    Interest on Capital Account Dr.
    To Capital Account.

12. For Interest on Drawings :
    Capital or Drawings A/c. Dr.
    To Interest on Drawings A/c.

Illustration

Give journal entries for the following adjustments :

i. Wages outstanding Rs.3,000.

ii. Rent receivable Rs.500

iii. Insurance prepaid for 2 months at Rs.1200 per annum.

iv. Bad debts to be written off Rs. 2,500 out of total debtors of Rs.42,500 and a provision to be made for doubtful debts at 5%. A further provision for discount to be made at 2 1/2% of the debtors.

v. Provision for discount on creditors (totalling Rs.30,000) to be made at 2% of the creditors.

vi. Interest on capital at 6% p.a. Capital in the beginning of the year was Rs.60,000.

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Solution

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Date	Particulars		L.F	Debit	Credit
				Rs.	Rs.
	i. Wages A/c	Dr.		3,000	
	To Outstanding Wages A/c				3,000
	(Being outstanding wages brought into account)				
	ii. Outstanding Rent A/c	Dr.		500	
	To Rent A/c				500
	(Being outstanding Rent brought into account)				
	iii. Prepaid Insurance A/c	Dr.		200	
	To Insurance A/c				200
	(Being the adjustment of insurance paid in advance)				
	iv. Bad Debts A/c.	Dr.		2,500	
	To Sundry Debtors A/c.				2,500
	(Being Bad Debts written Off)				
	v. Profit and Loss A/c	Dr.		2,000	
	To Provision for Doubtful Debts A/c				2,000
	(Being the provision made for doubtful debts)				
	vi. Profit and Loss A/c	Dr.		950	
	To Provision for Discount on Debtors A/c				950
	(Being the provision for discount on debtors)				
	vii. Provision for discount on Creditors A/c	Dr.		600	
	To Profit and Loss A/c.				600
	(Being the provision for discount on creditors)				
	viii. Interest on Capital A/c	Dr.		3,600	
	To Capital A/c.				3,600
	(Being interest on capital)				

17.10 HINTS

The following are some practical hints useful in working out the problems on final accounts:

1. Read the problem carefully and note what you are required to do. Usually the problem will be silent with regard to the passing of closing and adjusting entries, in which case you need not pass them.

2. Mark the items given in the Trial Balance with 'T' for Trading Account items, 'P' for Profit and Loss Account items and 'B' for Balance Sheet items.

3. Read the adjustments given outside the Trial Balance and mark the related items (i.e., items which need adjustment) in the Trial Balance with 'A' ('A', stands for adjustment to be made).

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4. Remember the order in which the items are to be shown in the final accounts and prepare the Trading Acccount, the Profit and Loss Account, and the Balance Sheet, one after the other, after giving suitable headings. The items appearing in the Trial Balance will be shown in the final accounts only at one place either in the Trading Account, or in the Profit and Loss Account, or in the Balance Sheet. The moment you take an item from the Trial Balance to its proper place in the final accounts put a tick mark.

5. For the items which require adjustment, put two tick marks after you have recorded the adjustment at the two relevant places.

6. Some times, the debit balances and credit balances may be clubbed and given in one amount column in the Trial Balance. In such a case,treat all nominal accounts as expense accounts unless otherwise indicated.

17.11 SUMMING UP

Adjustments pertaining to closing stock, depreciation, interest on capital and drawings, accidental losses, transfers to General Reserves, commission payable on net profit are explained in this unit which are summarised below :

Items	Trading and P&L A/c	Balance Sheet
1. Closing Stock	Show it on credit side of Trading Account	Show it on Assets side.
2. Depreciation	Show it on debit side of P&L Account	Assets side by way of deduction from the asset concerned.
3. Interest on Capital	Show it on debit side of P&L Account	Show it on Liabilities side by way of addition to capital.
4. Interest on Drawings	Show it on credit side of P&L Account	Show it on Libilities side by way deduction from capital.
5. Accidental Losses :	a) Not Covered by Insurance	
	i) Credit to Trading A/c. (if Asset, to Asset Account). ii) Debit to P&L Account.	
	b) Covered by Insurance	
	i) Credit to Trading A/c with the stock destroyed (if Asset, to Asset Account). ii) Debit the net loss (uncovered loss) to P&L account.	Show Insurance claim on assets side
6. Transfer to Reserve	Debit side of P&L A/c	Show it on Liabilities side
7. Commission payable on net Profit.	Show it on debit side of Profit and Loss A/c	Show it on Liabilities side.

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17.12 ANSWERS TO CHECK YOUR PROGRESS

1) i) Debit - Closing Stock Account
   Credit - Trading Account
   ii) Debit - Depreciation Account
   Credit - Building Account

2. Debit - Interest on Capital Account
   Credit - Capital Account

3. Debit - Capital or Drawings Account
   Credit - Interest on Drawings Account

17.13 MODEL EXAMINATION QUESTIONS

A . Short Answer Questions

1. Explain the following :
   a) Closing stock
   b) Depreciation
2. Write short notes on :
   a) Accidental Loss
   b) Commission
3. Explain the accounting treatment to the loss of stock due to fire accident.
4. What do you understand by interest on capital and drawings ?

B. Essay Answer Questions

5. Explain the following :
   a) Transfers to General Reserve
   b) Commission payable to manager
   c) Depreciation on asset
   d) Loss of stock due to fire accident
6. Explain the following and show their accounting treatment in final accounts.
   a) Loss of stock due to fire accident
   b) Interest on capital and drawings
   c) Commission payable to manager on net profit.

PROBLEMS

1. Give journal entries for the following adjustments :

   a) Wages outstanding Rs.2,000
   b) Rent receviable Rs.1,000
   c) Interest on Drawings Rs.250
   d) provision for discount on creditors (totalling Rs.20,000) to be made at 2%.
   e) Depreciation at 5% on Office Furniture of Rs.30,000.
   f) Interest on Capital at 6% per annum is to be allowed (Capital in the beginning of the year was Rs.50,000).

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17.14 RECOMMENDED BOOKS

1. RL Gupta and VK Gupta : 'Principles and practice of Accountancy' (Sultan Chand & Sons, New Delhi)
2. TS Grewal : 'Introduction to Accountacny' (Sultan Chand & Co., New Delhi)
3. VA Patil and JS Korlahalli : Principles and practice of Accountancy' (S.Chand & Co., New Delhi)
4. SN Maheswari : "Advanced Accountancy' Volume one (Vani Educational Books New Delhi)

17.15 GLOSSARY

1. Depreciation : Denotes permanent decrease in the value of an asset due to its continuous use or for any other reason

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UNIT - 18 : COMPREHENSIVE PROBLEMS

Contents

18. 0 Aims and Objectives
18. 1 Introduction
18. 2 Comprehensive Illustrative problems
18. 3 Summing Up
18. 4 Answers to check your progress
18. 5 Model Examination Questions
18. 6 Recommended Books

18. 0 AIMS AND OBJECTIVES

The aim of this unit is to present certain comprehensive illustrative problems including adjustments. On having worked through this unit you would be able to :

– Solve the problems including adjustments.

8. 1 INTRODUCTION

So far you have studied, in the previous five units the method of preparing the final accounts, such as Trading, Profit and Loss Accounts and Balance Sheet, and the various adjustments that are required to be made while preparing final accounts. In this unit, It is proposed to present some comprehensive problems with solutions including adjustments, which will help you in solving problems.

18. 2 COMPREHENSIVE ILLUSTRATIVE PROBLEMS

Illustration - 1

From the following Trial Balance of R. Ramdas as on 31st December 1989. you are required to prepare the Trading and Profit and Loss Account for the year ended 31st December, 1989, and Balance Sheet as on that date:

	Dr. Rs.	Cr. Rs.
Capital		60,000
Drawings	7,200	
Stock, 1st January, 1989	20,500	
Purchases	68,000	
Carriage inwards	1,500	
Sales		1,40,500
Sundry Debtors	23,500	
Sundry Creditors		14,300
Cash in Hand	500	
Cash at Bank	2,200	
Carriage Outwards	1,700	
Salaries	16,000	
Factory Rent	4,000	
Bills Receivable	5,300	

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PROFIT AND LOSS ACCOUNT OF R. RAMDAS
for the year ended 31st December, 1989.

Dr. Cr.

Particulars	Rs.	Rs.	Particulars	Rs.	Rs.
To Salaries		16,000	By Gross Profit b/d		62,500
" Office Rent		2,000			
" Insurance	1,200				
Less: Prepaid	300				
		900			
" General Expenses		5,400			
" Carriage Outwards		1,700			
" Provision for Doubtful Debts :					
Provision required	1,150				
Add: Bad Debts	500				
	1,650				
Less: Existing Provision	1,000				
		650			
"Depreciation on:					
Machinery	1,500				
Furniture	1,000				
		2,500			
" Loss by Fire		4,000			
" Net Profit (Transferred to Capital Account)		29,350			
		62,500			62,500

BALANCE SHEET OF R. RAMDAS
as on 31st December, 1989.

Liabilities	Rs.	Rs.	Assets	Rs.	Rs.
Bills Payable		4,200	Current Assets :		
Sundry Creditors		14,300	Cash in hand		500
			Cash at Bank		2,200
Capital :			Bills Receivable		5,300
Balance on 1st Jan. 1989	60,000		Sundry Debtors	23,500	
Add: Net Profit	29,350		Less: Bad Debts	500	
	89,350			23,000	
Less : Drawings	7,200		Less: Provision for Doubtful Debts	1,150	
		82,150			21,850
			Outstanding Insurance Claim		6,000
			Closing Stock		27,000
			Insurance Prepaid		300
			Fixed Assets :		
			Furniture	10,000	
			Less:Depreciation @10%	1,000	
				28,000	9,000
			Machinery		
			Add: Erection charges	2,000	
				30,000	
			Less: Depreciation at 5 percent	1,500	
					28,500
		1,00,650			1,00,650

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Bills Payable		4,200
Insurance	1,200	
Furniture	10,000	
Machinery	28,000	
Office Rent	2,000	
Manufacturing Wages	21,500	
Provision for Doubtful Debts		1,000
Manufacturing Expenses	1,500	
General Expenses	5,400	
	2,20,000	2,20,000

The following adjustments are required :

(a) Stock on 31st December, 1989 amounted to Rs. 27,000.

(b) Write off Rs. 500 as Bad Debts and maintain the Provision for Doubtful Debts at 5% on Sundry Debtors.

(c) Unexpired Insurance Rs. 300.

(d) Manufacturing Wages include Rs.2,000 for erection of new machinery purchased on 1st January, 1989.

(e) Depreciate Machinery by 5% and Furniture by 10%

(f) On 24th December, 1989 a fire broke out and destroyed stock of the value of Rs.10,000. The Insurance company admitted the claim for loss of stock of the value of Rs.6,000 only and paid the amount on 15th January, 1990.

Solution

TRADING ACCOUNT OF RAMDAS
for the year ended 31st December, 1989.

Dr. Cr.

Particulars	Rs.	Rs.	Particulars	Rs.	Rs.
To Opening Stock		20,500	By Sales		1,40,500
" Purchases		68,000	" Closing Stock	27,000	
"Carriage Inwards		1,500	" Goods destroyed by fire	10,000	
"Manufacturing Wages	21,500				
Less : Charged to Machinery	2,000	19,500			
" Factory Rent		4,000			
" Mfg. Expenses		1,500			
" Gross Profit c/d		62,500			
		1,77,500			1,77,500

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Illustration – 2

From the undermentioned Trial Balance of Haridas prepare Trading and Profit and Loss Account for the year ended 31st December, 1989, and Balance Sheet as on that date :

	Dr. Rs.	Cr. Rs.
Capital		1,28,500
Stock	25,000	
Purchases	1,30,500	
Sales		2,45,000
Returns Inwards and Outwards	3,000	2,000
Provision for Doubtful Debts		1,000
Bills Receivable and Payable	50,000	5,000
Carriage Inwards	7,500	
Plant and Machinery	60,000	
Office Furniture	3,500	
Sundry Debtors and Creditors	70,000	46,000
Coal, Gas and Water	1,500	
Wages	12,500	
Duty and Clearing charges	1,500	
Office Rent	4,800	
Printing and Stationery	1,000	
Insurance	400	
Carriage Outwards	6,200	
Salaries	27,000	
Factory Rent	2,400	
Sundry Expenses	1,290	
Drawings	12,000	
Cash in hand	1,610	
Cash at Bank	5,800	
	4,27,500	4,27,500

The following adjustments are to be taken into consideration :

a) Closing Stock Rs.50,000

b) Outstanding liabilities to be provided for : Salary R.4,800, Factory Rent Rs.2,400

c) Provision for Doubtful Debts to be adjusted to 2.5% of Sundry Debtors after elimination of Bad Debts amounting to Rs. 4,000.

d) Goods withdrawn Rs. 3,000 for domestic use.

e) Depreciation on Plant and Machinery at 10% and on Furniture at 10%.

f) Interest on capital at 5% per annum.

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Solution

TRADING ACCOUNT OF HARIDAS
for the year ended 31st December, 1989

Dr. Cr.

Particulars	Rs.	Rs.	Particulars	Rs.	Rs.
To Opening Stock		25,000	By Sales	2,45,000	
" Purchases	1,30,500		Less: Returns inwards	3,000	
Less: Goods for domestic use	3,000				2,42,000
	1,27,500	1,25,500	" Closing Stock		50,000
Less : Ret. Outwards	2,000				
" Duty & Clearing charges		1,500			
: Carriage inwards		7,500			
" Wages		12,500			
" Coal & Water		1,500			
" Factory Rent	2,400				
Add: Outstanding rent	2,400				
		4,800			
" Gross Profit c/d		1,13,700			
		2,92,000			2,92,000

PROFIT AND LOSS ACCOUNT OF HARIDAS
for the year ended 31st December, 1989

Dr. Cr.

Particulars	Rs.	Rs.	Particulars	Rs.	Rs.
To Salaries	27,000		By Gross Profit b/d		1,13,700
Add: Outstanding	4,800				
		31,800			
To Office Rent		4,800			
" Printing & Stationery		1,000			
" Insurance		400			
" Sundry Expenses		1,290			
" Carriage Outwards		6,200			
" Provision for doubtful debts :					
" Provision required	1,650				
Add: Bad debts	4,000				
	5,650				
Less: Existing provision	1,000				
		4,650			
" Depreciation on: Plant & Machinery	6,000				
" Office Furniture	350				
		6,350			
" Interest on capital		6,425			
" Net Profit (transferred to Capital Account)		50,785			
		1,13,700			1,13,700

B B A O U

BALANCE SHEET OF HARIDAS
as on 31st December, 1989.

Liabilities	Rs.	Rs.	Assets	Rs.	Rs.
Liabilities for expenses:			Current Assets:		
Salary	4,800		Cash in hand		1,610
Factory Rent	2,400		Cash at Bank		5,800
	7,200		Bills Receivable		50,000
Bills Payable	5,000		Sundry Debtors	70,000	
Sundry Creditors	46,000		Less: Bad Debts	4,000	
Capital :				66,000	
Balance on 1st Jan. 1989	1,28,500		Less: Provision for		
Add: Int. on capital	6,425		doubtful debts	1,650	
Net Profit	50,785				64,350
	1,85,710		Closing Stock		50,000
Less: Drawings			Fixed Asets:		
(including goods for			Office furniture	3,500	
domestic use)	15,000		Less: Depn.at 10%	350	3,150
(12,000 + 3,000)	1,70,710		Plant & Machinery	60,000	
			Less: Depn. at 10%	6,000	
					54,000
	2,28,910				2,28,910

Illustration - 3

From the following Trial Balance of S. Kumar as on 31st December, 1989, you are required to prepare the Trading and Profit and Loss Account for the year ended 31 st December, 1989 and Balance Sheet as on that date.

	Dr. Rs.	Cr. Rs.
Capital		40,000
Drawings	6000	
Sundry Creditors		20,000
10% Loan (taken on 1-7-1989)		10,000
Cash in hand	2,500	
Cash at Bank	6,000	
Sundry Debtors	25,500	
Provision for Doubtful Debts		2,000
Furniture	6,000	
Machinery	14,000	
Stock 1-1-1989	40,000	
Purchases	90,000	
Rent and Taxes	3,400	
Salaries	9,000	
Manufacturing Wages	12,500	
Sales		1,40400
Sundry Expenses	1,000	
Insurance (including premium of Rs. 300 per annum paid upto 30-6-1990)	400	
Commission		700
Carriage	2,000	
Travelling Expenses	800	
Bills Receivable	4 000	
General Reserve		10,000
		2,23,100

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The following adjustments are required :

a. Stock on 31st December, 1989 was Rs.38,000
b. Write off Rs,500 as bad debts and maintain the provision for doubtful debts at 5% on Debtors.
c. Depreciate Machinery by 5% and Furniture by 10%
d. 5% of the net profit is to be carried to th e General Reserve

Solution

TRADING AND PROFIT AND LOSS ACCOUNT OF S. KUMAR
for the Year ended 31st December 1989.

Dr. Cr.

Particulars	Rs.	Rs.	Particulars	Rs.	Rs.
To Opening Stock		40,000	By Sales		1,40,400
" Purchases		90,000	" Closing Stock		38,000
" Carriage		2,000			
" Manufacturing Wages		12,500			
" Gross Profit c/d		33,900			
		1,78,400			1,78,400
" Salaries		9,000	By Gross Profit b/d		33,900
" Rent & Taxes		3,400			
" Insurance	400				
Less: Prepaid	150				
		250	" Commission		700
" Sundry Expenses		1,000	" Provision for		
" Travelling Expenses		800	Doubtful Debts:		
			Existing Provision	2,000	
" Depreciation on :			Less: Bad debts 500		
Machinery	700		Provision		
Furniture	600	1,300	required 1,250		
" Interest on Loan		500		1,750	250
" Net Profit c/d		18,600			
		34,850			34,850
To Transfer to General Reserve		930	By Net Profit b/d		18,600
To Net Profit (Transferred to Capital Account)		17,670			
		18,600			18,600

BRAOU

BALANCE SHEET OF S. KUMAR
as on 31st December, 1989.

Liabilities	Rs.	Rs.	Assets	Rs.	Rs.
Sundry creditors		20,000	Current Assets :		
10% loan(taken On 1-7-89)		10,000	Cash in hand		2,500
Outstanding Int. on above		500	Cash at Bank		6,000
General Reserve :			Bills Receivable		4,000
Balance b/f	10,000		Sundry Debtors	25,500	
Add: Transfer from current			Less: Bad Debts	500	
year's profit	930				
		10,930		25,000	
Capital	40,000		Less: Provision	1,250	
Add; Net Profit	17,670				23,750
			Closing Stock		38,000
	57,670		Insurance prepaid		150
Less: Drawings	6,000		Fixed assets :		
		51,670	Furniture	6,000	
			Less : Depn. at 10%	600	
					5,400
			Machinery	14,000	
			Less: Depn. at 5%	700	
					13,300
		93,100			93,100

Note

The Adjustments are silent about the interest due on loan. If the rate of interest is given along with the loan item in the Trial Balance, the student must calculate interest for the full period. In case the date on which the loan was taken is given, interest should be calculated only from that date interest so calculated should be compared with the interest already paid, given in the Trial Balance (if any). If there is any difference between the two amounts, it indicates the amount of interest outstanding. Such outstanding interest must be provided for by the debit Interest Account and the credit Outstanding Interest Account. The Oustanding Interest will be shown in the Profit and Loss Account by way of addition to the interest already paid. Since it is a liability it will also appear on the liabilities side of the balance sheet. Such an adjustment not expressly stated in the problem is called an implied adjustment. However, if the rate of interest is not given in the problem, the student is advised not to calculate the interest.

In the above problem, interest on the loan comes to Rs. 500 (on Rs. 10,000 for a month). The Trial Balance makes no mention of the interest. It means that the interest is outstanding. Hence, it has been shown both in the Profit and Loss Account and in the Balance Sheet.

Similarly, the amount of Insurance given in the Trial Balance includes Rs.300 per annum paid upto 30-6-1990. As the accounting year ends on 31-12-1989, the prepaid insurance premium for six months (from 1-1-1990 to 30-6-1990) amounting to Rs. 150 has been adjusted.

Illustration : 4

From the following Trial Balance of Raghuveer prepare his final accounts relating to 1989.

BRAOU

	Dr. Rs.	Cr. Rs.
Capital		50,000
Sales		3,40,000
Adjusted Purchases	2,89,200	
Salaries	12,000	
Carriage Inwards	400	
Carriage Outwards		300
Lighting	400	
Rates and Insurance	600	
Discounts	1,000	900
Building	30,000	
Expenses Outstanding		700
Furniture	7,000	
Prepaid Insurance	200	
Sundry Debtors	7,000	
Depreciation	1,200	
Sundry Creditors		21,200
Petty Cash	50	
Cash at Bank	3,200	
Stock at 31st December, 1989	60,250	
	4,12,800	4,12,800

Solution

TRADING AND PROFIT AND LOSS ACCOUNT OF RAGHUVEER

For the year ended 31 st December, 1989.

Dr.			Cr.		
To Adjusted purchases		2,89,200	By Sales		3,40,000
" Carriage Inwards		400			
" Gross Profit c/d		50,400			
		3,40,000			3,40,000
To Salaries		12,000	By Gross Profit b/d		50,400
" Rates and Insurance		600	" Discount		900
" Lighting		400			
" Carriage Outwards		300			
" Discount		1,000			
" Depreciation		1,200			
" Net Profit (transfered to Capital Account)		35,800			
		51,300			51,300

BRAOU

BALANCE SHEET OF RAGHUVEER
as on 31st December, 1989.

Liabilities	Rs.	Rs.	Assets	Rs.	Rs.
Expenses Outstanding		700	Current Assets :		
			Petty Cash		50
Sundry Creditors		21,200	Cash at Bank		3,200
Capital :			Sundry Debtors		7,000
Balance on 1st			Closing stock		60,250
Jan. 1989	50,000		Prepaid Insurance		200
Add: Net Profit	35,800		Fixed Assets :		
			Furniture		7,000
		85,800	Building		30,000
		1,07,700			1,07,700

Note

From the information given in the Trial Balance it is clear that the adjustments have already been made. Hence, the relevant items have been shown only at one place in the final accounts.

Illustration - 5

Given below is the Trial Balance of G. Ganesh as on 31st March, 1990.

	Dr. Rs.	Cr. Rs.
Capital		1,50,000
Drawings	10,000	
Sundry Creditors		30,000
Bills Payable		10,000
Stock, 1st April 1989	26,500	
Purchases	95,000	
Carriage Inward	5,000	
Sales		1,88,000
Carriage Outward	6,000	
Salaries	20,000	
Postage and Telegrams	500	
Printing and Stationery	1,200	
Cash in hand	600	
Cash at Bank	4,800	
Travelling Expenses	1,300	
Sundry Expenses	2,100	
Discounts	1,200	900
Sundry Debtors	38,000	
Bills Receivable	6,000	
Lease hold Premises (Lease to run for 4 years from 1-4-1989)	40,000	
Furniture and Fittings	24,000	
Depreciation	3,600	
Plant and Machinery	47,500	
Wages	28,000	
Good Will	50,000	
Bad Debts	1,200	
Provision for Doubtful Debts		1,600
Commission		2,000
General Reserve		30,000
	4,12,500	4,12,500

BRAOU

You are required to prepare the Trading and Profit and Loss Account for the year ended 31 st March, 1990 and a Balance Sheet as on that date after taking into consideration the following :

i) The stock on hand on 31st March, 1990 was valued at Rs. 31,000.

ii) Goods of the cost of Rs. 2,200 were sent to a customer on sale or return basis (the customer still having the right to return the goods) The invoice for Rs. 4,000 was entered in the Sales Book.

iii) Goods of the value of Rs. 5,000 had been received on 29th March, 1990 but the Purchase Invoice was not recorded in the Purchases Book.

iv) Sales include Rs. 500 worth of goods which were taken by the proprietor for personal use.

v) Sundry Creditors include an amount of Rs. 3,000 received from Mr. Ramana and credited to his account. The amount was written off as a bad debt in the previous year.

vi) The provision for Doubtful Debts should be maintained at 5% on Debtors.

vii) Provide 2% for Discount on Debtors and Creditors.

viii) Commission earned but not received Rs. 400.

BRAOU

Solution

TRADING AND PROFIT AND LOSS ACCOUNT OF G. GANESH
Dr. for the year ended 31st March 1990. Cr.

Particulars	Rs.	Rs.	Particulars	Rs.	Rs.
To Opening Stock		26,500	By Sales	1,88,000	
" Purchases	95,000				
Add: Unrecorded Purchases	5,000		Less: Goods on Sale or return basis	4,000	
	1,00,000			1,84,000	
Less: Goods taken for personal use	500		Less: Goods for personal use	500	
		99,500			1,83,500
" Carriage Inward		5,000	" Closing Stock	31,000	
" Wages		28,000	Add: Goods sent on sale or return basis	2,200	
" Gross Profit c/d		57,700			33,200
		2,16,700			2,16,700
To Salaries		20,000	By Gross Profit b/d		57,700
" Postage and Telegrams		500	" Commission	2,000	
			Add: Outstanding	400	
" Printing and Stationery		1,200			2,400
" Sundry Expenses		2,100	" Discount		900
" Carriage Outward		6,000	" Provision for Disct. on Creditors		640
" Travelling Expenses		1,300	" Bad Debts recovered		3,000
" Provision for Doubtful Debts:					
Provision required	1,700				
Add: Bad Debts	1,200				
	2,900				
Less: Existing Provision	1,600				
		1,300			
" Discount		1,200			
" Provision for Discount on Debtors		646			
" Depreciation		3,600			
" Leasehold Premises- 1/4th written off		10,000			
" Net Profit (transferred to Capital Account)		16,794			
		64,640			64,640

BRAOU

BALANCE SHEET OF G. GANESH
as on 31st December, 1990.

Liabilities	Rs.	Rs.	Assets	Rs.	Rs.
Bills Payable		10,000	Current Assets:		
Sundry Creditors	30,000		Cash in hand		600
Add: Creditors For unrecorded Purchases	5,000		Cash at Bank		4,800
			Bills Receivable		6,000
	35,000		Sundry Debtors	38,000	
Less: Adjustment in respect of bad debts recovered	3,000		Less: Adjustment in respect of goods sent on sale or return basis	4,000	
	32,000			34,000	
Less: Provision for Disc.	640		Less: Provision for Doubtful Debts	1,700	
		31,360		32,300	
General Reserve		30,000	Less: Provision for Disc.	646	
					31,654
Capital:			Outstanding Commission		400
Balance on 1st April 1989	1,50,000		Closing Stock		33,200
Add: Net Profit	16,794				
	1,66,794		Fixed Assets:		
			Furniture and Fittings		24,000
Less: Drawings	10,000				
		1,56,794	Plant and Mechinery		47,500
			Lease hold Premises	40,000	
			Less 1/4th written off	10,000	
					30,000
			Goodwill		50,000
		2,28,154			2,28,154

Notes: 1. As already discussed above, goods sent on sale or return basis should not be treated as sales. Therefore, the invoice price of the goods (Rs. 4,000) has been deducted both from sales and Sundry Debtors. The cost of such goods (Rs. 2,200) has been added to closing stock.

2. The Trial Balance states that the premises were taken on lease from 1-4-1989 for four years. As one year has expired onefourth of the lease amount has been written off to the Profit and Loss Account and the balance has been shown in the Balance Sheet.

3. It is stated in the adjustments that sales include Rs. 500 worth of goods taken by the proprietor for personal use. It means that Sales Account, instead of Purchases Account, has been credited with the amount. Therefore, the amount is now deducted both from Sales and Purchases in the Trading Account.

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Check Your Progress – 1

i) The assets of a company are Rs. 40,000; the liabilities Rs. 10,000. The claims of the owners are – Rs. .....

ii) The liabilities of a company are Rs.50,000; the owner s' equity is Rs.80,000. The total assets are Rs ..... the net worth is Rs.....

iii) The owner's equity is Rs. 60,000; the assets of the company are Rs. 1,00,000; the outside claims are Rs.....

18. 3 SUMMING UP

In this unit an overall picture of preparing final accounts has been discussed. The principles and procedures you have learnt in units 12 to 17 are applied here. This unit shows the procedure to ascertain the financial result, i.e., profit and the financial position of an organization.

18. 4 ANSWERS TO CHECK YOUR PROGRESS

1) i. Owners claims are Rs. 30,000;
ii. Total assets are Rs.1,30,000; Net worth is Rs.80,000.
iii. The outside claims are Rs. 40,000.

18. 5 MODEL EXAMINATION QUESTIONS

A. Short Answer Questions

1. Prepare Trading Account using imaginary accounts and figures.
2. Prepare Profit and Loss Account using imaginary accounts and figures.

B. Essay Answer Questions

3. Prepare Trading, Profit and Loss Account and Balance Sheet using imaginary accounts and figures.

Problems

1. From the following Trial Balance of A. Anand as on 31st December, 1989 you are required to prepare the Trading and Profit and Loss Account for the year ended 31st December, 1989 and the Balance Sheet as on that date :

	Dr. Rs.	Cr. Rs.
Capital		80,000
Drawings	10,000	
Stock, 1st January, 1989	22,000	
Purchases	75,000	
Carriage	1,400	
Sales		1,35,500
Sundry Debtors	38,000	
Sundry Creditors		28,000
General Reserve		10,000
Provision for Doubtful Debts		800
10% Loan		20,000

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Interest on Loan	1,000	
Cash in hand	600	
Cash at Bank	14,800	
Salaries	24,000	
Salaries outstanding		2,000
Furniture	18,000	
Building	60,000	
Bad Debts recovered		200
Depreciation	1, 200	
Sundry Expenses	8,500	
Repairs	2,000	
	2,76,500	2,76,500

The following adjustments are required :

(a) Stock on 31 st December, 1989 amounted to Rs. 26,000.

(b) On 24th December, 1989 a fire broke out and destroyed stock of the value of Rs.6,000. The Insurance Company admitted the claim for loss of stock of the value of Rs. 4,000 only and paid the amount on 10th January, 1990.

(c) Provision for Doubtful Debts required is Rs. 500.

(d) Interest on Capital at 5% p.a.

(e) Interest on Drawings Rs.300

(Gross Profit Rs. 69,100; Net Profit Rs. 26,200; Total of Balance Sheet Rs. 1,60,900).

2. From the following Trial Balance of M. Srinivas as on 31st December, 1989 you are required to prepare the Trading and Profit and Loss Account for the year ended 31st December, 1989 and the Balance Sheet as on that date :

	Dr. Rs.	Cr. Rs.
Capital		90,000
Stock on 1st Jan. 1989	46,000	
Purchases	2,44,000	
Returns Inward	8,600	
Freight	19,500	
Sales		2,90,000
Returns Outward		6,800
Rent	5,700	
Salaries	9,300	
Outstanding Salaries		700
Sundry Debtors	24,000	
Sundry Creditors		19,800
Cash at Bank	8,200	
Printing & Stationery	14,500	
Investments	5,000	
Interest on Investments		300
Furniture	5,000	
Insurance	500	
Postage and Telegrams	950	
Discount	3,300	1,600
Cash in hand	350	
Drawings	10,000	
Sundry Expenses	4,300	
	4,09,200	4,09,200

BRAOU

The following adjustments are required :

i. Stock on 31 st December, 1989 amounted to Rs. 80,000.
ii. Provide for depreciation on furniture at 5% p.a.
iii. Outstanding interest on investments amounted to Rs. 100.
iv. Write off Rs. 500 as bad debts out of sundry debts,
v. The manager is entitled to a commission of 5% on the net Profit before charging such commission.

(Answer: Gross Profit Rs. 58,700; Net Profit Rs.20,330 Total of Balance Sheet Rs. 1,21,900.)

3. Prepare Trading and Profit and Loss Account for the year ended 31st December, 1989, and Balance Sheet as on that date from the following Trial Balance of K. Kishanlal :

	Dr. Rs.	Cr. Rs.
Capital		98,600
Drawings	12,000	
Sundry Creditors		60,000
Bills Payable		12,500
9% Loan (taken on 1.1.1989)		10,000
Interest on Loan	450	
Cash in hand	1,100	
Cash at Bank	17,500	
Provision for Doubtful Debts		2,000
Furniture	18,000	
Plant and Machinery	30,000	
Stock at Commencement	60,000	
Purchases (LessReturns)	2,31,000	
Manufacturing Wages	30,000	
Sales (Less Returns)		3,28,000
Salaries	17,300	
Rent and Taxes	4,800	
Discount Allowed	6,800	
Discount Received		5,100
Insurance		600
Repairs and Renewals	1,800	
Bad Debts	4,100	
Sundry Expenses	4,800	
Sundry Debtors	68,000	
Bills Receivable	7,950	
	5,16,200	5,16,200

Adjustments :

(a) Closing Stock was Rs. 1,18,500.
(b) Provision for Doubtful Debts is to be maintained at 5% on Sundry Debtors.
(c) Insurance prepaid Rs.300.
(d) Charge 5% interest on capital.
(e) Depreciate Plant and Machinery by 10% and Furniture by 15%.
(f) The manager is entitled to a commission of 10% on the net profit after charging such commission.

(Answer : Gross Profit Rs. 1,25,500; Net Profit Rs.70,700; Total of Balance Sheet Rs.2,52,250)

BRAOU

4. From the following Trial Balance of R. Raghavan as on 31st December, 1989 you are required to prepare the Trading and Profit and Loss Account for the year ended 31st December, 1989 and Balance Sheet as on that date :

	Dr. Rs.	Cr. Rs.
Capital		60,000
Sales		3,30,000
Adjusted Purchases	2,65,400	
Drawings	12,000	
Building	40,000	
Carriage Inward	800	
Carriage Outward	400	
Furniture	8,000	
Depreciation	1,400	
Discounts	1,000	800
Salaries	15,000	
Sundry Debtors	9,000	
Sundry Creditors		18,200
Rates and Insurance	700	
Prepaid Insurance	100	
Office Expenses	500	
Expenses Outstanding		300
Cash in hand	200	
Cash at Bank	5,800	
Stock on 31st December, 1989	49,000	
	4,09,300	4,09,300

(Answer : Gross Profit Rs. 63,800; Net Profit Rs. 45,600; Total of Balance Sheet Rs. 1,12,100)

5. From the following Trial balance of M. Aditya as on 31st December, 1989 you are required to prepare the Trading and Profit and Loss Account for the year ended 31st December, 1989 and Balance Sheet as on that date:

	Dr. Rs.	Cr. Rs.
Capital		70,000
Trade Creditors		41,800
Stock on 1st Jan. 1989	25,000	
Purchases	80,000	
General Reserve		20,000
Provision for Doubtful Debts		1,000
Carriage	1,500	
Sales		1,32,500
Discounts	1,200	900
Returns	3,000	4,000
Furniture	10,000	
Building	60,000	
Book Debts	52,000	
Travelling Expenses	900	
Salaries	24,000	
Salaries Unpaid		2,000
Sundry Expenses	5,500	
Repairs	1,300	
Bad Debts recovered		300
Cash at Bank	8,000	
Petty Cash	100	
	2,72,500	2,72,500

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The following adjustements are required:

(a) Stock on 31st December, 1989 amounted to Rs. 30,000

(b) Depreciation is to be written off at 10% on Furniture and at 5% on Building.

(c) Provision for doubtful debts required is Rs. 800.

(d) Interest on Capital at 5% p.a

(e) On 25th December, 1989 a fire broke out and destroyed stock of the value of Rs. 5,000 (not covered by insurance)

(f) 5% of the net Profit is to be credited to the General Reserve

(Answer: Gross Profit Rs. 62,000; Net Profit before Reserve Rs. 18,000; Total of Balance Sheet Rs. 1,55,300.)

6. From the following Trial Balance of M.Mukherjee as on 31st December, 1989, you are required to prepare the Trading and Profit and Loss Account for the year ended 31st December 1989 and the Balance Sheet as on that date :

	Dr. Rs.	Cr. Rs.
Capital		1,00,000
Drawings	12,000	
Sundry Creditors		40,000
10% Loan taken on 1.10.1989		10,000
Cash in hand	1,200	
Cash at Bank	11,400	
Sundry Debtors	50,500	
Provision for Doubtful Debts		4,000
Furniture	12,000	
Machinery	28,400	
Stock 1st January, 1989	75,000	
Purchases	1,80,000	
Returns Inward	2,000	
Rent and Taxes	6,800	
Salaries	18,000	
Manufacturing Wages	30,000	
Travelling Expenses	1,600	
Sales		2,80,800
Office Expenses	2,500	
Insurance (including premium of Rs.600 p.a. paid up to 31st Mar. 1990	800	
Commission received		1,000
Discounts	1,600	2,000
Carriage	4,000	
	4,37,800	4,37,800

The following adjustments are required:

(a) Stock on 31st December 1989 Rs. 68,500

(b) Write off Rs. 500 as bad debts and maintain the provision for Doubtful Debts at 5% on Debtors.

(c) Make a provision of 2% for Discounts on Debtors and Creditors.

(d) Manufacturing Wages include Rs. 1,600 for erection of new machinery purchased on 1st January, 1989.

(e) Depreciation on Machinery at 5% and Furniture at 10%

(f) Commission earned but not received amounts to Rs. 500.

(Answer : Gross Profit Rs. 59,900; Net Profit Rs. 30,150; Total of Balance Sheet Rs. 1,67,600).

BRACU

7. From the following Trial Balance of A. Raghavan as on 31st December, 1989, you are required to prepare the Trading and Profit and Loss Account for the year ended 31st December, 1989 and Balance Sheet as on that date:

	Dr. Rs.	Cr. Rs.
Capital		50,000
Trade Creditors		25,500
General Reserve		30,000
Provision for Doubtful Debts		1,000
Stock, 1st January, 1989	21,000	
Purchases	70,000	
Carriage	1,600	
Sales		1,21,000
Discount Allowed	1,200	
Furniture	12,000	
Building	50,000	
Book Debts	39,500	
Cash in hand	400	
Cash at Bank	2,400	
Salaries	24,000	
Salaries unpaid		2,000
General Expenses	5,200	
Repairs	1,100	
Discount received		1,000
Bad Debts recovered		300
Depreciation	2,400	
	2,30,800	2,30,800

The following adjustments are required:

(a) Stock on 31st December, 1989 amounted to Rs. 24,500.
(b) Provision for Doubtful Debts required is Rs. 400.
(c) Invoice amounting to Rs. 4,000 had been omitted from the books.
(d) Private purchases amounting to Rs. 500 had been included in the Purchases Book.

(Answer : Gross Profit Rs. 49,400; Net Profit Rs. 17,400; Total of Balance Sheet Rs. 1,28,400).

8. From the undermentioned Trial Balance of S.Suresh prepare the Trading and Profit and Loss Account for the year ended 31st December, 1989 and the Balance Sheet as on that date:

	Dr. Rs.	Cr. Rs.
Capital		1,28,500
Stock, 1st January, 1989	25,000	
Purchases	1,30,500	
Sales		2,45,000
Returns in and out	3,000	2,000
Provision for Doubtful Debts		1,000
Bills Receivable and Payable	50,000	5,000
Carriage in	7,500	

Plant and Machinery	60,000	
Office Furniture	3,500	
Sundry Debtors and Creditors	70,000	46,000
Coal, Gas and Water	1,500	
Wages	12,500	
Duty and Clearing Charges	1,500	
Office Rent	4,800	
Printing and Stationery	1,000	
Insurance	400	
Carriage Out	6,200	
Salaries	27,000	
Factory Rent	2,400	
Electricity and Telephone	1,200	
Bank Charges	90	
Drawings	12,000	
Cash in Hand	1,610	
Cash at Bank	5,800	
	4,27,500	4,27,500

The following adjustments are to be taken into consideration:

(a) Closing Stock Rs. 50,000.

(b) Outstanding liabilities to be provided for Salary Rs. 4,800; Factory Rent Rs. 2,400

(c) Provision for Doubtful Debts to be adjusted to 2 1/2% of Sundry Debtors after elimination of Bad Debts amounting to Rs. 4,000.

(d) Goods withdrawn Rs. 3,000 for domestic use

(e) Depreciation on Plant Machinery at 10% and Furniture at 10%

(f) Interest on Capital at 5% per annum.

(g) Included in sales is an amount of Rs. 5,000 representing goods on sale or return, the customers still having the right to return the goods. The goods were invoiced showing a profit of 20% on sales.

(Answer : Gross Profit Rs. 1,12,700; Net Profit Rs. 49,785; Total of Balance Sheet Rs. 2,27,910)

18.6 RECOMMENDED BOOKS

1. **R.L. Gupta and V.K. Gupta** — 'Principales and Practice of Accountancy' (Sultan Chand & Sons, New Delhi)

2. **T.S. Grewal** — ' Introduction to Accountancy' (Sultan Chand & Co., New Delhi)

3. **V.A. Patil and J.S. Korlahalli** — 'Principles and Practice of Accountancy' (S.Chand & Co, New Delhi)

4. **S.N. Maheswari** — 'Advanced Accountancy' Volume One, (Vani Educational Books New Delhi)

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UNIT -19 : ERRORS AND THEIR RECTIFICATION

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19.0 AIMS AND OBJECTIVES

The aims of this unit are: i) to classify the various types of errors and ii) to explain the methods of rectifying them.

At the end of this unit, you will be able to:
-classify the various types of errors;
- explain the methods of rectifying the errors.

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19.1 INTRODUCTION

We have already seen that a Trial Balance is prepared at the end of each accounting period as a preliminary measure before the final accounts for the period are prepared. The purpose of preparing the Trial Balance is to verify the arithmetical accuracy of the books of accounts. Sometimes, a trial balance does not tally thereby indicating that there are certain errors. Therefore the errors must be detected and corrected in order that the trial balance may tally or agree. The steps to be taken to locate errors have been explained in Unit 11.

From the view-point of the agreement of trial balance, errors can be classified into two categories.

(i) errors that affect the agreement of Trial Balance, and
(ii) errors that do not affect the agreement of Trial Balance.

Errors can also be classified from another point of view as:

(i) errors of principle, and
(ii) clerical errors

In Unit 11 the errors of principle and clerical errors have been discussed with examples.

19.2 RECTIFICATION OF ERRORS

When the Trial Balance does not tally, as stated earlier, certain steps are taken to locate the errors. These errors must be now rectified. Some of the errors involve only one of the two sides of a ledger account, i.e., either the debit side only or the credit side only. Errors of this type can be called 'one -sided errors'. These one -sided errors always affect the agreement of Trial Balance.

Certain other errors may involve both sides, i.e., the debit and credit sides of two or more accounts in respect of an identical amount. Such errors can be called 'two-sided errors'.

Classification of errors as one-sided and two-sided helps in determining the procedure to be adopted for rectifying them. The rectification of one sided errors is achieved by means of noting the correction on the appropriate side in the ledger account where the mistake is required to be rectified. Thus, these one-sided errors do not require a journal entry for rectification. A journal entry for rectification can be passed only when the two sides (i.e., both debit and credit) of two or more accounts are involved in the rectification process inrespect of an identical amount. In such a situation the entry passed for this purpose is called a 'rectification entry'. It is useful to note that there is no transaction as such, which forms the basis for this rectification entry; it is an error the correction of which is attempted through the rectification entry. Two - sided errors require rectification entries for their correction.

It is necessary to understand the nature of the error i.e., whether it is a one-sided error or a two-sided error before deciding to rectify the error because, as seen above, it is only a two-sided error that requires a journal entry for rectification. The following hints will be helpful to the rectification of errors:

i. The statement containing the error must be carefully studied. The actual transaction must be noted and the correct method of recording the actual transaction identified.

ii. Analyse carefully the statement given to identify the exact mistake which was committed, so that the existing wrong position could be compared with the correct position that ought to have existed. Note the differences between the two carefully. The differences may be inrespect of the name of the account, the side of the account (debit side, instead of credit side or vice-versa), the amount of the transaction (either more or less than the amount to be taken into account), etc.

iii. Having identified the difference between the wrong and the correct positions, decide whether the particular error can be classified as a one-sided error or as a two-sided error. This identification of the type of mistake committed helps you to determine whether a journal entry is required for rectification or not.

iv. The purpose of rectification is to eliminate the wrong position/effect of the error by replacing it with the correct position/effect. Check up whether the rectification procedure determined by you achieves this objective.

Now it is proposed to consider the rectification of one-sided errors.

19.2.1 Rectification of One-Sided Errors

1. The sales book for the month of December was undercast by Rs. 10,000/-

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It is obvious that this error was committed while totalling. We are aware that the periodical total of the Sales Book is posted to the credit of Sales A/c in the ledger. The error in totalling naturally affects the Sales A/c. as only one side of one account is affected, this is a one-sided error. As the Sales A/c has been credited short by Rs. 10,000, this error can be rectified by now crediting the Sales A/c. with Rs. 10,000/-. This correction will appear in the Sales A/c as follows.

Dr. SALES ACCOUNT Cr.

	Rs.		Rs.
		By Undercasting of Sales Book for the month of December	10,000

The date on which the error is rectified will be entered in the Date column. Further, having made out that there is an error, the wrong total in the Sales Book for the month of December will be circled with red ink and the correct total entered above the circle and initialled with date. As the error states that the Sales Book was undercast, we can assume that the individual accounts of the debtors have been correctly posted. Further, note that this error in totalling upsets the debit credit correspondence and hence affects the agreement of Trial Balance. This error is an example of a clerical error, and it can be further classified as an error of commission.

2. The purchases book for the month of January was overcast by Rs. 1000/-

This error is also a totalling error. The periodical total of the Purchases Book is posted to the debit of Purchases A/c. The effect of overcasting in the Purchases Book is that the Purchases A/c. gets debited with an excess amount of Rs. 1000/-. This excess debit has to be removed by crediting the Purchases Account with Rs. 1000/- as shown below:

Dr. PURCHASES ACCOUNT Cr.

	Rs.		Rs.
		By Overcasting of Purchases Book for the month of January	1,000

Certain steps mentioned inrespect of rectifying the error No. 1.,given above will be applicable here also, i.e., (i) correcting the wrong total in the Purchases Book for the month of January by circling it with red ink, (ii) inserting the correct balance above the circle, and (iii) initialling the same with date. Similarly, we can assume that the individual accounts of the creditors have been correctly posted. Again as this error is a totalling error it upsets the debit-credit correspondence and affects the agreement of the Trial Balance.

3. A payment of Rs. 500/- for rent has been posted twice to the Rent A/c.

In this the Rent A/c has been debited twice with Rs. 500/-. The excess debit of Rs. 500/- must now be removed by crediting the Rent A/c. as shown below:

Dr. RENT ACCOUNT Cr.

	Rs.		Rs.
		By Double posting on ----------(date) rectified	500

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The error states that the amount has been posted twice, which means that there is no error in recording this transaction in the Cash Book, but that the error is only in posting. Only the second posting is being corrected now. This error is a one-sided error and affects the agreement of the Trial Balance.

4. A receipt of Rs. 100/- towards interest was not posted at all.

As the posting was not done, the debit credit correspondence is upset. This is a one-sided error because for the debit of Rs. 100/- in the Cash Book there is no corresponding credit in the Interest A/c. This error can be corrected by now giving the posting as shown below:

Dr.	INTEREST ACCOUNT		Cr.
	Rs.		Rs.
		By Omission of Posting now rectified	100

5. Salaries paid amounting to Rs. 5,400/- was posted as Rs. 4,500/-

This error is in posting the amount which means that there is no error in recording the transaction in the Cash Book. Thus, the credit aspect is correctly recorded, but the debit aspect falls short by Rs. 900/- because instead of posting Rs. 5,400/- to the debit of Salaries A/c, it was wrongly posted as Rs. 4,500/-. As the amount posted to the debit of Salaries A/c is less than what it ought to have been, this short debit will be corrected by debiting the Salaries A/c as shown below.

Dr.	SALARIES ACCOUNT		Cr.
	Rs.		Rs.
To Short debit in posting on ----------(date)	900		

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6. A credit purchase from Mr. Rao for Rs. 5,000 was posted to the debit of his A/c.

The purchase from Mr. Rao should have been posted to the credit side of his personal account but instead his account was wrongly debited. In order to rectify this error, Rao's A/c should now be credited with double the amount, i.e., Rs. 10,000/- (Rs. 5,000 for cancellation of the wrong debit, and another Rs. 5,000 for recording the original purchase). This correction will be done as shown below.

Dr.	RAO'S ACCOUNT		Cr.
	Rs.		Rs.
		By Wrong debit instead of credit on ----------(date) rectified	10,000

7. Discount received from Mr. Venkat Rs. 150/- has not been entered in the Discount Received Column of the Cash Book but has been posted to his personal a/c

This error affects the Discount Received Account only as there has been no error in posting in the personal account. As the discount received has not been entered in the discount column of the Cash Book, the Discount Received A/c has not received the credit for Rs. 150/-. Thus, there is a short credit which will be corrected now by crediting as shown below.

Dr. DISCOUNT RECEIVED ACCOUNT Cr.

	Rs.		Rs.
		By Omission in the Cash Book on ----------(date) now rectified	150

8. The total of discount column in the Cash Book on the debit side of Rs. 549/- was carried forward to the next page as Rs. 459/-

The error is in carrying forward the total of debit side discount column of the Cash Book. The amount carried forward is short by Rs. 90/- and can now be corrected by debiting the Discount Allowed A/c as shown below.

Dr. DISCOUNT ALLOWED ACCOUNT Cr.

	Rs.		Rs.
To Mistake is carrying forward in the Cash Book on ----------(date) rectified	90		

9. Rs. 1000 received from Raghava has been debited to Reghuveer (Cash Book entry is correct).

The amount of Rs. 1,000 ought to have been posted to the credit of Raghava's A/c from the Cash Book. But instead, Raghuveer's A/c was debited. Thus, there are two mistakes in this case; (i) An un-concerned A/c viz., Raghuveer's A/c is involved and whether it is a debit or a credit given to his account, it must be removed, (ii) the concerned A/c. of Mr. Raghava must be given the credit now, as it has not got the credit. The two mistakes have to be rectified as shown below.

i. The debit to Raghuveer's A/c is cancelled by crediting his personal account.

Dr. RAGHUVEER'S ACCOUNT Cr.

	Rs.		Rs.
		By Wrong debit on---------- (date) rectified	1,000

ii. As Raghava's A/c has not got the credit it will now be credited as shown below:

Dr. RAGHAVA'S ACCOUNT Cr.

	Rs.		Rs.
		By Omission of posting on ----------(date) rectified	1,000

We have seen above certain examples of one-sided errors. As stated earlier, these errors upset the debit-credit correspondence and thus affect the agreement of the trial balance. As only one aspect/ one-side is involved in the error, no journal entry is required for rectifying these errors. The rectification is done by making an entry in the concerned account. Now it is proposed to take up the rectification of two sided errors.

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19.2.2 Rectification of Two-Sided Errors

Two-sided errors are those which involve, in the process of rectification, two or more accounts and both the debit and credit sides in respect of an identical sum. A complete omission to record a transaction, recording a transaction twice, posting the amount to a wrong account (correct side) can be cited as examples of two-sided errors. These two-sided errors require a Journal entry to rectify them. Now we shall consider certain two sided errors and analyse them.

1. Purchase of a typewriter from Godrej & Co. for Rs. 4,500 was wrongly entered through the Purchases Book.

As the purchase is of an asset, the concerned Asset A/c must be debited. Purchases Book is meant for recording only the credit purchases of goods and not of Assets. The correct entry should have been:

	Typewriter A/c	Dr.	4,500	
	To Godrej & Co., A/c			4,500

By passing this transaction through the Purchases Book, the wrong entry, in effect, that was passed was:

	Purchases A/c	Dr.	4,500	
	To Godrej & Co., A/c			4,500

The effect of this wrong entry is that the Typewriter A/c, which ought to have got the debit has not got it and that an unconcerned account, viz., the Purchases A/c has been wrongly debited. So far as the credit to Godrej & Co. is concerned, there is no error. To rectify this, the wrong debit given to Purchases A/c, must be removed by crediting it and the Typewriter A/c must now be debited. As two accounts, two sides and an identical sum are involved in the process of rectification, a journal entry to rectify this error can be passed, as shown below:

	Typewriter A/c	Dr.	4,500	
	To Purchases A/c			4,500
	(Being the rectification of wrong debit to Purchases A/c for the purchase of Typewriter)			

Note that when this error existed in the books, the debit-credit correspondence was not affected, and hence the Trial Balance would continue to tally in spite of the presence of such errors. So long as a debit exists for a credit, the Trial Balance is unaffected. The Trial Balance indeed, is not concerned whether the debits and credits have gone to correct accounts or not. Thus, for example, if goods purchased from Shastry were wrongly passed through Sales Book, the Trial Balance would continue to tally.

2. A credit sale of Rs. 2,000 to Reagan was omitted and not entered in the Sales Book.

As the transaction has not been recorded at all, neither a debit nor a credit exists in the Books. This is a case of complete omission. This error can be now rectified by recording the transaction, as shown below:

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	Reagan A/c To Sales A/c (Being the credit sale previously omitted now recorded)	Dr.	2,000	2,000

3. A credit purchase from Ahmed for Rs. 1,500 was recorded as Rs. 5,100.

In this case only the amount entered is wrong, i.e., Rs. 5,100 instead of 1,500. There is no error in respect of the Purchases A/c getting the debit aspect and Mr.Ahmed's A/c getting the credit aspect. As the amount entered is more than the correct amount, the error can be rectified by passing the reverse entry for the difference, as shown below:

	Ahmed's A/c To Purchases A/c (Being the rectification of a credit purchase of Rs, 1,500 wrongly recorded for Rs. 5,100)	Dr.	3,600	3,600

4. A credit purchase of goods from Reddy, amounting to Rs. 4,000, has been wrongly passed through the Sales Book.

As this is a case of credit purchase of goods, this transaction must have been recorded through the Purchase Book. this means the entry that should have been passed, in effect, is

	Purchase A/c To Reddy's A/c	Dr.	4,000	4,000

As this transaction was wrongly recorded through the Sales Book, the wrong entry could be stated as:

	Reddy's A/c To Sales A/c	Dr.	4,000	4,000

The effect of this wrong entry is that the purchase transaction has not been recorded at all, but that instead, a sale that has not taken place has been recorded. Therefore, the wrong sales entry must be cancelled by passing the reverse entry:

	Sales A/c To Reddy's A/c (Being cancellation of the wrong entry)	Dr.	4,000	4,000

The reverse enrty shown above merely cancels the wrong entry, but does not serve the purpose of bringing into record the original purchase transaction. The entry normally passed for credit purchases will have now to be passed to restore the correct position, as here under:

	Purchase A/c To Reddy's A/c (Being the record of the transaction previously omitted)	Dr.	4,000	4,000

Note that the credit is common in the two entries given above. Hence, a combined entry can be passed as follows:

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	Purchases A/c	Dr.	4,000	
	Sales A/c	Dr.	4,000	
	To Reddy's A/c			8,000
	(Being the correction of a credit purchase wrongly recorded through the Sales Book)			

5. Rs. 100/- received from Ramam has been wrongly credited to Raman's A/c

The amount should have been credited to Ramam's A/c but instead, it was wrongly credited to Raman's A/c. This error can be rectified by cancelling the wrong credit given to Raman by debiting his account and giving now the credit to Ramam's A/c as he is the giver of the amount. The following rectifying entry can be passed:

	Raman's A/c	Dr.	100	
	To Ramam's A/c			100
	(Being the cancellation of wrong credit to Raman's A/c)			

6. Repairs to building amounting to Rs. 150/- was debited to Buildings A/c

The expenditure by way of repairs is a revenue item and hence must be debited to the Repairs Account. The wrong debit to Buildings A/c capitalises the revenue expenditure wrongly. This is an example of 'an error of principle'. The wrong debit given to Buildings A/c must be cancelled and the Repairs A/c should be debited. The rectifying entry for this purpose would be:

	Repairs A/c	Dr.	150	
	To Buildings A/c			150
	(Being the rectification of wrong debit to Buildings A/c for the repairs)			

7. An amount of Rs. 200 due from Sanjay had been written off earlier as a bad debt. This amount was later recovered and posted to his personal account.

When a bad debt is recovered subsequently, the amount so recovered should be credited to Bad Debts Recovered A/c and not to the personal account of the party, as the party's account has already been closed. The wrong credit given to Sanjay must be cancelled by debiting his account and the corresponding credit should now be given to the Bad Debts Recovered A/c as shown below:

	Sanjay's Account	Dr.	200	
	To Bad Debts Recovered Account			200
	(Being the correction of wrong credit in respect of a recovered Bad Debt)			

Thus, whenever the process of rectification involves two or more accounts, both debit and credit sides, inrespect of an identical sum then the journal entry is required to rectify such errors.

The following illustrations concern combinations of both one-sided and two-sided errors. The students are advised to identify the error correctly and apply the procedure indicated earlier in order to understand the rectification given in the illustrations.

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Illustration - 1

How would you rectify the following errors in the books of Madan & Co ?

a. The Sales Returns Book has been undercast by Rs. 300/-
b. The total of the Bills Receivable Book of Rs. 3,900/- has been posted to the credit of Bills Receivable account.
c. While posting Purchases Book to the Ledger, the personal account of Raman Lal has been credited with Rs. 291 instead of Rs. 219.
d. Rs. 5,000 paid for the purchase of a T.V. Set for the proprietor is debited to General Expenses Account.
e. An amount of Rs. 500/- paid by Kewal Khanna has been credited to the account of Kanwal Khanna.
f. Goods sold to M/s.Mahender and Bhushan for Rs. 700/- have been entered in the Purchases Book. The entry has been posted to the Ledger.

Solution

a. The error will be rectified by entering Rs. 300 on the debit side of Sales Returns A/c in the Ledger as "To undercasting of Sales Returns Book for the month of ----------of Rs. 300".

b. This error will be rectified by entering an amount of Rs. 7,800 on the debit side of Bills Receivable A/c as "To wrong posting of total of Bills Receivable Book on the opposite side on ---------- Rs. 7,800".

c. The Personal Account of Raman Lal has been credited with an excess amount of (Rs. 291 less Rs. 219). The error will be rectified by debiting his account with Rs. 72 as " To difference in amount posted on Rs.---------- 72".

d. The following journal entry is required for rectification.

	Drawings A/c Dr. To General Expenses A/c (Being the rectification of error caused by wrongly debiting the General Expenses A/c)		5,000	5,000

e. The following journal entry is required:

	Kanwal Khanna's A/c Dr. To Kewal Khanna's A/c (Being the rectification of wrong credit to Kanwal Khanna instead of Kewal Khanna)		500	500

f. The following journal entry is required:

	M/s Mahender and Bhushan A/c Dr. To Purchases A/c To Sales A/c (Being the rectifying entry for sale to M/s Mahender and Bhushan wrongly entered in the Purchases Book)		1,400	700 700

Illustration - 2

How would you rectify the following errors:

a. Rs. 2,600, received from the sale of old machinery has been posted to Sales Account.

b. Rs. 490, the cost of repairing the floor of a room, has been charged to Buildings Account.
c. A purchase of goods for Rs. 255 from Giff Bros has been wrongly debited to Furniture Account.
d. A sale of Rs. 821 has been credited to the Customer's A/c
e. A Payment of Rs. 200 on account of rent has been posted twice to the Rent Account,
f. An item of Rs. 175 has been debited to a personal account as Rs. 157

Solution

a. The following journal entry is required:

	Sales A/c	Dr.	2,600	
	To Machinery A/c			2,600
	(Being the entry to rectify the wrong credit to Sales A/c)			

b. The following journal entry is required:

	Repairs A/c	Dr.	490	
	To Buildings A/c			490
	(Being rectification of error caused by debiting Buildings a/c instead of Repairs A/c			

c. The following journal entry is required:

	Purchases A/c	Dr.	255	
	To Furniture A/c			255
	(Being rectifying entry for the error caused by debiting Furniture A/c for goods purchased)			

d. This error will be rectified by debiting the personal A/c of the customer with Rs. 1,642 (double of Rs. 821) as 'To wrong posting on the credit side on ----------, Rs. 1,642. Rs. 821 on the debit side will cancel the wrong credit and the other Rs. 821 will record the sale.

e. This error will be rectified by entering the amount of Rs. 200 on the credit side of the Rent Account as 'By double posting on -------- Rs. 200.

f. The Personal A/c has been debited Rs. 18 short (Rs. 175 — Rs. 157). To rectify the error, the Personal A/c will be debited with the difference as 'To difference in amount posted on ---------- Rs. 18'.

Check Your Progress -1.

i) Which Account is to be debited for Wages paid on the installation of a new machine

a) Wages Account;
b) Capital Account;
c) Machine Account.

ii) Which type of error is involved for an expense on major repairs of a machinery has been debited to repairs acccount.

a) Error of commission
b) Error of principle
c) No error

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iii) Shyam Sunder is debited with Rs.67 instead of Rs.76. What is the effect of this error
a) affect the agreement of Trial Balance
b) not affect the agreement of trial balance.

19.3 SUMMING UP

Some times, a Trial Balance does not tally thereby indicating that there are certain errors. Some of the errors involve only one of the two sides of a ledger account, i.e., either the debit side only or the credit side only. Errors of this type are called one sided errors. Certain other errors may involve both sides, i.e., the debit and oredit sides of two or more accounts, in repect of an indentical amount. Such errors are called two sided errors.

The rectification of one sided errors is achieved by means of noting the correction on the appropriate side in the ledger account where the mistake is required to be rectified. Thus these one sided errors do not require a journal entry for rectification; where as two-sided error are required a journal entry for rectification.

19.4 ANSWERS TO CHECK YOUR PROGRESS

I. i) c) Machine account should be debited
ii) b) Error of principle
iii) a) Affect the agreement of Trial Balance.

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19.5 MODEL EXAMINATION QUESTIONS

A. Short Answer Questions

1. What is rectification entry?
2. Distinguish between clerical error and error of principle.
3. Explain the following:
   a) Error of Omission
   b) Error of Commission
4. What do you understand by:
   a) One-sided errors ?
   b) Two-sided errors ?
5. Explain the difference between one-sided error and two-sided error.
6. Does a Trial Balance reveal all the mistakes ?

B. Essay Answer Questions

7. What are the mistakes that the Trial Balance show and what mistakes does it not show?
8. What are errors of omission and commission ? How do they occur ?
9. Give two examples of the one sided errors and two-sided errors. How are they corrected?

Problems

1. Rectify the following errors :

   a) The Sales Book for the month of June was undercast by Rs. 300.
   b) The Purchases Book for the month of November was overcast by Rs. 400.
   c) A payment of Rs. 250 for interest has been posted twice to Interest Account.
   d) Cash amounting to Rs. 1,080 paid to Mohandas has not been posted to his account
   e) Rs. 245 received from Devidas was posted to the debit of his account.
   f The total of the discount allowed column in the Cash Book of Rs. 68 was carried forward to the next page as Rs. 86.

2. Rectify the following errors :

   a) A credit, purchase of goods from Kapil amounting to Rs. 12,000 has been wrongly passed through the Sales Book.
   b) A credit sale of Rs. 1,200 to Murali was omitted to be entered in the Sales Book.
   c) Rs. 300 withdrawn for personal use has been debited to General expenses Account.
   d) Purchase of Wooden cupboard for Rs. 1,400 has been passed through the Purchases Day Book.
   e) A sale of an old Typewriter for Rs. 1,200 was passed through the Sales Book.
   f) Rs. 354 received from Mohan Krishna was credited to Krishna Mohan.

3. Rectify the following errors

   a) Rs. 980 paid as wages for construction of a room was debited to the Wages Account.
   b) Rs. 1,200 the amount of rent paid to the landlord was debited to his personal account.
   c) Goods purchased for the personal use of the Proprietor, costing Rs. 400 was debited to the Purchases account.
   d) Discount allowed amounting to Rs. 200 had been credited to Discount Received Account.
   e) Total of Purchases Book of one page was carried forward to the next page as Rs.986 instead of 896.
   f) Total Sales Book of one page was carried forward to the next page as Rs. 685 instead of Rs. 865.

4. Rectify the following errors

   a) Goods sold to Manohar amounting to Rs. 770 was posted to his account as Rs. 707.
   b) Total of a page in the Purchase Returns Book, Rs. 331, was carried forward as Rs. 313.
   c) Sales Returns were wrongly entered in the Sales Book and posted there from wrongly to the credit of the party's personal account amounting to Rs. 500.
   d) An amount of Rs. 2,100 was received in full settlement from a customer after he was allowed a discount of Rs. 185, but while recording the same in the Cash Book, the amount received was entered in the discount column and the discount allowed was entered in the amount column.
   e) Cash Sales amounting to Rs. 515 was posted to the Sales Account as Rs. 551.
   f) Commission paid amounting to Rs. 345 was posted twice to the account.

5. Rectify the following errors

   a) Rs. 448, recovered on account of a bad debt written off earlier, was credited to the customer's personal account.

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b) Goods returned by Mukesh amounting to Rs. 123 has been entered in the Returns Outward Book.

c) An amount of Rs. 200 withdrawn by the proprietor for his personal use has been debited to General Expenses Account.

d) Discount allowed to Kishore amounting to Rs. 12 has not been entered in the discount column of the Cash Book, but it has been posted to the customer's personal account.

e) A cash sale to Rao for Rs. 880 was recorded in the Cash Book and also in the Sales Book and posted from both the books.

f) The Bank column of the payments side of the Cash Book was overcast by Rs. 80.

6. Rectify the following errors

a) A credit purchase of goods from Ramesh, amounting Rs. 800, has been wrongly passed through the Sales Book.

b) A credit sale of Rs. 450 to Rakesh was entered in the Returns Outward Book.

c) Rent paid for proprietor's residence amounting to Rs. 500 was debited to the Rent Account.

d) The Returns Outward Jounal has been overcast by Rs. 1,500.

e) Rs. 850 paid as interest was wrongly debited to Commission account.

f) A credit sale of Rs. 400 to Anand was posted to his credit.

19.6 GLOSSARY

One-sided errors : When the error involves only one of the two-sides of a ledger account, i.e., either the debit side only or the credit side only, it is called a 'one-sided error'.

Two-sided errors : When an error involves both the sides, i.e., debit as well as the credit side of two or more accounts, such an error is called 'a two-sided error'.

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UNIT - 20 : SUSPENSE ACCOUNT AND EFFECT OF RECTIFICATION ON PROFITS

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20. 0 AIMS AND OBJECTIVES

The aims of this unit are to explain i) the meaning and purpose of creating a 'Suspense Account' and the method of rectifying the errors when a Suspense Account is in operation; ii) the effect of rectification of errors on the trading result.

Having studied this unit you will be :

- aware of the need for opening a Suspense Account
- able to rectify the errors when a Suspense Account is in operation
- able to identify the effect of rectification of errors on the net profit.

20. 1 INTRODUCTION

We have already seen that when a Trial Balance disagrees indicating thereby the presence of certain errors, the businessman goes through the books of accounts and attempts to locate and rectify the errors. After rectifying the errors, a revised Trial Balance is prepared. If there are no more errors in the books of accounts, the revised Trial Balance would tally. However, it is possible that the revised Trial Balance also may not tally indicating thereby the presence of some more errors. In such a situation, the businessman, if in a hurry to prepare the final accounts, may put the difference between the two amount columns of the Trial Balance against a Suspense Account, and make the Trial Balance tally. The tallying of Trial Balance with the help of a Suspense Account is necessary because with a Trial Balance that does not tally. You can not expect the Balance Sheet to tally. If the total of the items in the debit column in the Trial Balance is more than the total of the items in the credit column of the Trial Balance, then the difference will be put against the Suspense Account in the credit column of the Trial Balance. This means that the Suspense Account gets created with a credit balance. Now this Suspense Account will appear on the liabilities side of the Balance Sheet and thus help it in tallying. Similarly, if the total of the credit items is more than the total of the debit items, then the Suspense Account will come into existence with a debit balance and will appear on the assets side of the Balance Sheet. The Suspense Account is also known as 'Difference in Books Account'.

The Suspense Account will be carried forward to the next accounting period in the Books of Account. As and when errors are located rectification entries will be passed. The two-sided errors, discussed in the previous unit, do not affect the agreement of the Trial Balance and hence cannnot be considered responsible for the creation of the Suspense Account. Thus for the two-sided errors the rectification entries

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discussed in the previous lesson will hold good. But it is the one-sided errors which affect the agreement of the Trial Balance, that can be considered responsible for the creation of Suspense Account. Thus, after the creation of the Suspense Account, when one-sided errors are located, their rectification would now certainly involve the Suspense Account. This is so because the amount with which the Suspense Account, started is the net difference between all one-sided errors involving various debits and credits to different accounts. Thus, when a Suspense Account is opened, even one-sided errors require journal entries for their rectification. Two-sided errors are rectified in the usual way and they do not involve the Suspense Account.

When all the errors have been rectified, the Suspense Account will be promptly closed. But if there is still some balance left in the Suspense Account, it means that there are still some errors lying concealed. In so far as the problems set in the examination are concerned, usually the rectification of given errors would result in the closure of the Suspense Account.

20. 2 SUSPENSE ACCOUNT AND RECTIFICATION OF ERRORS

We shall now consider the method of rectifying the one-sided errors when a Suspense Account is in existence. Let us assume that a businessman who could not tally his Trial Balance placed the difference of Re, 1/- between the totals of debit and credit columns of the Trial Balance to a Suspense Account on its credit side. When this Suspense Account was carried forward to the next accounting period he discovered the undermentioned errors :,

i. The Purchases Book was overcast by Rs. 1,000/-.

On account of this error the Purchases Account must have got an excess debit of Rs. 1,000. This is a one-sided error and earlier, it is shown that it is corrected by crediting the Purchases Account with Rs. 1,000. Now that the Suspense Account is in existence, there is no change in so far as the credit to purchases A/c. is concerned; but the corresponding debit must be given to the Suspense Account as the existence of this error must be considered responsible for the creation of the Suspense Account. Thus a journal entry would now be required for this one sided error. The rectifying entry is :

	Suspense Account Dr.		1,000	
	To Purchases Account			1,000
	(Being the rectification for overcasting in the Purchase Book)			

Earlier, we have seen that the total in the Purchases Book is corrected besides making the correction in the Purchases Account. But the position is different now because the relevant year's books of account have been closed and a new set of books opened. Hence, there is no need to reopen the already closed previous year's books. Instead, the above mentioned entry will be passed involving the Suspense Account.

ii. A discount of Rs.25 allowed to a customer has been credited to him as Rs. 52.

In this one-sided error, for a debit of Rs.25 appearing in the Discount Allowed account a credit of Rs.52 appears in the customer's account. Thus the excess credit of Rs.27 must have affected the agreement of the Trial Balance, which is responsible for the creation of the Suspense Account. This error requires the debiting of the customer's account with Rs.27 to rectify the excess credit given to his account. There will be no change in respect of the debit to Customer's account. But the corresponding credit will now be given to the Suspense Account, as the Suspense Account represents the effect of all such one-sided errors. The entry for rectifiction will be :

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	Customer's Account Dr. To Suspense Account (Being the rectification of the excess credit given to customer's account)	27	27

iii. A credit purchase of Rs.972 was posted twice to the Supplier's Account.

This error, i.e., the posting of the amount twice, to the Supplier's account is to be rectified by debiting his account with Rs.972, and crediting the Suspense Account with the same amount. The rectification entry will be :

	Supplier's Account Dr. To Suspense Account (Being the rectification to cancel the excess credit to Supplier's account)	972	972

The Suspense Account would now appear as follows, when the above mentioned rectifying entries are posted to it :-

Dr. SUSPENSE ACCOUNT Cr.

	Rs.		Rs.
To Purchases A/c	1,000	By Difference in Trial Balance	1
		By Customer's Account	27
		By Supplier's Account	972
	1,000		1,000

It may be seen that the Suspense Account has been closed on the rectifiction of the errors. When the Trial Balance did not tally, the difference was only Re.1/-. The size of the difference cannot by itself indicate either the number of errors or the amount involved in those errors. The illustration given above shows that there were three errors in all, although their net difference was only Re.1/-.

The closing of the Suspense Account generally indicates that there are no more errors in the books. But it might happen that there were some compensating errors on account of which the Suspense Account got closed. In such a case, the errors will be rectified as and when located and posted to the Suspense Account. What is to be noted is that as long as there is some balance on the Suspense Account. It should be taken that there are still some errors in the books of account.

The following illustrations will further explain the method of rectifying the errors when a Suspense Account is in operation.

Illustration - 1

Rectify the following errors found in the books of Mr. Ramesh. The Trial Balance was out by the excess credit of Rs.2,804-60. The difference has been posted to a Suspense Account.

(a) The discount column of the Cash Book on the debit side has been overcast by Rs.20/-.

(b) A credit sale of Rs.1,000 to Rama has been credited to his account.
(c) The total of the Purchases Returns Book has been overcast by Rs.200/-
(d) A sum of Rs.69-40 received from Narayan has been posted to his account as Rs.694.

Solution

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Date	Particulars		L.F	Rs.	Rs.
	(a) Suspense Account	Dr.		20	
	To Discount Allowed Account				20
	(Being the rectification of overcasting of discount column on the debit side of the cash book)				
	(b) Rama's Account	Dr.		2,000	
	To Suspense Account				2,000
	(Being the rectification of wrong credit given to Rama)				
	(c) Purchases Returns Account	Dr.		200	
	To Suspense Account				200
	(Being the rectification of overcast in the purchases Returns Book)				
	(d) Narayana's Account	Dr.		624.60	
	To Suspense Account				624.60
	(Being the rectification of excess credit given to Narayana's A/c.)				

Dr. SUSPENSE ACCOUNT Cr.

	Rs.		Rs.
To Balance	2,804.60	By Rama's A/c	2,000.00
" Discount Allowed A/c	20.00	" Purchase Returns A/c	200.00
		" Narayan's A/c	624.60
	2,824.60		2,824.60

Illustration - 2

Shankar, the book-keeper, committed certain errors in the books. He transferred the difference in the Trial Balance to the credit of a Suspense Account. Subsequently, the following errors were discovered. Pass the necessary journal entries to rectify the errors and show the Suspense Account.

(a) An amount of Rs.120 paid as insurance premium was not posted to Insurance Premium Account.
(b) Rs.250 paid towards salaries wrongly entered in the Salaries Account as Rs.2,500.
(c) Discount allowed column of the Cash Book was overcast by Rs.100.
(d) Cash sales not entered in the Sales Account amounted to Rs.700.

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NOTE: The illustration states that a Suspense Account was created but does not state the amount with which it was started. In such a case, the student has to find out for himself the balance with which the Suspense Account was started. Rectifying entries will be passed in the usual way, and posted to the Suspense Account. The difference between the two sides, i.e., the balancing figure, will be considered as the amount with which the Suspense Account was started originally.

Solution

JOURNAL

Date	Particulars		L.F	Rs.	Rs.
	(a) Insurance Premium A/c	Dr.		120	
	To Suspense A/c				120
	(Being the omission of posting to Insurance premium A/c now rectified)				
	(b) Suspense Account	Dr.		2,250	
	To Salaries A/c				2,250
	(Being excess debit to salaries A/c now rectified)				
	(c) Suspense A/c	Dr.		100	
	To Discount Allowed A/c				100
	(Being rectification of overcast in the discount allowed column of the Cash Book)				
	(d) Suspense A/c	Dr.		700	
	To Sales A/c				700
	(Being the omission of posting to Sales A/c now rectified)				

Dr. SUSPENSE ACCOUNT Cr.

	Rs.		Rs.
To Salaries A/c	2,250	By Balance	2,930
" Discount Allowed A/c	100	" Insurance Premium A/c	120
" Sales A/c	700		
	3,050		3,050

Illustration - 3

Rectify the following errors assuming that a Suspense Account was opened.

1. A Purchase made from Andhra Stores for Rs.5,000 was not entered in the Purchases book.
2. An amount of Rs.200 received from Rajaram was credited to Raghuram's Account.
3. A sale of Rs.250 to Gopal was debited to his account as Rs.520.
4. Wages paid amounting to Rs.750 was wrongly debited to Salaries A/c.
5. Rs.100 received on account of interest stands wrongly credited to Commission Account.
6. The total of Returns Outwards Book amounting to Rs.220 was not posted in the ledger.
7. A credit sale of Rs.1,000 to Rakesh was wrongly credited to his account.
8. A credit sale of Rs.140 to Gupta debited to him as Rs.104.
9. A credit purchase from Kaitan of Rs.250 was debited to him.
10. In Cash Book total of discount (Dr.) column Rs.102 has been carried forward as Rs.201.

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NOTES : 1. In this illustration, the balance in the Suspense Account is not indicated ; further, whether it was started with a debit balance or a credit balance is also not mentioned. As stated earlier, post the rectifying entries to the Suspense Account and consider the balancing figure as the amount with which the Suspense Account was originally started.

2. Sometimes, some two-sided errors are also given. Candidates should distinguish between one-sided and two-sided errors. Note that the rectification of two-sided errors would not involve Suspense Account.

Solution

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Date	Particulars		L.F	Rs.	Rs.
	(1) Purchases A/c	Dr.		5,000	
	To Andhra Stores A/c				5,000
	(Being the omission of credit purchases, now recorded)				
	(2) Raghuram's A/c	Dr.		200	
	To Rajaram's A/c				200
	(Being credit given to Raghuram's account instead of Rajaram's account, now rectified)				
	(3) Suspense A/c	Dr.		270	
	To Gopal's A/c				270
	(Being excess debit given to Gopal's A/c. now rectified)				
	(4) Wages A/c	Dr.		750	
	To Salaries A/c				750
	(Being debit to Salaries A/c instead of Wages A/c, now rectified)				
	(5) Commission A/c	Dr.		100	
	To Interest A/c				100
	(Being credit given to Commission A/c instead of interest A/c, now rectified)				
	(6) Suspense A/c	Dr.		220	
	To Returns Outwards A/c				220
	(Being the omission of posting to Returns outwards Book, now rectified)				
	(7) Rakesh's A/c	Dr.		2,000	
	To Suspense A/c				2,000
	(Being wrong credit given to Rakesh, now rectified)				
	(8) Gupta's A/c	Dr.		36	
	To Suspense A/c				36
	(Being amount debited short to Gupta's A/c, now rectified)				
	(9) Suspense A/c	Dr.		500	
	To Kaitan's A/c				500
	(Being debit given to Kaitan instead of credit, now rectified)				
	(10) Suspense A/c	Dr.		99	
	To Discount A/c				99
	(Being excess amount carried forward in Cash Book, now rectified)				

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Dr. SUSPENSE ACCOUNT Cr.

	Rs.		Rs.
To Balance (Balancing figure)	947	By Rakehs A/c	2,000
" Gopal A/c	270	" Gupta's A/c	36
" Returns outward A/c	220		
" Kaithan's A/c	500		
" Discount A/c	99		
	2,036		2,036

20.3 EFFECT OF RECTIFICATION ON THE NET PROFIT

We have seen that a Trial Balance is temporarily tallied by creating a Suspense Account and that the final accounts are prepared. The Profit and Loss A/c so prepared naturally would determine the Profit/Loss which is subject to the influence of these errors. The rectification of some of the errors might affect the profit/loss already ascertained.

Errors relating to personal and real accounts affect the Balance Sheet items and do not directly influence the trading result of the previous period. But errors relating to nominal accounts influence the profit or loss.

The effect of errors on the trading result, i.e., the profit or loss may be summarised as follows :

Error in Nominal Account	Effect of Error	
	Profit	Loss
1. Short debit	Increases	reduces
2. Short credit	reduces	increases
3. Excess debit	reduces	increases
4. Excess credit	increases	reduces
5. Wrong debit	reduces	increases
6. Wrong credit	increases	reduces
7. Omission of debit	increases	reduces
8. Omission of credit	reduces	increases

Consequently, when the errors are rectified the effect of the rectification on the profit or loss will be the reverse of what has been stated in the table given above.

The following explanation will make it clear:

i) Salaries for the month of December amounting to Rs.2,000 was posted to the Salaries Account as Rs.200

This is a case of short debit in a nominal account. As the short debit reduces the amount of expenses charged to Profit and Loss Account during the year, the profit so determined will increase (if there was a loss in that year this short debit reduces the loss). Rectification of this short debit would naturally have

the opposite effect, i.e.the previous year's profit will be decreased by Rs.1800/-(if there was a loss in the previous year, such a loss will now stand increased by Rs.1800). The rectification entry will, however, be the same i.e.,

	(1) Salaries A/c To Suspense A/c (Being the rectification of short debit to Salaries Account)	Dr.	1,800	1,800

ii) interest received for the half year ending on the 31st of December amounting to Rs.180 was posted to Interest Received A/c as Rs.80

This is a case of short credit in a nominal account. As this is an income account, a short credit here reduces the amount of income appearing in the Profit and Loss Account and hence the profit will be a lower figure. Rectification of this short credit will naturally have the opposite effect, i.e., the previous year's profit will now be increased by Rs.100. The rectification entry will, however, be the same, i.e.,

	Suspense A/c To Interest Received A/c (Being the rectification of short credit to Interest Received A/c)	Dr.	100	100

Note that the effect of excess debit will be the reverse of short debit and similarly, the effect of excess credit will be the reverse of short credit. Irrespective of the nominal account being an expense account or an income account the effect explained in the table above will be valid. Similarly, the effect of wrong debit is comparable to the effect of excess debit and the effect of wrong credit is comparable to that of excess credit. Further, note that the effect of omission of a debit is similar to that of a short debit., and that the effect of omission of credit is similar to that of short credit.

The explanation offered above is applicable to Purchases Account, Sales Account Purchases Returns Account and Sales Returns Account. If a wrong debit is given to Purchases Account, it reduces the profit. When such a wrong debit is rectified, it increases the profit. Further, note that similar is the effect on Purchase Returns, Sales and Sales Returns accounts.

The following illustration would clarify further the effect of rectification on profits:

Ilustration - 4

A businessman finds that he could tally his Trial Balance only by opening a Suspense Account. In the following year, he discovers following errors:

i) The debit side discount column of the Cash Book was overcast by Rs.20

ii) Sale of old furniture amounting to Rs.200 had been credited to Sales Account

iii) A sale of Rs.670 to Hameed had been debited to his account as Rs.760.

iv) The total of Bills Payable Book amounting to Rs.2,500 for the month of December was not posted.

Rectify the above errors and prepare the Suspense Account. Further, explain the effect of rectification of errors on the profits.

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Solution

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Date	Particulars		L.F	Rs.	Rs.
	(i) Suspense A/c	Dr.		20	
	To Discount Allowed A/c				20
	(Being the rectification of the overcasting)				
	(ii) Sales A/c	Dr.		200	
	To Furniture A/c				200
	(Being the entry for rectification of wrong credit to Sales Account)				
	(iii) Suspense A/c	Dr.		90	
	To Hameed A/c				90
	(Being entry for rectification of excess debit)				
	(iv) Suspense A/c	Dr.		2,500	
	To Bills Payable A/c				2,500
	(Being the entry for the omission of posting)				

Dr. SUSPENSE ACCOUNT Cr.

	Rs.		Rs.
To Discount Allowed A/c	20	By Balance(being the balance figure)	2,610
" Hameed A/c	90		
" Bills Payable A/c	2,500		
	2,610		2,610

Effect of rectification on Net Profit	Increases Rs	Decreases Rs.
1. Credit to Discount Allowed A/c	20	
2. Debit to Sales A/c		200
3. As no nominal account is involved there is no effect	-	
4. As no nominal account is involved there is no effect	-	
	20	200

The net decrease in profits will be to the extent of Rs. 180 (Rs.200 less Rs.20).

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NOTE : In the illustration given above, rectifying entries for errors involving nominal accounts have been passed through such nominal accounts by either debiting or crediting the nominal account, depending on the case concerned. The nominal accounts really involved were those pertaining to the previous year, and they were closed by transferring to the Profit and Loss Account in the previous year. Now, if the nominal accounts of the current year are involved, then it would unnecessarily affect the current year's position. In such a case, the difficulty is overcome by creating a Profit and Loss Adjustment Account, which would receive the debits and credits on behalf of the nominal accounts involved in the rectification. The balance in the Profit and Loss Adjustment account will be transferred ultimately to the Profit and Loss Account of the current year. If this method is to be adopted the following would be the entries for errors (i) and (ii):-

(1)	Suspense Account To P&L Adjustment A/c (Being the rectification of overcasting the Discount Allowed Account)	Dr	20	20
(2)	P&L Adjustment A/c To Furniture A/c (Being the rectification for wrong credit given to Sales Account)	Dr	200	200

There will be no change in the rectification entries in respect of errors (iii) and (iv).
The Profit and Loss Adjustment Account will appear as follows

Dr. PROFIT AND LOSS ADJUSTMENT ACCOUNT Cr.

	Rs.		Rs.
To Furniture Account	200	By Suspense Account	20
		" P&L A/c	180
	200		200

The debit balance in the P&L Adjustment A/c shows that the rectification of errors resulted in a decrease in the profits to the extent of Rs.180/-. The P&L Adjustment Account is transferred to Profit and Loss Account by means of the following entry, and is closed:

	Profit & Loss Account To P&L Adjustment Account (Being the entry for transferring the decrease in profits arising out of rectification of errors)	Dr	180	180

Check Your Progress -1.
Fill in the blanks selecting from the alternatives given in brackets:

i) Errors relating _____ accounts influence the profit or loss.
(Personal/Real/Nominal)

ii) Short debit in nominal account _____ the profit.
(increases/decreases)

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iii) Wrong debit in nominal account _____ the profit.
(increases/decreases)

iv) The omission of debit item in nominal account reduces _____.
(Profit/Loss)

20.4 SUMMING UP

In this unit the method of rectifying the errors when a Suspense Account is in operation is explained. In addition the effect of rectification of errors on the trading result is also explained.

When a suspense account has been created, the errors are rectified as follows:

a)One-sided errors, which earlier did not require a journal entry would now require a journal entry involving the Suspense Account, (i.e., if the correction requires a debit to a particular account then the corresponding credit entry will be given to the Suspense Account and Vice-versa).

b) In the case of two-sided errors, there is no change in the rectification procedure. The rectification entry that was passed for rectifying a two-sided error when the Suspense Account had not yet been created, would be passed now also for rectifying such errors.

A Suspense Account gets closed when all the errors that were responsible for its creation are rectified. If some balance is still left in the Suspense Account then it can be assumed that there are still certain errors which have not yet been located.

In the process of rectification of an account that appears in the Trading and Profit and Loss Account is involved, the rectification of that error affects the trading results. Owing to rectification if an expense item increases the profit decreases and vice-versa. Similarly, owing to rectification if an income item increases the profit increases and vice-versa.

The effect of rectification as explained above will be reversed if the trading result for the period is a net loss and not a net profit.

20.5 ANSWERS TO CHECK YOUR PROGRESS

1. i) Nominal accounts influence the Profit or Loss.
   ii) Short debit increases the profit
   iii) Wrong debit reduces the profit
   iv) Omission of debit item in nominal account reduces Loss.

20.6 MODEL EXAMINATION QUESTIONS

A. **Short Answer Questions**

1. What is the Suspense Account ? When is it closed ?
2. What do you understand by the following:
   a) Over casting
   b) Under casting.
3. Explain the difference between short debit and excess credit.
4. What is Suspense Account ? When is it made use of ?
5. Does a Trial Balance reveal all the errors ?

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B. Essay Answer Questions

6. Explain the method of rectification of errors when a Suspense Account is opened?
7. Explain the effect of rectification of errors on the trading result of a business?

PROBLEMS

1. Correct the following errors found in the books of Mr. Srikanth, whose Trial Balance was out by Rs. 582 (excess debit), and the difference posted to a Suspense Account:

   a) The Sales Book has been totalled Rs. 50 short.
   b) The Purchases Book has been totalled Rs. 50 more
   c) Goods purchased amounting to Rs. 250 has been posted to the debit of the supplier, Mr. Sreeramulu.
   d) The Sales Return Book has been totalled Rs. 18 short.

2. On taking out a Trial Balance a book-keeper finds an excess credit of Rs. 615. Being desirous of closing the books, he places the difference to a Suspense Account, which is carried forward. In the next period, he discovers the following errors:

   a) The Sales Book was undercast by Rs.1,000
   b) A sum of Rs. 1,200, written off as depreciation on Machinery, has not been posted to the Depreciation Account.
   c) A discount of Rs. 250 allowed to a customer has been posted to his account as Rs. 25.
   d) The total of Returns Inward book has been totalled Rs. 100 short.
   e) A sale of Rs.390 was posted as Rs. 930 in the Sales Account.

   Give the correcting entries and prepare the Suspense Account.

3) A book-keeper failed to balance his Trial Balance. He places the difference to a newly opened Suspense Account which is carried forward. The following errors were subsequently discovered:

   a) Goods returned by Moorthy amounting to Rs. 1,000 has been entered in the Returns Outward Book; however, the posting was done correctly to Moorthy's account.
   b) The total of purchases Day Book had been undercast by Rs. 100.
   c) Purchase of a Typewriter on credit from Godrej & Co., for Rs. 4,800 was entered in the Purchases Book.
   d) A cheque received from Moses for Rs. 4,080 had been debited in the Cash Book, but the double-entry had not been completed.
   e) A cash sale of Rs. 1,250 to Subash, correctly entered in the Cash Book, was posted to the credit of his personal account.

   Make the necessary correcting entries and show the Suspense Account.

   (Suspense Account was opened with a credit balance of Rs. 1,980)

4. The book-keeper of a firm found his Trial Balance out by Rs. 1,844 (excess credit). He placed the amount in the Suspense Account and subsequently detected the following errors:

   a) The total of the discount column on the credit side of the Cash Book amounting to Rs. 156 was not posted in the ledger.
   b) The total of the Purchases Book was short by Rs. 2,000
   c) A sale of Rs. 567 to Ramesh was entered in the Sales Book as Rs. 765.
   d) A sale to Rama of Rs. 1,040 has been entered in the Purchases Book.

   Give Journal entries to rectify the above errors and show the Suspense Account.

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5) You are presented with a Trial Balance showing a difference which was carried to a Suspense Account; the following errors were found later :

a) Rs. 4,088 paid for the cash purchase of Furniture was not posted to the Furniture Account.
b) The total of the Sales Book for the month of March was undercast by Rs. 2,000.
c) Goods amounting to Rs. 1,200, sold to parameshwar, were correctly entered in the Sales Book, but posted to his account as Rs. 2,100.
d) A credit purchase of Rs. 7,500 from Paramahamsa was wrongly passed through the Sales Book.

Rectify the above errors and show the Suspense Account.

(Suspense Account was opened with a debit balance of Rs. 1,188).

6) The Trial Balance prepared by Diwakar did not tally and the difference was transferred to a Suspense Account. Subsequently, the following errors were found. Rectify the errors and show the Suspense Account.

a) A sale of Rs. 500 to Kamat was posted to Kamal
b) Insurance paid amounting to Rs. 130 was posted twice.
c) A purchase of Rs. 470 from Krishna was not passed through the books.
d) A sale of Rs. 300 for old machinery was passed through the Sales Book.
e) The total of Purchases Returns Book for the month of November was undercast by Rs. 375.
f) Rs.35 the debit balance on commission account, was omitted from the Trial Balance.

Further, show the effect of rectification of errors on the profits.

(Suspense Account was started with a credit balance of Rs. 470; Profit will be reduced by Rs. 300).

7) A trader opened a Suspense Account and later found the following errors:

a) The total of the Purchases Book had been undercast by Rs. 100
b) The discount column on the debit side of the Cash Book had been posted to the credit of Discount Account amounting to Rs. 20
c) Rs. 76 for repairs to furniture had been debited to Furniture Account.
d) A cheque received from Murthy for Rs. 39 had been debited in the Cash Book, but the double entry had not been completed.
e) The Returns Outward Book was overcast by Rs. 50.

Rectify the errors and show the Suspense Account also explain the effect of the rectification of the errors on the net profit.

(Debit balance on the Suspense Account amounting to Rs. 151; Profit will be decreased by Rs. 266)

20.7 RECOMMENDED BOOKS

1. **RL Gupta and VK Gupta** — 'Principles and practice of Accountancy' (Sultan Chand & Sons, New Delhi)
2. **TS Grewal** — 'Introduction to Accountancy' (Sultan Chand & Co., New Delhi)
3. **VA Patil and JS Korlahalli** — 'Principles and Practice of Accountancy' (S.Chand & Co., New Delhi)
4. **SN Maheswari** — 'Advanced Accountancy', Volume one (Vani Educational Books New Delhi)

Writer Prof. V. Viswanadham.

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BLOCK-IV : OTHER ACCOUNTING TOPICS

UNIT -21 : PROVISIONS AND RESERVES

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21.0 AIMS AND OBJECTIVES

This unit aims at discussing provisions, Reserves, the difference between provision and reserve and their accounting treatment.

On having gone through this unit, you would be able to :

— explain the terms provision and reserve
— classify the reserves and funds
— distinguish between provision and reserve
— classify the reserves
— solve the problems.

21.1 INTRODUCTION

'Reserves' refer to undistributed profits set aside for the purpose of meeting some liability, contingency or some other commitment. Creation of reserves reduces the profits available for distribution to the owners. The presence of reserves strengthens the financial position of the organisation. As they are created out of profits, reserves show a credit balance and appear on the liabilities side of the Balance Sheet.

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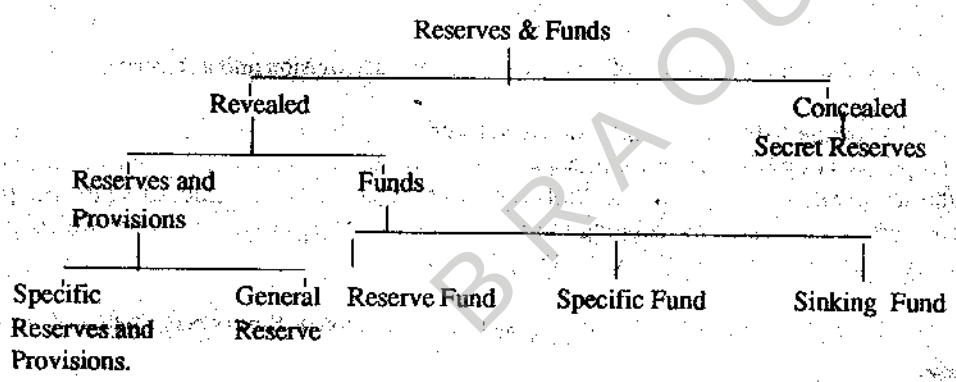
When a reserve is represented by some specific investment made outside the business, the word 'Fund' is added to denote the same. However, when no such outside investments are made, the account, is merely called a 'Reserve'

The word, 'Provision', refers to the amount set aside as a charge against the profits.
Reserve and Reserve Funds, generally speaking, refer to amounts set apart out of the Profits. The purpose of creating them may be any one of the following:

i. For meeting future (anticipated or unanticipated) liabilities or losses; e.g, provision for repairs, provision for doubtful debts, etc.,
ii. For fulfilling some specific purpose ; e.g, equivalisation of dividends.
iii. For redemption of a liability. e.g, redemption of redeemable Preference shares. Debentures, etc.,
iv. For replacing assets; e.g., Depreciation Fund for replacement of Machinery , lease etc.,
v. For strengthening the financial position of the organisation. e.g., General Reserve.

21.2 CLASSIFICATION OF RESERVES AND FUNDS

The reserves and funds may be created for a short or specified period or may remain the existence continuously for long periods. Further, such a reserve might have been created for meeting a known liability or for an unknown liability, i.e., contingency. Again, the reserves created may be revealed in the books of accounts may remain concealed. Keeping in view, these points, the reserves and funds can be classified and presented as follows:



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The basic purpose of creating Reserves and Provisions is to meet with greater confidence the uncertainties and unforeseen commitments that are natural in the conduct of any business.

21.3 PROVISION

The term, 'Provision' refers to any amount retained for meeting any known liability or loss; the amount of liability may not be accurately known. However, if the amount of the liability can be accurately ascertained, it will be considered a liability and not a provision. The uncertainty regarding the amount makes it necessary to create some provision which makes it possible to meet any liability as and when it actually occurs. Thus, the provision made may be less than adequate or more than adequate to meet the actual purpose, for which it has been created. However, as the amount of the estimated provision is based on what the past experience indicates, it should generally be sufficient to meet any liability or loss in respect thereof. The following can be cited as examples of 'Provision'.

Provision for Depreciation.
Provision for Doubtful Debts.
Provision for Taxation.
Provision for Repairs and Renewals,
Provision for contingencies.

21.4 RESERVE

The term 'Reserve' is used to denote any sum which is created by appropriating profit for the purpose of meeting any contingency, commitment, etc. Creation of Reserves generally improves the financial strength of the the business concern. Usually, the amount represented by the Reserve is retained within the business and thus adds to the working capital available for conducting the operations. Sometimes, the reserve amount is not invested within the business, but is taken out and invested outside the business, i.e., some securities are purchased. The purpose of investing the amount outside the business is to ensure that when the amounts are actually needed the outside securities can be readily disposed off and the amounts realised in cash. On the contrary, if the amounts are reinvested within the business, it may be difficult to have adequate cash readily available for meeting the particular purpose for which the reserve is created. Whenever a reserve is represented by amounts investing the amount outside the business it is called 'Reserve Fund'. Thus the suffix, 'Fund' generally denotes the presence of specific outside investments.

21.5 DISTINCTION BETWEEN A PROVISION AND A RESERVE

The following are the important points of distinction between a Provision and a Reserve:

1 A Provision is a charge to the Profit and Loss A/c and is created, whether profits exist or not,. a Reserve is an appropriation of profit, which is otherwise availabe for distribution as dividends to owners. Provisions are created by debiting the Profit and Loss Account before calculating the net profit or loss; Reserves are created by debiting the Profit and Loss Appropriation Account which means that Reserves can be created only when there are profits.

2. Creation of provisions is usually a matter of necessity ; but creation of Reserves is a matter of business prudence.

3. Provisions are generally shown as deductions from the concerned asset item on the assets side of the Balance Sheet. This helps the showing of asset items at the expected realisable values. Reserves are shown on the liabilities side of the Balance Sheet, but are not to be treated as a liability Reserves represent accumulations from divisible profits which otherwise belong to the owne and hence a part of the net profit.

21.6 CLASSIFICATION OF RESERVES

Reserves can be classified as : (i) Statutory Reserves, (ii) Capital Reserves and (iii) Reve Reserves.

(i) Statutory Reserves

Statutory Reserves are those whose creation has become an obligation on account of certain provisions in the relevant Statutes: e.g., Statutory Reserve required under the provisions of section 17, Companies Act, 1949.

(ii) Capital Reserves

Sometimes, a concern acquires certain capital profits. These capital profits cannot be considered to have been earned in the context of day to day trading operations and hence cannot be treated as readily available for distribution amongst the shareholders. When reserves are created out of such capital profits, they are called 'Capital Reserves'. Examples of such Capital Reserves are: Premium on the issue of shares and Debentures; Profits made on the re-issue of forfeited shares; Profits, if any, made prior to incorporation; Profit on sale of a part of the business; Profit on redemption of Debentures, etc.

(iii) Revenue Reserves

These are reserves which are created out of revenue surpluses only, and they are otherwise available for distribution as dividends to the shareholders. Examples of Revenue Reserves are General Reserve, Debenture Redemption Reserve, Investment Fluctuation Reserve, Contingency Reserve, Dividend Equivalisation Reserve, etc.,

Reserves can also be classified as (a) General Reserves and (b) Specific Reserves.

(i) General Reserves

General Reserves, as the name implies, are not created for any specific purpose. Thus, they must be considered available for meeting unexpected future losses or any other contingencies. So long as the amounts are available, they can be utilised for financing the expansion of the business. Thus, they generally represent the provision of additional working capital and help in strengthening the financial position of the business; e.g., General Reserve.

(ii) Specific Reserves

Specific Reserves are those which are created for a definite or specific purpose and are generally utilised to meet that definite purpose. Strictly speaking, nothing prevents the owners from utilising the unspent balances on these specific reserves. But in practice it is considered a self-imposed restriction and acts as a restraint or check on the making use of funds for any other purpose other than the originally intended one. Examples are: Dividend Equivalisation Reserve, Debenture Redemption Reserves.

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21.7 SINKING FUND

A Sinking Fund is a fund that is created to have some money readily available at the end of a specific period for replacement of an asset or redemption of a liability. We shall discuss this in the next Unit.

A Secret Reserve is a reserve whose existence is not revealed in the Balance sheet. Thus, the amount with which the Secret Reserve exists is also not disclosed in the Balance Sheet. The creation of Secret Reserves is prohibited under the provisions of the Companies Act, 1956 (Except in the case of Banks). Such a prohibition is to ensure all material facts regarding the financial position of the concern are fully disclosed or made known in the final accounts.

Secret Reserves are created in the following ways:

i. By Charging excessive depreciation: Though the asset is appearing at a very low or nominal value, the business continues to have the fullest advantage of the asset in question.

ii. By undervaluing Goodwill or stock in trade: Profits are as a consequence understated and the real strength/success of the concern remains concealed.

iii. By creating certain accounts like, provisions for bad debts with for larger amounts than are needed or warranted by circumstances : This measure also results in the suppression of profits.

iv. By charging capital expenditure as revenue expenditure to Profit and Loss Account: Installation charges have to be capitalised along with the cost of the machinery. But by writing them off to the Profit and Loss Account, the profits get understated and this measure results in the creation of secret reserves because the asset also now gets understated. Certain other measures that are resorted to for the creation of Secret Reserves can be stated as :

a. suppressing the sales:
b. showing some contingent liability as a real liability:
c. grouping certain free reserves along with creditors.

Advantages of Secret Reserve

Secret reserves are permitted only when it is important for the concern to enjoy the public confidence without interruption. The presence of secret reserves ensures the following advantages:

1. The financial position of the concern is strengthened .

2. As profits and financial position are both understated, the presence of secret reserves discourage potential competitors ; thereby ensuring continued market share and profits.

3. It helps to tide over unfavourable times, i.e., the lower profits in any year can be manipulated and the payment of a regular dividend becomes possible.

Objections to the creation of Secret Reserves:

1. As the method of creating secret reserve is by understating/omitting the assets and by overstating the liabilities, the Balance Sheet does not furnish a true picture of the financial position of the concern.
2. As the charging of excessive depreciation is one of the methods of creating secret reserves , the Profit and Loss Account will not disclose the true profit earned and thus the published accounts do not reveal the correct position.
3. The presence of secret reserves may encourage mismanagement, conceal the inefficiency or cover up the manipulations by the management, as it is only they who are aware of the existence and size of the secret reserves.

Now it is proposed to take up illustrations pertaining to (i) Provision for Doubtful Debts; and (ii) Provision for Discount on Debtors and Creditors.

21.9 PROVISION FOR DOUBTFUL DEBTS

When credit sales are made, some of the amounts might not have been realised by the end of the year and so would appear as Sundry Debtors. As both cash sales and credit sales (including the unrealised portion of credit sales) are taken to the credit side of the Trading and Profit & Loss Account, the profit is determined on accrual basis, i.e., the profit might not yet have been actually realised in cash and the profit figure represents 'profit earned' and not 'profit received or realised'. Further, it is possible that all the Sundry Debtors may not pay the amounts due from them. When some of them become insolvent, either the whole amount may be lost or only a part of it is realised and thus the remaining part must be

considered as a bad debt. Business experience dictates that as the determination of the profits during the current year are based on the unrealised credit sales. It would be prudent to set aside a part of the current year's profits as provision for doubtful debts to meet the probable loss that might arise in the ensuring period on account of some of the debts becoming bad. The creation of a provision for doubtful debts from out of the profits of an accounting period simultaneously achieves the following two purposes:

a. brings down the profits for the year to a more reasonable level.
b. helps the Sundry Debtors to appear at expected realisable level on the assets side of the Balance Sheet.

It is true that no one can accurately determine the actual loss that would arise in the next accounting period and that is why an estimate is made. The Sundry Debtors are classified into good and doubtful debtors and as regards the doubtful the amount is estimated as a probable loss on account of bad debts. However, for all practical purposes the provision to be made is given as a specified percentage of the total Sundry Debtors' amount.

Accounting Treatment

The following are the journal entries usually passed for the purpose of creating, and maintaining a provision for ' Doubtful Debts Account.

1. For Creating a provision for doubtful debts A/c
   Profit & Loss A/c Dr.
   To Provision for Doubtful Debts A/c
   (Being the provision for doubtful debts)

2. Whenever a bad debt occurs, the following entry is passd :
   Bad Debts A/c Dr.
   To Concerned Debtors A/c
   (Being bad debts written off)

3. When a Provision for doudbtful debts Account exists, the Bad Debts A/c's debit balance is transferred to the Provision A/c
   The entry being :
   Provision for Doubtful Debts A/c Dr.
   To Bad Debts A/c
   (Being bad debts written off against the provision)

Note that the debit balance on Bad Debts A/c represents that total loan on account of bad debts in that year, whereas the provision was created at the end of the previous year to meet bad debt losses that might arise from out of the Sundry debtors receivable at the end of the year. Thus, if some debtors of the current year also became bad during the current year then such bad debt losses also would get transferred to the Provision for Doubtful Debts A/c after transferring 'bad debts' to 'Provision for Doubtful Debts A/c' the Provision for Doubtful Debts Account may show:

a) a credit balance, which means that the provision made last year is more than the loss incurred during the current year: or

b) a debit balance indicating that the loss on account of bad debts is more than the provision made.

4. After ascertaining the balance on the Provision for Doubtful Debts Accounts whether a debit balance or a credit balance, the amount of provision required to be created at the end of the year so as

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to be carried forward to the next year is again estimated. Now the balance on the Provision for Doubtful Debts Account is adjusted against the new provision required to be made. This implies:

a) If a credit balance appears on the Provision A/c (after transferring the bad debt losses) it would be compared with the provision required for the coming year. Usually, the available credit balance would be less than the amount required for the new provision. Hence, for the difference which is needed to be provided now the entry No.1 stated above will be passed.

b) If the credit balance appearing on the Provision Account more than adequate to cover the provision for the coming year also leaving a balance, it would represent a surplus, i.e., the provision made in the previous year is more than adequate to meet the combined amount of current year's bad debt losses and the new provision required for the coming year. This surplus amount will be transferred back to the Profit and Loss Account by means of the following entry.

Provision for Doubtful Debts A/c	Dr
To Profit & Loss A/c	
(Being the surplus amount credited back)	

Note that though the surplus amount is credited back to Profit and Loss Account still new provision account exists and that this new Provision Account has to be deducted from Sundry Debtors on the asset side of the Balance Sheet.

The following illustration presents the possible combinations explained above :

Illustration - 1

A Trader's book showed Sundry Debtors as Rs.1,00,000 as on the 31st December, 1986. He decided to open a Provision for Doubtful Debts Account at 5% on the Debtors.

During the year 1987 bad debts amounted to Rs.8,000. His Sundry Debtors' amount on the 31st of December, 1987 was Rs. 3,00,000 he wanted to continue maintaining a Provision for Doubtful Debts Account at 5% on the debtors.

During the year 1988 his bad debts amounted to Rs.3,000. His Sundry Debtors amount as on the 31st of December, 1988 was 2,00,000 he desired to continue the policy of maintaining a Provision Account at 5% on Debtors.

Show the journal entries and the necessary ledger accounts and also how these items appear in the final accounts during the 3 year period.

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Solution

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Date	particulars	L.F.	Dr. Rs.	Cr.Rs.
1986 Dec.31	Profit and Loss A/c Dr. To Provision for Doubtful Debts A/c (Being the provision for doubtful debts)		5,000	5,000
1987	Bad Debts A/c Dr. To Sundry Debtors A/c (Being bad debts written off)		8,000	8,000
Dec.31	Provision for Doubtful Debts A/c Dr. To Bad Debts A/c (Being the transfer of Bad Debts to Provision for Doubtful Debts A/c)		8,000	8,000
Dec.31	Profit & Loss A/c Dr. To Provision for Doubtful Debts A/c (Being the amount required for the creation of Provision for the coming year, besides the excess bad debts amount over the old provision)		18,000	18,000
1988 ?	Bad Debts A/c Dr. To Sundry Debtors A/c (Being bad debts written off)		3,000	3,000
Dec. 31.	Provision for Doubtful Debts A/c Dr. To Bad Debts A/c (Being the transfer of bad debts)		3,000	3,000
Dec.31	Provision for Doubtful Debts A/c Dr. To Profit and Loss A/c (Being the transfer of surplus amount to Profit & Loss Account the excess amount on Provision A/c after meeting both the bad debt loss and the amount required for a new provision for the coming year)		2,000	2,000

Dr. **BAD DEBTS ACCOUNT** Cr.

		Rs.			Rs
1988	To Sundry Debtors	8,000	1988 Dec. 31	By Provision for Doubtful Debts	8,000
		8,000			8,000
1989	To Sundry Debtors	3,000	1989 De.31	By Provision for Doubtful Debts A/c	3,000
		3,000			3,000

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Dr. **PROVISION FOR DOUBTFUL DEBTS ACCOUNT** Cr.

		Rs.			Rs.
1986			1986		
Dec.31	To Balance c/d	5,000	Dec.31	By P & L A/c	5,000
		5,000			5,000
1987			1987		
Dec.31	To Bad Debts a/c	8,000	Jan.1	By balance b/d	5,000
Dec.31	To Balance c/d	15,000		" P & L A/c	18,000
		23,000			23,000
1988			1988		
Dec.31	To Bad Debts A/c	3,000	Jan.1	By Balance b/d	15,000
	" P & L A/c	2,000			
	" Balance c/d	10,000			
		15,000			15,000
			1989		
			Jan.1	By Balance b/d	10,000

Dr. **PROFIT & LOSS A/c** Cr..

			Rs.				Rs.
1980	To Provision for Doubtful Debts A/c		5,000				
1981	To Bad debts	8,000					
	Add: Provision required	15,000					
		23,000					
	Less: Provision at the beginning	5,000					
			18,000				
				1988	By Provision for Doubtful Debts at the beginning	15,000	
					Less : Bad Debts 3,000		
					Less Provision required 10,000	13,000	2,000

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BALANCE SHEET AS ON DECEMBER 31,1986

	Rs.			Rs.
			Sundry Debtors 1,00,000	
			Less Pro vision for	
			Doubtful Debts 5,000	95,000

BALANCE SHEET AS ON DECEMBER 31, 1987

	Rs.			Rs.
			Sundry	
			Debtors 3,00,000	
			Less : Provision	
			for Doubt.	
			ful Debts 15,000	2,85,000

BALANCE SHEET AS ON DECEMBER 31, 1988

	Rs.			Rs.
			Sundry debtors 2,00,000	
			Less:	
			Provision for Doubt	
			full Debts 10,000	1,90,000

NOTE : The bad debts entry will be passed whenever bad debts occur. Thus the bad debts appearing in the Trial Balance represent the amount already written off from the Sundry Debtors. Sometimes, in addition to the bad debts given in the Trial Balance, additional bad debts are given in the adjustments below the Trial Balance. This means the relevant entry for writing off the bad debts amount is required to be passed now. Thus, when the entry is passed, bad debts amount, given in the Trial Balance, will be increased by the additional bad debts given in the adjustments and the sum of Sundry Debtors given in the Trial Balance will stand decreased by the additional bad debts given in the adjustment. It is on this reduced balance of Sundry Debtors the required new Provision has to be estimated.

In the illustration worked out above it was assumed that the Sundry Debtors given is the amount after bad debts were written off. However, in order to show clearly the journal entries regarding the writing off bad debts, their transfer to Provision A/c, etc., the journal entries are given.

Check Your Progress -1

Pass the entry for bad debts written off against the provision.

---

21. 10 PROVISION FOR DISCOUNT ON DEBTORS

Just as the expected bad debt losses are provided out of the year's profits, so also the estimated loss likely to arise on account of the allowing of some cash discount as an incentive to encourage prompt payment

to the debtors is created by having a 'Provision for Discount on Debtors A/c'. Broadly speaking, the treatment of Provision for Discount on Debtors Account is similar to that of Provision for Doubtful Debts A/c. Some books usually refer to this item as a 'Reserve for discount on Debtors' even though it is appropriate to call it a provision'. The point is that the Provision for Discount on Debtors is always calculated after deducting the Provision for Doubtful Debts from the Sundry Debtors. The following are the entries to be passed.

i. When a provision for Discount on Debtors is created :

	Profit & Loss A/c Dr. To Provision for Discount on Debtors (Being the creation of a Provision for discount on Debtors)			A/c.

ii. You are aware that cash discount will be allowed for prompt payment by the debtors whenever cash is received, the entry would be :

	Cash A/c Dr. Discount A/c Dr. To Debtor's A/c (Being the receipt of cash and discount allowed)			

iii. The total discounts allowed during the year get posted from the Cash Book debit side to the debit of Discount Allowed A/c in the Ledger. Now that a provision for discount on Debtors A/c exists, the Discount Allowed Account is transferred to the Provision A/c by means of the following entry :

	Provision for Discount on Debtors A/c Dr. To Discount Allowed A/c (Being the transfer of Discount Allowed to Provision Account)			

iv. As explained in the context of Provision for Doubtful Debts A/c the balance on 'Provision for Discount on Debtors A/c' shows either a credit balance representing excess provision or a debit balance thereby indicating that the provision is less than adequate to meet the loss. The provision required for the coming year will be estimated and the provision for Discount on Debtors A/c will have this amount appear on its debit side as 'To Balance c/d'. Now this provision account would reveal whether (a) any amount is required to be transferred from Profit and Loss Account or (b) if any surplus is existing on the Provision A/c., the amount required to be transferred to the Profit and Loss Account.

(1) When situation (a) stated above exists :

	Profit & Loss A/c. Dr. To Provision for Discount on Debtors A/c. (Being the provision of the amount required for maintaining the new reserve after adjusting the loss on account of discount)			

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(2) When situation (b) stated above exists :

Provision for Discount on Debtors A/c.	Dr.			
To Profit & Loss A/c.				
(Being the transfer of excess amount on Provision A/c after meeting the requirements of current years loss and the new provision required.)				

Check Your Progress - 2

Pass the entry for the creation of a provision for Discount on Debtors.

21.11. PROVISION FOR DISCOUNT ON CREDITORS

When timely payments are made by the trader to his creditors, he is likely to receive some discount which will be a gain to him. Thus, the amount of Sundry Creditors appearing at the end of the year may represent a higher amount than he is likely to pay in the coming year. The probable gain, estimated to be obtained, is taken into account by creating a 'Provision for Discount on Creditors Account. Except for the fact that this Provision account represents a debit balance in all other respects. The treatment is similar to what is explained above in the context of Provision for Discount on Debtors Account.

The following are the entries to be passed :

i. When a provision for Discount on Creditors is created :

Provision for Discount on Creditors Account.	Dr.			
To Profit & Loss A/c.				
(Being the creation of provision for discount on Creditors))				

ii. You are aware that the creditor allows cash discount to the trader when the latter makes prompt payment. Whenever cash is paid the entry would be :

Creditors A/c	Dr.			
To Cash A/c.				
To Discount A/c.				
(Being the payment of cash and discount received)				

iii. The total discount received during the year gets posted from the Cash Book credit side to the credit of Discount Received A/c. in the ledger. As a 'Provision for Discount on Creditors Account exists, the Discount Received A/c. is transferred by means of the following entry.

Discount Received A/c.	Dr.			
To Provision for Discount on Creditors A/c.				
(Being the transfer of discount received to Provision A/c.)				

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iv. As explained earlier, the balance on 'Provision for Discount on Creditors A/c. now shows either a debit balance signifying excess provision or a credit balance suggesting that the provision was less and that the gain made was more. The provision required for the coming year will be estimated and the 'Provision for Discount on Creditors A/c. will have this amount appear on its credit side as 'By Balance c/d'. Now the Provision A/c would reveal whether any amount is required (a) to be credited to Profit & Loss Account or (b) to be debited to Profit & Loss Account.

1. When situation (a), stated above, exists :

	Provision for Discount on Creditors A/c. Dr. To Profit & Loss A/c. (Being the transfer of amount from Provision A/c. after taking care of the current year's gain and the new provison made.)				

2. When situation (b), stated above exists :

	Profit & Loss A/c. Dr. To Provision for Discount on Creditors A/c (Being the transfer of excess amount from Provision Account to Profit & Loss A/c.)				

The following illustration shows a situation where the accounts of both Provisions are maintained :

Illustration - 2

A Trader's books showed the following balances on the 1st of Jan., 1988 :

	Rs.
Provision for Discount on Debtors	3,000
Provision for Discount on Creditors	2,000

During the year 1988, discounts allowed by him amounted to Rs.5,000 and discounts received by him, Rs.4,000. He finds that on the 31st of Dec., 1988, his Sundry Debtors and Creditors were Rs.2,00,000 and Rs.1,20,000 respectively. He decided to provide a Provision for Discount on both Debtors and Creditors at 2%.

During the year 1989, discounts allowed by him amounted to Rs.1,000 and discounts received by him, Rs.800. He finds that on the 31st of Dec., 1989, his Sundry Debtors and Creditors stood at Rs. 1,00,000 and Rs.60,000 respectively. He decided to provide a Provision for Discount on both Debtors and Creditors at 2%.

You are required to show the journal entries and the Provision for Discount on Debtors and Creditors Accounts, besides indicating how these items appear in the final accounts during the two years.

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Date	Particulars	L.F.	Debit Rs.	Credit Rs.
1988				
Dec. 31	Provision for Discount on Debtors A/c. Dr.		5,000	
	To Discounts Allowed A/c.			5,000
	(Being the transfer of discounts allowed to the Provision A/c.)			
Dec.31	Discounts Received A/c. Dr.		4,000	
	To Provision for Discounts on Creditors A/c.			4,000
	(Being the transfer of discounts received to the Provision A/c.)			
Dec.31	Profit & Loss A/c. Dr.		6,000	
	To Provision for Discounts on Debtors A/c.			6,000
	(Being the amount required for meeting the new provision and the excess of discounts allowed over the Provision)			
Dec.31	Provision for Discount on Creditors A/c. Dr.		4,400	
	To Profit & Loss A/c.			4,400
	(Being the transfer of excess amount discounts received, over the provision along with the new provision)			
1989				
Dec.31	Provision for Discount on Debtors A/c. Dr.		1,000	
	To Discounts Allowed A/c.			1,000
	(Being the transfer of discounts allowed to the Provision A/c.)			
Dec.31	Discount Received A/c. Dr.		800	
	To Provision for Discount on Creditors A/c.			800
	(Being the transfer of Discount received to the Provision A/c.)			
Dec.31	Provision for Discount on Debtors A/c. Dr.		1,000	
	To Profit & Loss A/c.			1,000
	(Being the transfer of excess provision to the Profit & Loss Account.)			
Dec.31	Profit & Loss Acount. A/c. Dr.		400	
	To Provision for Discount on Creditors A/c.			400
	(Being the transfer of excess provision to the Profit & Loss Acount			

NOTE: Journal entries require for recording the discounts allowed and received have not been passed separately,as these amounts are considered to have been passed through the Cash Book. Thus, only the entries required to transfer these sums to the respective provisions accounts have been shown above.

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LEDGER

Dr. DISCOUNTS ALLOWED ACCOUNT Cr.

Date	Particulars	Amount	Date	Particulars	Amount
		Rs.			Rs.
1988	To Sundries	5,000	1988 Dec.31	By Provision for Discount on Debtors A/c	5,000
		5,000			5,000
1989	To Sundries	1,000	1989 Dec.31	By Provision for Discount on Debtors A/c	1,000
		1,000			1,000

Dr. DISCOUNTS RECEIVED ACCOUNT Cr.

Date	Particulars	Amount	Date	Particulars	Amount
		Rs.	1988	By Sundries	Rs. 4,000
1988 Dec.31	To Provision for Discount on Creditors A/c.	4,000			
		4,000			4,000
1989 Dec.31	To Provision for Discount on Creditors A/c	8 00	1989	By Sundries	8 00
		8 00			8 00

BRAOU

Dr. PROVISION FOR DISCOUNT ON DEBTORS A/C Cr.

Date	Particulars	Amount	Date	Particulars	Amount
		Rs.			Rs.
			1988		
			Jan.1	By Balance b/d	3,000
1988			Dec.31	By P&L A/c.	6,000
Dec.31	To Discount AllowedA/c	5,000			
Dec.31	To Balance c/d	4,000			
		9,000			9,000
			1989		
1989			Dec.31	By Balanc b/d	4,000
Dec.31	To Discounts AllowedA/c	1,000			
Dec.31	To P&L A/c.	1,000			
Dec.31	To Balance c/d	2,000			
		4,000			4,000
			1990		
			Jan.1	By Balance b/d	2,000

Dr. PROVISION FOR DISCOUNT ON CREDITORS A/C Cr.

Date	Particulars	Amount	Date	Particulars	Amount
		Rs.			Rs.
1988			1988		
Jan.1	To Balanced b/d	2,000	Dec.31	By Discounts Received A/c	4,000
Dec.31	To P&L A/c.	4,400	Dec.31	By Balance c/d	2,400
		6,400			6,400
1989			1989		
Jan.31	To Balance b/d	2,400	Dec.31	By Discounts Received A/c	800
			Dec.31	,, P&L A/c.	400
			Dec.31	,, Balance c/d	1,200
		2,400			2,400
1990					
Jan.1	To Balance b/d	1,200			

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Dr. PROFIT & LOSS A/C Cr.

1988		Rs.	1988		Rs.
	To Provision for Discount on Debtors A/c:			By Provision for Discount on Creditors A/c :	
	Discounts Allowed 5,000			Discounts Received 4,000	
	Add : New Provision 4,000			Add New Provision 2,400	
	9,000			6,400	
	Less: old Provision 3,000	6,000		Less:old Provision 2,000	4,400
1989			1989		
	To Provision for Discount on Creditors A/c:			By Provision for Discount on Debtors A/c	
	Old Provision 2,400			Old Provision 4,000	
	Less:Disc. Received 800			Less:Disc. Allowed 1,000	
	Less: New Prov. 1,200 2,000	400		Less: New Provision 2,000 3,000	1,000

BALANCE SHEET AS ON THE 31 ST DECEMBER,1988

	Rs.	Rs.		Rs.	Rs.
Sundry Creditors	1,20,000		Sundry Debtors	2,00,000	
Less: Provision for Discount on Creditors	2,400	1,17,600	Less: Provision for Discount on debtors	4,000	1,96,000

BALANCE SHEET AS ON THE 31 ST OF DECEMBER,1989

	Rs.	Rs.		Rs.	Rs.
Sundry Creditors	60,000		Sundry Debtors	1,00,000	
Less: Provision for Discount on Creditors	1,200	58,800	Less: Provision for Discount on Debtors	2,000	98,000

Now it is proposed to give one comprehensive illustration dealing with provision for doubtful debts and provision for discounts to be made on Debtors

Illustration - 3

The following relevant information is extracted from theTrial Balance of a Trader on 31.12.1988

	Rs.	Rs.
Bad Debts	4,000	
Provision for Doubtful Debts		3,000
Sundry Debtors	1,02,000	
Discount Allowed	1,200	
Provision for Discount on Debtors		1,000

In the adjustments,it was given that :

a) Additional bad debts were Rs.2,000

b) Make a Provision for Doubtful Debts @5% on Debtors

c) Make a Provision for Discounts on Debtors @ 2%on Debtors

These adjustments were made and the relevant accounts were carried forward. At the end of the following year i.e. on 31-12-1989 the Position was as follows:

	Rs.	Rs.
Bad Debts	1,600	
Provision for Doubtful Debts		5,000
Sundry Debtors	40,500	
Discount Allowed	400	
Provision for Discount on Debtors		1,900

In the adjustments, it was given that;

a) Additional bad debts were Rs.500

b) Make a Provision for Doubtful Debts @ 5% on Debtors

c) Make a Provision for Discounts on Debtors @ 2% on Debtors

Show the journal entries, ledger accounts and also how these items appear in the Final Accounts during these two years.

Solution

JOURNAL

Date	Particulars	L.F	Dr.	Cr.
			Rs.	Rs.
1988 Dec,31	Bad Debts A/c Dr. To Sundry Debtors A/c (Being the additional bad debts written off)		2,000	2,000
	Provision for Doubtful Debts A/c Dr. To Bad Debts A/c (Being the transfer of bad debts to the Provision A/c)		6,000	6,000
	Profit & Loss A/c Dr. To Provision for Doubtful Debts A/c (Being the amount needed to write off the total bad debts and leave a balance adequate to maintain a Provision @ 5% on Debtors)		8,000	8,000
	Provision for Discount on Debtors A/c Dr. To Discounts Allowed A/c (Being the transfer of discounts allowed to the Provision A/c)		1,200	1,200

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	Profit & Loss A/c Dr. To Provision for Discounts on Debtors A/c (Being the amount needed to write off the excess amount of discounts allowed over and above the provision besides the new provision in the coming year)			2,100	2,100
1989 Dec,31	Bad Debts A/c Dr. To Sundry Debtors A/c (Being the additional bad debts written off)			500	500
	Provision for Doubtful Debts A/c Dr. To Bad Debts A/c (Being the transfer of bad debts to Provision A/c)			2,100	2,100
1989 Dec,31	Provision for Doubtful Debts A/c Dr. To Profit & Loss A/c (Being the transfer of excess amount on Provision A/c to P & L A/c)			900	900
	Provision for Discounts on Debtors A/c Dr. To Discounts Allowed A/c (Being the transfer of discounts allowed to Provision A/c)			400	400
	Provision for Discounts on Debtors A/c Dr. To Profit & Loss A/c (Being the transfer of excess amount on Provision for Discounts on Debtors A/c)			740	740

Dr. BADDEBTS ACCOUNT Cr.

			Rs.			Rs.
1988						
?	To Debtors A/c		4,000	Dec.31	By Provision for	
Dec.31	" Debtors A/c		2,000		Doubtful Debts A/c	6,000
			6,000			6,000
1989				1989		
?	To Debtors		1,600	Dec.31	By Provision for	
Dec.31	" Debtors		500		Doubtful Debts A/c	2,100
			2,100			2,100

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Dr. PROVISION FOR DOUBTFUL DEBTS ACCOUNT Cr.

			Rs.				Rs.
1989				1989			
Dec.31	To Bad Debts A/c		6,000	Jan.1	By Balance b/d		3,000
Dec.31	To Balance c/d		5,000	Dec.31	By Profit & Loss A/c		8,000
			11,000				11,000
1989				1989			
Dec.31	To Bad Debts A/c		2,100	Dec.31	By Balance b/d		5,000
Dec.31	To Profit & Loss A/c		900				
	To Balance c/d		2,000				
			5,000				5,000
				1990			
				Jan.1	By Balance b/d		2,000

Dr. DISCOUNT ALLOWED ACCOUNT Cr.

			Rs.				Rs.
1988				1988			
?	To Sundries		1,200	Dec.31	By Provision for Discount on Debtors A/c		1,200
			1,200				1,200
1989				1989			
?	To Sundries		400	Dec.31	By Provision for Discount on Debtors Account		400
			400				400

Dr PROVISION FOR DISCOUNT ON DEBTORS ACCOUNT Cr.

			Rs.				Rs.
1988				1988			
Dec,31	To Discount Allowed A/c		1,200	Jan.1	By Balance b/d		1,000
Dec,31	To Balance c/d		1,900	Dec.31	By Profit & Loss A/c		2,100
			3,100				3,100
1989				1989			
Dec.31	To Discount Allowed A/c		400	Jan.1	By Balance b/d		1,900
Dec.31	To Profit & Loss A/c		740				
"	To Balance c/d		760				
			1,900				1,900
				1990			
				Jan.1	By Balance b/d		760

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Dr. SUNDRY DEBTORS ACCOUNT (1988) Cr.

		Rs.			Rs.
1988			1988		
Dec.31	To Balance b/d	1,02,000	Dec.31	By Bad debts	2,000
				By Balance c/d	1,00,000
		1,02,000			1,02,000
1989					
Jan.1	To Balance b/d	1,00,000			

Dr. SUNDRY DEBTORS ACCOUNT (1989) Cr.

		Rs.			Rs.
1988			1988		
Dec.31	To Balance b/d	40,500	Dec.31	By Bad debts	500
			"	By Balance c/d	40,000
		40,500			40,500
1989					
Jan.1	To Balance b/d	40,000			

PROFIT & LOSS ACCOUNT

Dr. For The Year Ending On 31.12.1988 Cr.

			Rs.		Rs.
1988				1988	
	To Provision for Doubtful Debts:				
	Bad Debts	4,000			
	Add: Addl.Bad Debts	2,000			
		6,000			
	Add : New Provision	5,000			
		11,000			
	Less: Old Provision	3,000			
			8,000		
	To Provison for Discount on Debtors:				
	Discounts allowed	1,200			
	Add : New Provision	1,900			
		3,100			
	Less : Old Provision	1,000			
			2,100		

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PROFIT & LOSS ACCOUNT

Dr. For The Year Ending On 31.12. 1989 Cr.

		Rs.	Rs.	Rs.
		1989		
		By Provision for Doubtful Debts :		
		Old Provision	5,000	
		Less: Bad Debts 1,600		
		Less : Addl. Bad Debts 500		
			2,100	
		Less: New Prov.	2,000	4,100
				900
		By Provision for Discounts on debtors:		
		Old Provision	1,900	
		Less : Discounts Allowed 400		
		Less : New Prov. 760	1,160	
				740

BALANCE SHEET

As On The 31st Of December, 1988

Liabilities	Rs	Assets		Rs.
			Rs.	
		Sundry Debtors	1,02,000	
		Less: Addl. Bad Debts	2,000	
			1,00,000	
		Less: Provision for Doubtful Debts @ 5%	5,000	
			95,000	
		Less: Provision for Discount on Debtors @ 2%	1,900	
				93,100

BALANCE SHEET

As On The 31st Of December, 1989

Liabilities	Rs	Assets		Rs.
			Rs.	
		Sundry Debtors	40,500	
		Less: Addl. Bad Debts	500	
			40,000	
		Less: Provision for Doubtful Debts @ 5%	2,000	
			38,000	
		Less: Provision for Discounts on Debtors @ 2%	760	
				37,240

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Check Your Progress - 3

Pass the entry for the creation of a provision for discount on creditors.

21.12 PROVISION FOR REPAIRS AND RENEWALS

It is common experience that as a machine gets older, the outlay on its repairs increases. Thus, the amount spent on repairs during the earlier years of the life of the machinery is likely to be lower than that spent in later years and thus it tends to increase over the years. This means that even though the benefit of the asset is almost uniformly available throughout its life, the burden of repairs is relatively light during the earlier years and relatively more during the later years. The purpose of creating a Provision for Repairs and Renewals is to equalise the total amount likely to be spent during the life-time of the asset as a uniform charge on the Profit and Loss Account. The Procedure for equalising the charge is as follows: The total amount of repairs and renewals likely to be spent during the life-time of the asset is estimated and divided by the estimated number of years of useful life, and the resultant amount is charged every year to the Profit and Loss Account, and a corresponding Provision for Repairs and Renewals created.

The actual amount spent on repairs now will not to be taken to the Profit and Loss Account, but instead, debited to the Provision Account. Thus, the excess provisions during the earlier years would be adequate to take care of the higher amounts spent on repairs during the later years. Thus, the excess provision would appear as credit balance on the Provision account, and it would appear on the liabilities side of the Balance Sheet. Towards the end of the estimated useful life of the asset, the Provision account may show either a debit balance or a credit balance. A debit balance on the Provision Account in any year would mean that the provision has been inadequate to meet the repairs and would be transferred to Profit and Loss Account. A credit balance on this account would mean that some balance is left, which can be transferred to the credit of the Profit and Loss Account. However, if the Provision Account is considered to be maintained on a continuous basis, the balance may not be transferred to the Profit and Loss Account.

The following journal entries are required to record the above.

1. When the estimated amount is provided every year:

	Profit and Loss A/c	Dr.			
	To Provision for Repairs and Renewals A/c				
	(Being the Provision for repairs, etc.,)				

2. When the amount spent on repairs increase:

	Repairs A/c	Dr.			
	To Cash A/c				
	(Being the amount spent on repairs)				

3. When the Repairs A/c is transferred at the end of the year.

	Provision for Repairs & Renewals A/c	Dr.			
	To Repairs A/c				
	(Being the transfer of Repairs a/c to the Provision A/c)				

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NOTE : 1. The Balance on the Provision A/c would appear on the liabilities side of the Balance Sheet.
2. Depending on the procedure determined, the balance on the Provision A/c can be either transferred to the Profit and Loss Account or allowed to continue.

Thefollowing illustration would present the method showing the Provision forRepairs andRenewalsA/c

Illustration - 4

A trader maintains a Provision for Repairs account by charging a uniform amount of Rs. 1,500 every year to the Profit and Loss Account. The actual amounts spent by him were: 1st year: Rs. 500, 2nd Year : Rs. 900: 3rd Year, Rs. 2,000, 4 th Year :Rs.2,600. Show the journal entries and the Provision for Repairs Account.

JOURNAL

Date	Particulars		L.F	Dr.Rs.	Cr.Rs.
1st Year	Profit & Loss A/c	Dr.		1,500	
	To Provision for Repairs A/c				1,500
	(Being the creation of a provision for repairs)				
	Provision for Repairs A/c	Dr.		500	
	To Repairs A/c				500
	(Being the transfer of Repairs to Provision A/c)				
2nd Year	Profit & Loss A/c	Dr.		1,500	
	To Provision for Repairs A/c				1,500
	(Being the Provision for repairs)				
	Provision for Repairs A/c	Dr.		900	
	To Repairs A/c				900
	(Being the transfer of Repairs to Provision A/c)				
3rd Year	Profit & Loss A/c	Dr.		1,500	
	To Provision for Repairs A/c				1,500
	(Being the Provision for Repairs)				
	Provision for Repairs A/c	Dr.		2,000	
	To Repairs A/c				2,000
	(Being the transfer of Repairs to Provision A/c)				
4th Year	Profit & Loss A/c	Dr.		1,500	
	To Provision for Repairs A/c				1,500
	(Being the Provision for Repairs)				
	Provision for Repairs A/c	Dr.		2,600	
	To Repairs A/c				2,600
	(Being the transfer of Repairs to Provision A/c)				

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NOTE : Whenever any expenditure on repairs is incurred, the Repairs account will be debited and Cash account credited. As such expenses on repairs are likely to be incurred throughout the year, the journal entries required for recording the payment of repairs have not been separately shown. Only, the entries that are passed at the end of the year to transfer the Repairs A/c to the Provision account and the transfer of the amount for the Provision Account have been shown above.

Dr. PROVISION FOR REPAIRS ACCOUNT Cr.

1st year	To Repairs A/c		500	1st year	By Profit & Loss A/c		1,500
	To Balance c/d		1,000				
			1,500				1,500
2nd year	To Repairs A/c		900	2nd year	By Balance b/d		1,000
	To Balance c/d		1,600		By Profit & Loss A/c		1,500
			2,500				2,500
3rd year	To Repairs A/c		2,000	3rd year	By Balance b/d		1,600
	To Balance c/d		1,100		By Profit & Loss A/c		1,500
			3,100				3,100
4th year	To Repairs A/c		2,600	4th year	By Balance b/d		1,100
					By Profit & Loss A/c		1,500
			2,600				2,600

The balance on the provision for Repairs account will appear on the liabilities side of the Balance Sheet during the first three years, and as there is no balance left on this account, it would not appear in the balance sheet in the fourth year.

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21.13 SUMMING UP

Reserves refer to undistributed profits, set aside for the purpose of meeting some liability or some contingency, when a reserve is represented by some specific investments made outside the business, the suffix, 'fund' is added. Both reserves and reserve funds represent amount set aside out of profits. Provision is a charge against the profits. Reserves can be classified as disclosed and undisclosed. Further, the disclosed reserve may be classified as specific reserve and general reserve. Funds can be classified as reserve fund, specific fund and sinking fund.

Reserves can also be classified as statutory reserves, capital reserves and revenue reserves and further as general reserve and specific reserve. Creation and maintenance of secret reserve is permitted only in the case of banking companies.

A Provision is created to take care of the losses that are likely to arise, for example; provision for doubtful debts. Similarly, as the sundry debtors are likely to be allowed a cash discount for prompt payment, a provision for discount on debtors account is maintained. On the same logic, a provision for discount on creditors account is also maintained. Sometimes, a provision for repairs and renewals account is maintained in order to equalise the charge to the profit and Loss Account on account of repairs.

21.14 ANSWERS TO CHECK YOUR PROGRESS

1. Provision for Doubtful Debts Account Dr.
   To Bad Debts Account.
2. Debit - Profit & Loss Account
   Credit - Provision for Discount on Debtors A/c
3. Debit - Provision for discount on Creditors A/c
   Credit- Profit & Loss Account.

21.15 MODEL EXAMINATION QUESTIONS

A. Short Answer Questions.

1. Write short notes on:
   a) Reserve : b) Provision.
2. Explain the following:
   a) Statutory Reserve
   b) Secret Reserve
3. What do you understand by the following:
   a) Provision for discount on debtors
   b) Provision for discount on creditors.
4. Distinguish between Provision and Reserve.
5. Distinguish between general reserve and specific reserve.
6. Distinguish between secret reserve and specific reserve.

B. Essay Answer Questions.

7. Distinguish between Capital reserves and Revenue reserves.
8. What is a secret reserve ? How is it created? What are its advantages and limitations?
9. Distinguish between provision for discount on debtors and provision for discount on creditors.
10. Explain the accounting treatment concerning the maintenance of a provision for doubtful debts.

PROBLEMS

1. A Businessman's books showed sundry debtors at Rs.10,00,000 as on the 31st December, 1987, On which date he decided to maintain a Provision for Doubtful Debts A/c at 5% on the Debtors. During the Year 1988 his bad debts amounted Rs.1,00,000. His Sundry Debtors stood at Rs. 25,00,000 as on the 31st December, 1988. He desired to continue the Provision for Doubtful Debts A/c, at the same rate of 5% on Debtors.

   During the year 1989 his bad debts amounted to Rs.25,000 . On the 31st of December, 1989 his Debtors stood at Rs.18,00,000. He desired to continue the Provision A/c at 5%.

   Give the Journal entries and show the necessary Ledger accounts, besides indicating how the relevant accounts would appear in the final accounts during the three year period.

   Answer : (Amount debited to the Profit & Loss A/c in 1987 ; Rs. 50,000, 1988: Rs. 1,75,000)
   (Amount credited to P&L A/c 1989: Rs. 10,000)

2. In the year 1987 the books of M/s .B.R. Ltd., showed bad debts to the tune of Rs. 30,000. The Provision for Doubtful Debts at the commencement of the year stood at Rs.40,000. The Debtors stood at Rs. 2,90,000. The firm adopts a policy of maintaining a Provision for Doubtful Debts A/c at 5%.

   During the year 1988 bad debts amounted to Rs.40,000 and on the 31st December of the year Debtors amounted to Rs.5,00,000 .

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During the year 1989 bad debts were Rs.10,000 and the Sundry Debtors at the end of the year stood at Rs.1,00,000 . The Policy of maintaining a Provision A/c was continued.

Show the Provision for Doubtful Debts A/c for all the three years and also show how this account appears in the Profit and Loss A/c and in the Balance Sheet.

(Answer : amount debited to P& L A/c in 1987 :Rs.4,500, in 1988 Rs.50,500, amount credited to P&L A/c in 1989 : Rs. 10,000)

3. The following is an extract of the Trial Balance of Grandly Plastics Ltd.

TRIAL BALANCE	Dr. Rs.	Cr Rs.
Sundry Debtors	3,20,000	
Bad Debts	8,000	
Provision for Doubtful Debts	9,000	

Outside the Trial Balance, adjustments are given as under:

1. Write off further Bad Debts at Rs.3,000
2. Maintain a Provision for Doubtful Debts @ 5% on Debtors)
3. Create a Provision for Discount on Debtors at 2%

Write up the necessary ledger accounts and show their position in the Profit & Loss Account and in the Balance Sheet.

(Answer : amount debited to P& L A/c towards the Provision for Doubtful Debts : Rs. 17,850; Provision for Discount on Debtors : Rs.6,023)

4. The following figures appear in the books of RR & Bros.

1989	Rs.
Jan.1 Provision for discount on Debtors	1,200
Dec,31 Discounts allowed during the year	3,000
Dec,31 Debtors	80,000

It was desired to maintain a Provision for discount on Debtors at 2%

Show the Provision A/c and also indicate how it appears in the Final Accounts.

(Amount debited to P & L A/c Rs.3,400)

5. Provision for Discount on creditors appears at Rs.1,000 on 1-1-1989, in the books of a Trader. During the year 1989 he receives discounts to the extent of Rs. 900. On Dec. 31, 1989 his creditors amounted to Rs.2,00,000. He desired to maintain a Provision for Discount A/c at 2% on the creditors.

Give the necesssary journal entries and show how the Provision A/c appears in the Ledger and also in final accounts.

(Answer : Amount credited to P& L A/c Rs.3,900.)

6. The following balances were extracted from the books of a Trader :

1989.		Rs.
Jan,1	Provision for Doubtful Debts	10,000
"	Provision for Discounts on Debtors	3,000
"	Provision for Discount on Creditors	2,000

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Dec,31	Bad Debts during the year	16,000
"	Discounts allowed during the year	5,000
"	Discounts received during the year	2,800
"	Sundry Debtors	5,06,000
"	Sundry Creditors	2,00,000

You are required to (i) Write off further bad debts amounting to Rs.6,000 (ii) Maintain the Provision for Discount on Debtors at 2% and (iii) Maintain the Provision for discount on Creditors A/c at 1% (iv) Maintain the Provision for Doubtful Debts at 5% on Sundry Debtors.

Give journal entries, and ledger accounts and show how these items appear in the final accounts.

(Answer : Amount to be debited to P& L A/c towards the Provision for Doubtful Debts Rs. 37,000
Amount to be debited to P &L A/c towards the Provision for Discount on Debtors Rs. 11,500
Amount to be credited to P& L A/c towards the Provision for Discount on Creditors Rs. 2,800)

7. Atlas industries Ltd. maintains a Provision for Bad Debts at 5% and a Provision for Discount at 2% on Debtors. It also maintains a Provision for Discount on Creditors at 2% . From the following particulars write up the Provision A/c for all the three years. The following were the balances as on the 1st of January, 1987.

	Rs.
Provision for Bad Debts	9,000
Provision for Discount on Debtors	8,000
Provision for Discount on Creditors	6,000

Other Particulars are as follows:

Year	Debtors Rs.	Creditors Rs.	Bad Debts Written off Rs.	Discount Allowed Rs.	Discount Received Rs.
1987	2,00,000	2,00,000	5,000	6,000	5,000
1988	1,40,000	1,78,000	21,000	3,500	2,000
1989	1,70,000	1,52,000	6,000	7,000	4,600

Show also how the items would appear in the final accounts

ANSWER :

	1987 P& L Account		1988 P & L Account		1989 P & L Account	
	Debited	Credited	Debited	Credited	Debited	Credited
Towards -						
Prov. for Doubtful Debts	6,000	—	18,000	—	7,500	—
" Prov. for disc. on Debtors	1,800	—	2,360	—	7,570	—
" Prov. for Disc.on Crs.	—	3,000	—	1,560	—	4,080

8. The Provision for doubtful Debts A/c in the books of M/s., Nirman Erectors Ltd., appeared at Rs. 4,000 on the 1st January, 1987 . The company decided to maintain a Provision of 5% on Debtors towards doubtful debts and Provisions for Discount on Debtors and Creditors at 2% respectively. The following further information is available.

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	1987	1988	1989
	Rs.	Rs.	Rs.
Bad Debts written off	500	2,000	4,000
Debtors at the end	60,000	80,000	1,00,000
Creditors at the end	50,000	75,000	80,000
Discount Allowed	600	1,000	1,800
Discount Received	5,000	1,100	1,600

You are required to show the Provision Accounts for Doubtful Debts, Discount on Debtors, Discount on Creditors and also indicate how the items will appear in the Profit and Loss Accounts and Balance Sheet of all the three years.

ANSWER :

	1987		1988		1989	
	P& L Account		P & L Account		P & L Account	
	Debited	Credited	Debited	Credited	Debited	Credited
Towards —						
Prov. for Doubtful Debts	500	—	3,000	—	5,000	—
" Prov. for disc. on Drs.	1,740	—	1,380	—	2,180	—
" Prov. for Disc. on Crs.	—	6,000	—	1,600	—	1,700

9. A company maintains a Provision for Repairs and Renewals by charging to the Profit and Loss Account each year a sum of Rs.15,000. The actual sums spent on this account were: 1st year : Rs. 4,000 ; 2nd Year : Rs. 8,000; 3rd year : Rs.14,000; 4 th year Rs.20,000 and 5 th year ; Rs.30,000

   Give journal entries and show the Provision for Repairs and Renewals Account.

(Answer : Rs. 1,000 from Provision for Repairs and Renewals A/c is debited to the Profit and Loss A/c. at the end of the 5th year)

10. A Trader maintains a Provision for Repairs and Renwals. He charges a fixed sum of Rs.2,000 each year to the Profit & Loss Account . The Actual expenses on repairs amounted to :

	Rs.
1st year	800
2nd year	1,200
3rd year	1,900
4th year	2,600
5th year	3,400

(Answer : Rs.100 is credited to the Profit and Loss A/c at the end of the 5th year from the Provision for Repairs and Renewals A/c).

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21.16 GLOSSARY

1. Capital Reserves	:	Represent reserves created out of capital profits to show that they are not generally available for distribution of regular dividend.
2. General Reserves	:	These reserves are not created for any specific purpose but are generally meant to strengthen the financial position.
3. Provision	:	Amounts charged to Profit and Loss Account.
4. Reserve	:	Undistributed profits set aside for the purpose of meeting some liability or contingency.
5. Reserve Fund	:	Represents the amount set apart from out of Profits and reveals that such amounts are invested outside the business.
6. Revenue Reserve	:	These reserves are created out of revenue profits.
7. Secret Reserve	:	Refers to a Reserve whose existence is not disclosed in the books. Only Banking Companies are permitted to create and maintain such reserves.
8. Specific Reserves	:	These reserves are created for a specific purpose.
9. Statutory Reserve	:	Reserves whose creation has become obligatory on account of the provisions in the relevant Statutes.

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UNIT - 22 : SINKING FUNDS

Contents

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22.1 Introduction
22.2 Kinds of Sinking Funds
22.3 Accounting Treatment
22.4 Summing Up
22.5 Answers to Check Your Progress.
22.6 Model Examination Questions.
22.7 Glossary

22.0 AIMS AND OBJECTIVES

This unit aims at discussing the meaning and purpose of maintaining sinking funds and the method of maintaining them.
Having studied and worked through this unit, you will be :

- able to explain the kinds of sinking funds;
- aware of accounting treatment of sinking funds ;
- able to solve the problems.

22.1 INTORDUCTION

As stated in the previous unit the suffix, 'Fund', usually implies the investment of money outside the business in some securities. A sinking fund is always started for a specific purpose like redemption of a liability or replacement of a depleting asset. Thus, a sinking fund is never a general fund. As a specific amount is needed at the end of a definite period, usually a certain fixed sum is set apart annually and immediately invested outside the business in easily realisable gilt-edged securities. Thus, by not investing the amounts within the business the ready availability of amounts without disturbing the business operations is ensured. As the annual amounts set apart are likely to earn some interest, actually compound interest, the amount of investment required each year is determined with reference to : (i) the total amount required at the end of the period; (ii) the period at the end of which the total amount is required; and (iii) the rate of interest which is likely to be earned by the annual instalments. This is determined by referring to Sinking Fund Tables.

22.2 KINDS OF SINKING FUNDS

Sinking Fund may be non-accumulating or accumulating. In the case of non-accumulating sinking funds the interest amount is not taken into account. The total amount needed at the end of a definite period is divided by the number of years during which the amount has to be provided, and the annual instalment amount determined, When this amount is invested outside the business usually some interest amount is earned, but the interest amount is not added to the fund. That is why this method of maintaining a sinking fund is called non-accumulating. The interest received is either credited to the Profit and Loss Account or sometimes applied to reduce the amount of instalment in subbsequent years. But this method is not usually followed. The Sinking Funds are generally kept on the accumulating basis.

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The important feature of maintaining a sinking fund on the accumulating basis is that the interest amount is taken into consideration in determining the annual instalment to be made. Usually, the type of invetment to be bought out of the Sinking Fund instalments is determined and thus the rate of interest that is likely to be earned is also known in advance. The annual instalment, as stated earlier, is determined by making a reference to the Sinking Fund Tables. When the interest amount is received, it is credited to the Sinking Fund Account and reinvested immediately in securities that earn the same rate of interest. The interest amount goes on accumulating in the fund, and hence, though complex, this method is usually followed and is called the 'Accumulating Sinking Fund'. Unless otherwise stated, it must be assumed that all sinking Funds are 'Accumulating Sinking funds'. As the annual instalment along with the interest received are continuously reinvested, at the end of the specified period, the required sum would be readily available.

Purpose of creating a Sinking Fund

The Purpose of creating a Sinking Fund could be either to replace a depleting asset or to provide funds for the redemption of a liability. In both the cases a fixed sum is needed at the end of a definite period. When a Sinking Fund is created for replacing a depleting asset (also called Depreciation Fund) the amount is provided by debiting the Profit and Loss Account. This is done because the asset is getting depreciated on account of its use, and the Profit and Loss Account must represent this. The other purpose for which a Sinking Fund is created is to repay some liability. As repayment of a liability is not an expense, the funds for this purpose are deemed to come from the profits and so it is the Profit and Loss Appropriation Account that is debited for this purpose.

There is one more important point of distinction between the two types of Sinking Funds. In the case of a Sinking Fund created for the purpose of replacing an asset, the Fund account is transferred to Asset Account and thus closed, as the Fund Account essentially represents the depreciation amounts. However, in the case of a Sinking Fund provided for repaying a liability, the Fund account is closed by transferring it to a Capital Redemption Reserve Fund as these amounts represent profits withheld from being distributed.

Check Your Progress -1

i) What is the purpose of creating a sinking fund ?

22.3 ACCOUNTING TREATMENT

Before we proceed to study the journal entries that are required for the recording of Sinking Fund transactions, it is proposed to give an extract of the Sinking Fund Tables.

Year	3%	4%	5%
3.	0.323530	0.320349	0.317208
4.	0.239027	0.235490	0.232012
5.	0.188350	0.184627	0.180975

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If it is desired to have 1 Rupee at the end of 4 years, and such investments are expected to earn interest at the rate of 4% p.a., then the annual instalment amount required to be invested can be found out by referring to the Table : i.e. Re.0.235490. This means, Re.0.235490, invested each year for four years at 4% interest per annum, with the interest received each year reinvested immediately at the same rate of 4% per annum would accumulate to Re. 1 at the end of four years. Let us assume that Rs.1,00,000 are required at the end of the four years. Thus, the annual Instalment amount is found out by multiplying the Re.0.235490 by Rs. 1,00,000.i.e., Rs.23,549. Note that the amount required to be invested would be lower, if either the interest rate expected to be earned is higher or the period at the end of which the amount is needed is longer. For example, if the investments are expected to earn 5% per annum and that the amount is required at the end of 5 years. Then the annual instalment would be Re. 0.180975. If Rs.1,00,000 is required at the end of 5 years, then 0.180975 x 1,00,000 = Rs.18,097.50 would be needed to be invested in each of the five years at 5% interest per annum.

The following are the Journal entries required at the end of the First Year.

a) For the amount to be set apart every year.

	Profit & Loss Appropriation A/c Dr. To Sinking Fund A/c. (Being the annual sum set apart)			

b) When the amount set apart is invested

	Sinking Fund Investment A/c Dr. To Bank A/c (Being the amount invested)			

At the end of the Second and Subsequent years :

a) For recording the Interest received on investment :

	Bank A/c Dr. To Interest on Sinking Fund Investment A/c (Being interest received)			

b) For transferring the interest to the Sinking Fund:

	Interest on Sinking Fund Investment A/c Dr. To Sinking Fund A/c (Being the transfer of interest)			

Sometimes, a combined entry is passed instead of the two entries (a) and (b) given above, as follows:

	Bank A/c Dr. To Sinking Fund A/c (Being the receipt of interest on Sinking Fund Investments)			

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NOTE: that (1) the last instalment will not be actually invested as the investments will be sold. The problem states that the investments were sold at a profit of Rs.100, i.e., investments of the face value of Rs.65,000 were sold for Rs.65,100.

(2) the investment made amounting to Rs.65,000 and the balance amount not invested at the end of the third year amounting to Rs.34,986.40 add up to Rs.99,986.40 only and not to Rs.1,00,000 as expected. This marginal difference arises becuase the total amount was not invested each year in view of the provision that investments are to be made in multiples of thousands. If every rupee was invested regularly, the amount would have accumulated to almost Rs.1,00,000.

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			Dr. Rs.	Cr. Rs.
1987 Jan.1	Bank A/c Dr To Debentures A/c (Being the issue of Debentures)		1,00,000	1,00,000
Dec.31	P&L Appropriation A/c Dr To Sinking Fund A/c (Being the annual amount set apart to provide for the redemption of Debentures)		32,035	32,035
Dec.31	Sinking Fund Investment A/c Dr To Bank A/c (Being the investment of amount in multiples of thousands).		32,000	32,000
1988 Dec.31	Bank A/c Dr To Interest on S.F.Investment A/c (Being the receipt of interest on investment for Rs.32,000 @ 4% for one year)		1,281.40	1,281.40
Dec.31	Interest on S.F.Investment A/c Dr To Sinking Fund A/c (Being the transfer of interest to Sinking Fund).		1,281.40	1,281.40
Dec.31	P&L Appropriation A/c Dr To Sinking Fund A/c (Being the second annual instalment set apart).		32,035	32,035
Dec.31	Sinking Fund Investment A/c Dr To Bank A/c (Being the investment of the annual instalment plus the interest in multiples of thousands).		33,000	33,000
1989 Dec.31	Bank A/c Dr To Interest on S.F.Investment A/c (Being the receipt of interest on investment for Rs.65,000 @ 4% for one year).		2,600	2,600

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Dec.31	Interest on S.F.Investment A/c Dr To Sinking Fund A/c (Being the transfer of interest to Sinking Fund).		2,600	2,600
Dec.31	P&L Appropriation A/c Dr To Sinking Fund A/c (Being the second annual instalment set apart).		32,035	32,035
Dec.31	Bank Dr To Sinking Fund Investment A/c (Being the amount realised on sale of investments at a profit of Rs.100).		65,100	65,100
Dec.31	Sinking Fund Investment A/c Dr To Sinking Fund A/c (Being the transfer of profit on sale of investment).		100	100
Dec.31	Debentures A/c Dr To Bank A/c (Being the redemption of debentures).		1,00,000	1,00,000
Dec.31	Sinking Fund A/c Dr To Capital Redemption Reserve Fund A/c (Being the transfer of the balance on Sinking Fund A/c to the capital Redemption Reserve Fund A/c.)		1,00,086.40	1,00,086.40

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LEDGER

Dr. SINKING FUND ACCOUNT Cr.

			Rs.				Rs.
1987				1987			
Dec.31	To Balance c/d		32,035.00	Dec.31	By P & L App.A/c		32,035.00
			32,035.00				32,035.00
1988				1988			
Dec.31	To Balance c/d		65,351.40	Jan.1	By Balance b/d		32,035.00
				Dec.31	By Interest on S.F Investment A/c		1,281.40
				Dec.31	By P & L App. A/c		32,035.00
			65,351.40				65,351.40
1989				1989			
Dec.31	To Capital Redemption Reserve Fund A/c		1,00,086.40	Jan. 1	By Balance b/d		65,351.40
				Dec.31	By Interest on S.F Investment A/c		2,600.00
				Dec.31	By P & L App. A/c		32,035.00
				Dec.31	By S.F. Investment A/c		100.00
			1,00,086.40				1,00,086.40

Dr. SINKING FUND INVESTMENT ACCOUNT Cr.

			Rs.				Rs.
1987				1987			
Dec.31	To Bank A/c		32,000.00	Dec.31	By By Balance c/d		32,000.00
			32,000.00				32,000.00
1988				1988			
Jan.1	To Balance b/d		32,000.00	Dec.31	By Balance c/d		65,000.00
Dec.31	To Bank A/c		33,000.00				
			65,000.00				65,000.00
1989				1989			
Jan 1	To Balance b/d		65,000.00	Dec.31	By Bank A/c		65,100.00
Dec.31	To Sinking FundA/c		100.00				
			65,100.00				65,100.00

NOTE: When a Sinking Fund is started exclusively for the purpose of redemption of debentures, it can also be called 'Debenture Redemption Fund ' , in which case the Sinking Fund Investments A/c, will be called 'Debenture Redemption Fund Investments A/c'. There is no other change in accounting treatment.

22.4 SUMMING UP

Sinking Fund is created for a specific purpose. It is not a general fund. Sinking Funds can be created either i) for the purpose of providing funds for the replacement of a depleting asset, or ii) for the purpose of redemption of a liability: say; debentures. The specified sum is invested outside the business so that the funds can be obtained without dislocating the business.

Sinking funds may be accumulating or non-accumulating. In the case of non-accumulating sinking funds, the interest amount is not taken into account. Generally sinking funds are kept only on the accumulating basis. In the case of accumulating sinking funds, the interest amount is taken into account in determining the annual instalments to be made. When the interest amount is received, it is credited to the sinking fund account and reinvested immediately in securities that earn the same rate of interest.

22.5 ANSWERS TO CHECK YOUR PROGRESS

1. i) The purpose of creating sinking fund could be either to replace a depleting asset or to provide funds for the redemption of a liability.

22.6 MODEL EXAMINATION QUESTIONS

A. Short Answer Questions

1. Explain the following :
   a) Sinking Fund
   b)Kinds of Sinking Funds.

2. What is sinking fund ? Why is it created ?

3. What do you mean by:
   a) Sinking Fund
   b) Reserve Fund

B. Essay Answer Questions

4. Distinguish between a sinking fund to replace an asset and the one to repay a liability.

PROBLEMS

1. On the 1st of January, 1986 Nirman & Nirman Ltd., issued debentures for Rs.10,00,000 redeemable at par at the end of 4 years with a provision that a Sinking Fund be formed for this purpose and that the amounts must be invested in certain approved Government Securities, carrying an interest rate of 5%

   Reference to the Sinking Fund Tables revealed that Rs.0.232012 invested at the end of each year at 5% compound interest would produce Re.1/- at the end of 4 years.

   Give journal entries and show how the Sinking Fund A/c and the Sinking Fund investments A/c appear in the Ledger, assuming that:

   i) interest was received annually and that it was reinvested immediately along with the annual instalment.
   ii) that the investments were sold at the end of the period at a loss of Rs.2,000; and that the Debentures were redeemed.

   (Answer: Amount realised on sale of Investments: Rs.7,29,417.
   Amount transferred from Sinking Fund to Capital Redemption Reserve :Rs.9,98,000.65).

2. On the 1st of January, 1985 D.O.R.A. Ltd., issued Debentures for Rs.10,00,000 redeemable at par at the end of 5 years and it was resolved that a Sinking Fund should be formed and invested in tax-free securities.

   Give journal entries and draw up the necessary Ledger Accounts for 5 years, assuming that the interest received on the investments was at the rate of 5% on cost, that the interest was received yearly and immediately invested in multiples of hundreds and that the investments were realised at a profit of Rs.3,000 at the end of five years.

   Reference to the Sinking Fund Tables shows that Re.0.180975 invested at the end of each year at 5% compound interest will produce Re.1 at the end of five years.

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(Answer: Amount realised on Sale of investments Rs.7,83,000
Amount transferred to Capital Redemption Reserve A/c. Rs.10,02,998).

3. The following Ledger balances are extracted from the books of Arihant Products Ltd., as on the 1st January, 1984.

Debentures	Rs.1,00,00,000
Debentures Redemption Fund	90,12,065
Debenture Redemption Fund Investments A/c(5% securities)	90,12,000

Further information available is as follows:

i) Amount set apart every year for the purpose of investing outside the business was Rs.5,35,000

ii) The investments were sold at a loss of Rs.4,000

The debentures were redeemed with the Sale Proceeds. Give the journal entries and show the Ledger Accounts.

(Answer: Amount transferred to Capital Redemption Reserve Fund:Rs.99,93,665/-).

22.7 GLOSSARY

1. **Sinking Fund** — A specific fund started for the purpose of redemption of a liability or replacement of a depleting asset.

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UNIT - 23 : DEPRECIATION

Contents

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23.9 Answers to Check Your Progress
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23.0 AIMS AND OBJECTIVES

This unit aims at discussing the meaning of Depreciation, causes and certain other aspects.
After Studying this Unit, you will be able to:

- explain the meaning of depreciation;
- identify the causes for depreciation;
- explain certain other accounting concepts relating to depreciation.

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23.1 INTRODUCTION.

The traditional view of Depreciation is that it is meant to be a provision for replacing depreciable assets. Therefore, it is left to the management to decide as to when they should provide for it and when they can dispense with it. Naturally, they used to provide for Depreciation only when the firm made profits and dispense with it during the years when the firm incurred losses. Even the Companies Act of 1956 has made the charging of Depreciation compulsory only if the company desires to declare dividends. The accounting practice of showing profits before charging Depreciation first and then later profits after charging Depreciation confirms the view that it is to be regarded as an appropriation of profit, But the modern view is different. All the fixed assets are considered to be 'future services' to be used by the enterprise over the entire period of the economic life(estimated useful life) of such assets. Therefore, the cost of investment must be properly allocated over the period of its economic life. The amount charged to each period is called 'Depreciation'(the expired portion of the cost of the asset) and it is a technique employed by the accountants to recover the cost of fixed assets. The effects of charging of depreciation in the accounts are:

1) it reduces the value of the fixed asset to the extent to which it has been used up;

2) it reduces the profits to the concern (in the case of loss, the loss will increase to that extent)
3) it is possible to show a true and fair view of the value of the fixed asset in the Balance Sheet; and
4) funds are made available to replace the old asset at the end of the life of the asset.

23.2 CATEGORIES OF FIXED ASSETS

From the point of view of spreading the cost of fixed assets over the years, during which benefits are received, the fixed assets can be classfied into the following categories

a) Tangible fixed assets: These assets have physical substance e.g. Land, Buildings, Machinery, etc. (Land is not depreciated as it has unlimited existence).
b) Intangible fixed assets: These assets do not have physical substance e.g., Patents, Copyrights, Trade Marks, Goodwill etc.

23.3 MEANING OF DEPRECIATION

The subject of depreciation does not appear to have engaged the serious attention of accountants. They seem to be content with paying attention to the practical aspects of the subject rather than its theoretical aspects.

The Institute defines depreciation as follows:
"Depreciation is the diminution in the financial value of an asset owing to wear and tear, effluxion of time, obsolescence or similar causes, the suggestion is being rather that of gradual depreciation than sudden loss or diminution in value."

The above mentioned difinition leaves 'financial value' vague. It is not clear whether it is cost price, market value or book value.

J.N. Carter's definition runs as follows:
"Depreciation is the gradual decrease in the value of an asset from any cause"

J.H.Burton, says that the depreciation is 'shrinkage in the value of an asset at a given date as compared with its value at a previous date.

In order to be depreciation, there should be permanent, gradual and continuing fall in the book value. But the two difinitions given above have not taken this into consideration. In addition, every shrinkage in value cannot be regarded as depreciation.

Horngren diffined depreciation as the allocation of the original cost of plant, property and equipment to the particular periods that benefit from the utilisation of assets ..... ('Accounting for Managerial Control').

This definition refers to the orginal cost but not the book value.

The object of charging depreciation is not to reduce the orginal value of an asset to the level of its market value. In fact, by its nature, a fixed asset is not meant for sale, and has thus nothing to do with the market value. The book value of fixed asset is actually sometimes more than the market value, and sometimes, less than its market value. Depreciation is directly concerned with the cost price of a fixed asset, besides other cost of acquisition, erection, etc. Again, depreciation does not necessarily represent the degree of

physical depreciation of fixed assets(except in revaluation method). Depreciation is not directly connection with any real thing - price, market price or physical wear and tear and it is directly related to the book value of a fixed asset.

Thus, we can define depreciation as a permanent, continuing and gradual shrinkage in the book value of the fixed asset.

23.4 DEPRECIATION AND RELATED CONCEPTS

We shall now discuss the precise relationship that depreciation has with certain other accounting concepts.

23.4.1 Depreciation and Profits

Depreciation is a fraction of the book value of a fixed asset. It should be charged to the Profit and Loss account of a given period. It shows that net profit cannot be arrived at unless depreciation is charged.

23.4.2 Depreciation and Fluctuations

Depreciation is likely to be confused with fluctuations. Fluctuation refers to a temporary variation in the market price. It is quite different from depreciation in the following respects:

a) Depreciation is permanent, while fluctuation is temporary;
b) Depreciation is shrinkage in value, while fluctuation can be either rise or fall in value.
c) Depreciation is a continuing feature, while fluctuation, is not.
d) Depreciation is connected with book value while fluctuation is related to market value.

23.4.3 Depreciation and Obsolescence

The term 'Obsolescence' refers to disappearing usefulness resulting from subsequent invention, change of style, legislation or other causes having no physical relation to the object affected. For example, when a new asset is put on the market, which reduces the cost of production per unit, the value of the old model of that asset suddenly falls and this fall in the value of the old model is known as 'Obsolescence'. This is to be distinguished from depreciation, which is a functional loss arising out of wear and tear, etc.,

23.4.4 Repairs, Replacement and Depreciation

When a fixed asset is purchased, provision has to be made for depreciation, repairs and replacement. Mistakes are often committed because they are not distinguished from one another.

Repairs and renewals are known as maintenance. An asset is to be maintained in proper working order and some money has to be spent on repairs and renewals. Such an expenditure is obviously a charge to P & L Account. Repairs have nothing to do with depreciation. These two concepts are quite different. Depreciation represents a part of the value of the asset which has vanished. While cash is paid to third parties for effecting repairs, a mere book-keeping entry is passed for depreciation.

Repairs and Depreciation differ from each other and each as a distant concept. Depreciation does not obviate the necessity of charging repairs.

When an asset becomes useless after its use for a number of years, it has to be replaced with a new asset. Provision is made for the purchase of a new asset when the old asset becomes useless. This is known as Replacement provision. Merely by charging depreciation, no provision is made for replacement.

It may be stated that repairs are carried out to keep the asset in proper working order. Depreciation is charged to take into account the capital that has vanished. Replacement provision is made to provide funds that may be needed in future. The Repairs have reference to the present, Depreciation to the past and Replacement to the future.

24.4.5 Depreciation, Depletion, Amortisation and Dilapidations.

Although 'Depreciation' is the word generally used for allocating the value of an asset, different terms have come to be used for describing it in respect of different types of assets. 'Depreciation' is used to record the expiry of utility of a physical asset (building, machinery, etc).

The term 'Depletion', is used for the process of measuring the exhaustion of natural reasources such as Oil Wells, Quarries, Coal Mines, etc. Depreciation is different from Depletion in that the former refers to a reduction in the service capacity of an asset, while the latter refers to diminishing of the available quantity.

The term, 'amortisation' refers to the process of writing off the long-term investements in intangibles such as leaseholds, patents, copyrights and heavy organisational costs.

Sometimes properties are taken on a lease basis for a specified period. After the expiry of the period the property is to be returned to the owner/landlord. When it is returned the landlord has a right to demand that the property be kept in good condition, as it was when it was leased out. The amount required to put the property in right condition is known as dilapidation. Leaseholders set aside some amount every year to meet such costs. Alternatively, the expected cost of dilapidation is added to the cost of leased property and depreciation provided on the total cost.

Check Your Progress - 1

i) Depreciation arises from:
   a) fall in the value of money,
   b) physical wear and tear
   c) fall in the market value of asset.

---

ii) What is the effect of charging depreciation in the accounts.
   a) reduces the profit
   b) reduces the loss
   c) remains constant.

---

iii) Depreciation is provided on
   a) fixed assets; b) fictitious assets; c) current assets.

iv) What is the difference between depreciation and depletion.

23.5 OBJECTS OF MAKING PROVISION FOR DEPRECIATION

As explained earlier, it is necessary that a reasonable amount is provided for as depreciation every year on fixed assets owing to the following reasons:

i. to ascertain correct profits of the period;
ii. to present correct financial position in the balance sheet;
iii. to include the depreciation in cost of production to arrive the true cost of production;

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iv to provide funds for replacement of asset at the end of the life of the original asset;
v to recover the cost of the fixed assets spread over their useful life to keep the capital in tact;
vi to conserve the cash resources of the concern (to the extent of depreciation)from being distributed as dividends (profits get reduced when depreciation is charged);
vii to save the tax payable on profits (as the profits get reduced to the extent of depreciation, which is a permissible deduction as per the Income Tax Act);and
viii to get an approximate idea of the amount for which the used asset can be sold in the second hand market.

23.6 CAUSES FOR DEPRECIATION

The following are important causes of depreciation:

i. *Physical factors* : When tangible assets like Machinery, Building etc,are exposed to wind,rain ,sun and other elements of nature, wear and tear is caused from use, erosion, rust, rot and decay.

ii *Economic factors* : The asset may be put out of use for some time, eventhough it is in good working condition the reasons could be obsolescence (due to technological development)and inadequacy.Due to obsolescence the asset may become out of date and in case of inadequacy,the use of asset may be terminated because of the acquisition of a bigger sized asset. Though the asset is not scraped, in both the cases the asset is not used.

iii. *Time factors* : The value of certain intangible assets may decrease with the passage of time. For instance, a lease can be entered into for a fixed period. The value of the asset (the amount paid for the lease) gets decreased every year as the time elapses. Provision for the consumption of these assets may be called amortization rather than depreciation.

iv. *Depletion* : Some assets are of wasting character. Natural resources such as mines, quarries and oil wells get decreased due to extraction of materials from them. To Provide for the consumption of these assets of wasting character the provision made can be called 'Provision for depletion'.

Check Your Progress - 2

i) List out the causes for depreciation.

23.7 BASIC FACTORS INFLUENCING DEPRECIATION

The first step in the depreciation accounting is the finding out of the total amount of depreciation. Then the second step is the spreading of the total depreciation over the estimated economic life of the asset. The second step is discussed in the following unit. As for the first step, the following factors influence the total amount of depreciation.

i. The original cost of fixed asset (i.e., cost price plus frieght, erection chrarges etc.).
ii. Sometimes, an estimated amount to expenditure on reapirs during the useful life of asset is also taken into account.

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iii. Estimated effective or useful life of the asset after which it will be discarded.

iv. Estimated scrap value : When the asset completes its useful life, the amount it can fetch as scrap is known as 'residual' or 'scrap' or 'salvage value'.

v. Interest on Investment : The amount invested on the purchase of an asset, would have fetched some income had it been invested elsewhere. This is foregone when it is invested in this fixed asset. Under certain methods of charging depreciation, this is taken into account.

vi. Obsolescence : The possibility of the asset getting obsolete because of new inventions should also be taken into consideration. Only so much amount should be charged as depreciation during the useful life of an asset in order that after the expiry of this period the total depreciation provided and the residual value put together may be equivalent to the original cost. In other words, depreciation to be provided should be that amount which reduces the asset to its residual value at the end of its useful life.

However, it is very difficult to estimate the useful life of an asset. More over it also depends upon the way the asset is used. There may be careful operators and reckless operators of machines. Thirdly, the depreciation also depends upon how carefully the asset is maintained , i.e. it depends upon the amounts spent on repairs and maintenance. Fourthly, the residual value of the asset, when it is out of use, cannot reasonably be estimated. Thus the amount of depreciation to be charged is based on certain assumptions and estimates.

23.8 SUMMING UP

Depreciation is a permanent, continuing and gradual shrinkage in the book value of the fixed asset. In the balance sheet the assets must be presented at their true and fair value. It is also necessary to charge the income of the concern with expenses and losses of the period. Hence, depreciation is charged every year to the relevant profit and loss account. Depreciation is different from fluctuation and obsolescence.

In order to maintain an asset in good working order, some money has to be spent on repairs of the asset, Such an amount is a charge to the profit and loss account in addition to depreciation. When an asset becomes old, it is to be replaced with a new one. Provision is to be made for the purchase of a new asset without imposing any strain on the financial resources and without upsetting the normal working. The important causes for depreciation are physical factors, economic factors, time factors and depletion. Depreciation is influenced by the cost of the asset, its useful life, estimated scrap value, and obsolescence.

23.9 ANSWERS TO CHECK YOUR PROGRESS

1. i) Physical wear and tear
   ii) a) Reduce the profit
   iii) b) Fixed assets
   iv) Depreciation refers to a reduction in the service capacity of an assets, whereas depletion refers to removal of natural resources, i.e., diminshing or lessening of an estimated available quantity.
2) i) a) Physical factors b) Economic factors c) Time factors d) Depletion.

23.10 MODEL EXAMINATION QUESTIONS

A. Short Answer Questions

1. Define Depreciation
2. Explain the following :
   a) Amortization
   b) Obsolescence
3. What are the causes for depreciation.
4. What are the tangible fixed assets and intangible fixed assets.

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5. What are the objects of making provision for depreciation.
6. Distinguish between depreciation and Depletion.

B. Essay Answer Questions

7. Explain the following:
   a) Fluctuation
   b) Amortisation
   c) Obsolescence
   d) Depletion
8. What is depreciation ? What are the basic factors influencing depreciation ?
9. What is the difference between depreciation and obsolescence ? How are they caused ?
10. Define depreciation and explain its connection with :
    a) Profits b) Fluctuations and c) Repairs.

23.11 GLOSSARY

1.	**Amortization**	:	Process of wirting off long term intangible assets like leaseholds, patents, etc.
2.	**Depletion**	:	Expired outlay on the basis of output as compared with the estimated total of the contents (like mines, etc.)
3.	**Depreciation**	:	Permanent, continuing and gradual shrinkage in the book value of a fixed asset.
4.	**Dilapidation**	:	Amount required to put the property back into its original position/ condition.
5.	**Fluctuation**	:	Temporary variation in the market price.
6.	**Intangible Assets**	:	Those assets which do not have physical substance.
7.	**Obsolescence**	:	Disappearing usefulness on account of subsequent inventions, change of style, legislation, etc. having no physical relations to the object affected.
8.	**Repairs and Renewals**	:	Amount spent to keep the asset in good working condition. Repairs and Renewals are known as maintenance.
9.	**Tangible Assets**	:	Those fixed assets which have physical substance.
10.	**Wear and Tear**	:	One of the causes for shrinkage in the value of a fixed asset resulting from friction, chemical reaction, weather, intensity of use, handling, etc.

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UNIT-24 : METHODS OF PROVIDING DEPRECIATION

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24.0 AIMS AND OBJECTIVES

This unit aims at discussing the accounting treatment of depreciation and various methods of charging depreciation.

On having studied and worked through this unit, you would be:

— aware of accounting treatment of depreciation ;
— able to acquaint yourself with various methods of charging depreciation ;
— able to solve the problems according to different methods of charging depreciation.

24.1 INTRODUCTION

This unit is in continuation of the previous unit, in which we have discussed the meaning and concepts of depreciation. In this unit, we will discuss the accounting treatment of depreciation and different methods of charging depreciation.

24.2 METHODS OF TREATMENT OF DEPRECIATION

The previous unit has explained the need for charging depreciation during every accounting period. There are basically two methods of treatment of the depreciation :

First Method : Under the first method the depreciation on the asset is debited to the depreciation account and credited to the concerned asset account. Thus, the asset appears at its reduced value. The following are the journal entries passed under the first method :

Every year (at the end of the accounting period)

1.	Depreciation A/c To Asset A/c (Being depreciation wirtten off)	Dr.			
2.	Profit and Loss A/c To Depreciation A/c (Being the depreciation charged to P & L A/c)	Dr.			

In the year in which the asset is sold :

3.	Bank A/c To Asset A/c (Being the amount realised on the sale of the asset)	Dr.			
4.	Depreciation A/c To Asset A/c (Being depreciation on the asset up to the date of sale)	Dr.			
5.	Profit and Loss A/c To Depreciation A/c (Being depreciation charged to the Profit and Loss A/c)	Dr.			
6.	a) Asset A/c To Profit on sale of Asset A/c (Being Profit on sale of the asset)	Dr.			
	Profit on sale of Asset A/c To Profit and Loss A/c (Being profit transferred)	Dr.			
	OR				
b)	Loss on sale of Asset A/c To Asset A/c (Being loss on sale of asset)	Dr.			
	Profit and Loss A/c To Loss on sale of Asset A/c (Being loss on sale of asset transferred)	Dr.			

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Second Method : Under the second method, the depreciation every year is accumulated in a separate Provision for Depreciation A/c and in the Balance Sheet the accumulated provision is shown as a deduction from the original cost of the asset. The following are the journal entries passed under the second method corresponding to those under the 1st method :

Every year (accounting period) :

1.	Depreciation A/c Dr. To Provision for Depreciation A/c (Being depreciation written off)			
2.	Profit and Loss A/c Dr. To Depreciation A/c (Being Depreciation charged to P & T A/c)			

In the year in which the asset is sold :

3.	Bank A/c Dr. To Asset A/c (Being the amount realised on the sale of the asset)			
4.	Depreciation A/c Dr. To Provision for Depreciation A/c (Being depreciation on the Asset upto the date of sale written off)			
5.	Profit and Loss A/c Dr. To Depreciation A/c (Being depreciation charged to Profit and Loss A/c)			
6.	Provision for Depreciation A/c Dr. To Asset A/c (Being the transfer of Provision to Asset A/c)			
7.	a) Asset A/c Dr. To Profit on sale of Asset A/c (Being profit on the sale of Asset)			
	Profit on sale of Asset A/c Dr. To Profit and Loss Account (Being profit transferred)			
	OR			
b)	Loss on sale of Asset A/c Dr. To Asset A/c (Being loss on the sale of asset)			
	Profit and Loss A/c Dr. To Loss on sale of Asset A/c (Being Loss on the sale of asset transferred)			

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The differences between the two methods of recording the depreciation in the books of accounts are as follows :

When depreciation is credited to Asset A/c	When depreciation is accumulated in the provision for Depreciation A/c
1. The asset will appear in the Asset A/c at its reduced (book) value, i.e. book value at the beginning of the year minus depreciation written off during the year.	1. The Asset will appear in the Asset A/c at its original cost throughout its life.
2. In the Balance Sheet, the asset is shown at the value at the beginning of the year; the depreciation of the year is deducted and then the net value at the end of the year is shown.	2. In the Balance Sheet, the asset will appear at its orginal cost every year; the accumulated provision for depreciation is deducted and the net value is shown.
3. Whether the asset is an old one or a recently purchased one cannot be known.	3. One can get an idea about the age of the asset from the accumulated provision for depreciation and also the original cost of the asset.

24.3 METHODS OF CHARGING DEPRECIATION

As has been pointed out earlier, the total depreciation to be written off during the life time of the asset is its original cost less scrap value or residual value. But there are different methods of calculating the amount of depreciation to be charged every year. They vary from asset to asset depending on their nature and also from concern to concern. The following are the principal methods :

1. Fixed Instalment (Straight Line) Method
2. Diminishing Balance (Reducing Instalment) Method
   a) Written Down Value Method
   b) Double Declining Balance Method
   c) 'Sum-of-year's Digits Method
3. Annuity Method'
4. Sinking Fund or Depreciation Fund Method
5. Insurance Policy Method
6. Depletion Method

Let us now discuss one by one in detail.

24.4 FIXED INSTALMENT METHOD

This method is also known as 'Equal instalment' or 'Straight line method'. According to this method, a fixed and equal amount is charged as depreciation every year during the life time of the asset. When the amount of depreciation presented as a graph it would be straight line. The amount is such that at the end of the useful life of the asset, the asset gets reduced to zero or its residual value. The amount is easily found out by subtracting from the cost (including erection/installation charges, if any) the residual value and dividing the balance by the number of years the asset will last. This can be calculated using the following formula

$$\text{Annual Depreciation} = \frac{\text{(Cost of Asset + Erection Charges) — Residual Value}}{\text{Life of the Asset in terms of years}}$$

When this method is followed all repairs and renewals are charged to the Profit and Loss A/c separately. Separate steps have to be taken for making provision for the replacement of the asset.

The journal entries to be passed are the same as explained at the beginning of the unit under 'Methods of Treatment of depreciation', depending upon the method followed, i.e., 'depreciation' or 'Provision for depreciation'. The following illustration will explain the position further.

Illustration - 1

M/s. Uma Nath & Co., purchased a cold storage plant on Jan.1, 1986 for Rs.10,500 and spent Rs.500 on its erection. The asset is expected to last for 4 years after which its break up value is estimated to be Rs.1,000. Find out the amount of depreciation to be charged every year and show how the Plant Account would appear for the 4 years assuming that it sold away for Rs.850/- at the end. Show also how the plant is shown in the Balance Sheet for these 4 years.

Solution

The annual depreciation is calculated as follows :

$$\text{Annual Depreciation} = \frac{\text{(Cost of Asset + Erection Charges) — Residual Value}}{\text{Life of the Asset in years}}$$

$$= \frac{\text{(Rs. 10,500 + Rs.500) — Rs.1,000}}{4}$$

$$= \frac{10,000}{4} = \text{Rs.2,500}$$

When Depreciation method is followed :

Dr. PLANT ACCOUNT Cr.

		Rs.			Rs.
1986 Jan.1	To Bank A/c	10,500	1986 Dec.31	By Depreciation A/c	2,500
	To Erection charges A/c	500		By Balance c/d.	8,500
		11,000			11,000
1987 Jan.1	To Balance b/d	8,500	1987 Dec.31	By Depreciation A/c	2,500
			Dec.31	By Balance c/d	6,000
		8,500			8,500
1988 Jan.1	To Balance b/d	6,000	1988 Dec.31	By Depreciation A/c	2,500
			Dec.31	By Balance c/d	3,500
		6,000			6,000
1989 Jan.1	To Balance b/d	3,500	1989 Dec.31	By Depreciation A/c	2,500
			Dec.31	By Bank A/c	850
			Dec.31	By Loss on Sale of Asset A/c	150
		3,500			3,500

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BALANCE SHEET AS ON Dec.31, 1986

			Rs.	Rs.
		Plant	10,500	
		Add: Erection charges	500	
			11,000	
		Less: Depreciation	2,500	
				8,500

BALANCE SHEET AS ON Dec.31, 1987

			Rs.	Rs.
		Plant	8,500	
		Less: Depreciation	2,500	
				6,000

BALANCE SHEET AS ON Dec.31, 1988

			Rs.	Rs.
		Plant	6,000	
		Less: Depreciation	2,500	
				3,500

BALANCE SHEET AS ON Dec.31, 1989

			Rs.	Rs.
		Plant	3,500	
		Less: Depreciation	2,500	
			1,000	
		Less: Sale Proceeds	850	
			150	
		Less: Loss Written off	150	—

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When 'Provision for Depreciation' method is followed :

Dr. PLANT ACCOUNT Cr.

		Rs.			Rs.
1986			1986		
Jan. 1	To Bank	10,500	Dec. 31	By Balance c/d	11,000
	" Erection charges	500			
		11,000			11,000
1987			1987		
Jan. 1	To Balance b/d	11,000	Dec. 31	By Balance c/d	11,000
		11,000			11,000
1988			1988		
Jan. 1	To Balance b/d	11,000	Dec. 31	By Balance c/d	11,000
		11,000			11,000
1989			1989		
Jan. 1	To Balance b/d	11,000	Dec. 31	By Provision for Depreciation	10,000
				" Bank	850
				" Loss on sale of Asset	150
		11,000			11,000

Dr. PROVISION FOR DEPRECIATION ACCOUNT Cr.

		Rs.			Rs.
1986			1986		
Dec. 31	To Balance c/d	2,500	Dec. 31	By Depreciation A/c	2,500
		2,500			2,5000
1987			1987		
Dec. 31	To Balance c/d	5,000	Jan. 1	By Balance b/d	2,500
			Dec. 31	By Depreciation A/c	2,500
		5,000			5,000
1988			1988		
Dec. 31	To Balance c/d	7,500	Jan. 1	By Balance b/d	5,000
			Dec. 31	By Depreciation	2,500
		7,500			7,500
1989			1989		
Dec. 31	To Balance c/d	10,000	Jan. 1	By Balance b/d	7,500
			Dec. 31	By Depreciation A/c	2,500
		10,000			10,000

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BALANCE SHEET AS ON Dec.31, 1986

		Rs.	Rs.
	Plant	10,500	
	Add:Erection Charges	500	
		11,000	
	Less: Provision for Depreciation	2,500	
			8,500

BALANCE SHEET AS ON Dec.31, 1987

		Rs.	Rs.
	Plant	11,000	
	Less: Provision for Depreciation	5,000	
			6,000

BALANCE SHEET AS ON Dec.31, 1988

		Rs.	Rs.
	Plant	11,000	
	Less: Provision for Depreciation	7,500	
			3,500

BALANCE SHEET AS ON Dec.31, 1989

		Rs.	Rs.
	Plant	11,000	
	Less: Provision for Depreciation	10,000	
		1,000	
	Less: Sale Proceeds	850	
		150	
	Less:Loss on sale write off	150	
			—

Advantages of the Fixed Instalment Method :

1. It is very simple, easily understandable and easy to calculate.

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2. It can reduce the book value of the asset to zero unlike certain other methods.
3. It spreads the provision equally over the period of its anticipated useful life and is most suitable for general application.

Disadvantages of the Fixed Instalment Method:

1. The depreciation charges for each of the year, are equal but the charge for repairs and renewals goes on increasing as the asset becomes older, with the result that the Profit and Loss Account will have to bear a lighter burden (both depreciation and repairs and renewals combined) in the earlier years and a heavier burden in the later years.

2. In the case of additional purchases of assets, separate calculations will have to be made as the new asset will not have the same lifetime as the orginal one.

3. Interest on the money locked up in the asset is not taken into account as is done insome other methods.

Check Your Progress - 1

i) What is the formula for calculating depreciation under fixed instalment method.

24.5. DIMINISHING BALANCE METHOD OR REDUCING INSTALMENT METHOD

The most important defect of the Fixed instalment method is that the burden (along with repairs and renewals) on the Profit and Loss A/c of various years is disproportionate. To remedy this defect the reducing instalment methods of depreciation are devised so that the total burden on the Profit and Loss A/c is the same every year, since while the depreciation instalments will be decreasing, the repairs and renewals charges will be increasing year after year.

There are three important methods under the Diminishing Balance system. They are:

24.5.1 Written Down Value Method
24.5.2 Double Declining Balance Method
24.5.3 Sum-of-years Digits Method

24.5.1 Written Down Value Method

Under this method, the amount of depreciation to be charged in any particular year is calculated as a given percentage of the debit balance of the Asset at the beginning of each year. It may be noted that the percentage at which depreciation is charged remains fixed, but since depreciation is calculated on the diminishing debit balance of the asset each year, the amount of depreciation goes on diminishing year after year. Since the depreciation is calculated on the written down value of the asset each year, it is known as Written Down Value method.

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Under this method also, repairs and renewals have to be separately charged to the Profit and Loss A/c and provision for replacement of the asset has also to be made separately.

The journal entries in this case will be the same as those discussed at the beginning of the unit under the topic, 'Methods of Treatment of Depreciation'. Only the amount of depreciation will be different for each year.

Illustration - 2

The problem given in the illustration (No.1) under the Fixed Instalment method will be worked out here so that you can note the differences in the asset account arising on account of the differences between the two methods. Further it is assumed that the rate of depreciation to be charged is 33 1/3%. The Asset account and the Balance Sheet (as far as the asset is concerned) will appear as under, when depreciation is provided under Written Down Value Method:

Solution

Dr. PLANT ACCOUNT Cr.

		Rs.			Rs.
1986	To Bank	10,500	1986	By Depreciation	3,667
Jan.1	To Erection charges	500	Dec.31	By Balance c/d.	7,333
		11,000			11,000
1987			1987		
Jan.1	To Balance b/d	7,333	Dec.31	By Depreciation A/c	2,444
			Dec.31	By Balance c/d	4,889
		7,333			7,333
1988			1988		
Jan.1	To Balance b/d	4,889	Dec.31	By Depreciation A/c	1,630
			Dec.31	By Balance c/d	3,259
		4,889			4,889
1989			1989		
Jan.1	To Balance b/d	3,259	Dec.31	By Depreciation A/c	1,086
			Dec.31	By Bank A/c	850
			Dec.31	By P& L A/c (loss written off)	1,323
		3,259			3,259

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BALANCE SHEET AS ON Dec.31, 1986

	Rs.	Rs.
Plant	10,500	
Add: Erection charges	500	
	11,000	
Less: Depreciation	3,667	
		7,333

BALANCE SHEET AS ON Dec.31, 1987

	Rs.	Rs.
Plant	7,333	
Less: Depreciation	2,444	
		4,889

BALANCE SHEET AS ON Dec.31, 1988

	Rs.	Rs.
Plant	4,889	
Less: Depreciation	1,630	
		3,259

BALANCE SHEET AS ON Dec.31, 1989

	Rs.	Rs.
Plant	3,259	
Less: Depreciation	1,086	
	2173	
Less:Sale Proceeds	850	
	1,323	
Less: Loss written off	1,323	

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Thus, you may note that inspite of providing depreciation for a very long time, the value of an asset can only be reduced to approximately nil. Even this is possible only when a very high rate is used in which case the burden on earlier years will excessive. However, this method would give better results when the repair expenses are considerably less in the earlier years than in the later years, as the reverse is the case with depreciation. Thus, the Profit and Loss Account over the period would get almost the same amount of combined charge (i.e., Depreciation and Repairs) during the life of the asset. This method is used by the Income Tax authorities for granting depreciation allowance.

The advantages of this method are :

1. It tends to give a fairly even charge of depreciation when combined with repairs expenses to the Profit and Loss account each year.
2. This is the permitted method under the Income Tax Act.

The disadvantages of this method are:

1. This method cannot reduce the book value of an asset to zero/scrap value.
2. It is difficult to fix the correct rate of depreciation. If the rate is too high there is the risk of charging a disproportionately heavy amount in earlier years.
3. The Interest on capital invested in the asset is not taken into account.

24. 5.2 Double Declining Balance Method

Under this method also depreciation charged is on the reduced balance at the beginning of the period, but the rate is arrived at, not as explained under the Written Down Value method, but by doubling the Straight Line rate. While calculating the rate under this method the residual value of the asset, if any, is ignored. In the problem under Illustration - 1 the rate can be arrived at as follows:

Cost of the asset to be depreciated (including erection charges) : Rs. 11,000

Estimated life : 4 years

Depreciation per annum = $\frac{11,000}{4} = 2,750$

Rate of depreciation under Straight Line method = $\frac{100 \times 2,750}{11,000} = 25\%$

Rate of depreciation under Double Declining Balance Method = 2 X 25 = 50% (of the balance at the beginning of each year)

The amount charged as depreciation during the 4year of life would be as follows:

	Balance at the beginning Rs.	Rate	Depreciation Rs.
1st Year	11,000	50%	5,500
2nd Year	5,500	50%	2,750
3rd Year	2,750	50%	1,375
4th Year	1,373	50%	688
Balance left at the end of Asset's life	687		

The journal entries are the same as the entries explained under methods of treatment of depreciation. The asset account will appear as under :

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Dr. PLANT ACCOUNT Cr.

		Rs.			Rs.
1986	To Bank	10,500	1986	By Depreciation A/c	5,500
Jan.1	To Erection charges	500	Dec.31	By Balance c/d.	5,500
		11,000			11,000
1987			1987		
Jan.1	To Balance b/d	5,500	Dec.31	By Depreciation A/c	2,750
			Dec.31	By Balance c/d	2,750
		5,500			5,500
1988			1988		
Jan.1	To Balance b/d	2,750	Dec.31	By Depreciation A/c	1,375
			Dec.31	By Balance c/d	1,375
		2,750			2,750
1989			1989		
Jan.1	To Balance b/d	1,375	Dec.31	By Depreciation A/c	688
	" Profit on Sale of Asset A/c	163	Dec.31	By Bank	850
		1,538			1,538

24. 5.3 Sum-of years' Digits Method

This method is an improvement over Written Down Value Method. In this method also, the depreciation charge gets reduced year after year, but the depreciation is not calculated on the balance at the beginning of each year. Since the rate, a constantly declining rate, is aplied to the original cost (plus erection charges minus residual value, if any), the asset value is reducible to zero. Under this method, the individual years (in the asset's life) in reverse order is taken as numerator and the total life of the asset in years is taken as the denominator. The cost is multiplied with this factor. Thus in the example we have taken up under illustration - 1, the cost of the asset to be depreciated is Rs. 10,000.
(Rs. 10,500 + Rs. 500 – Rs. 1,000). Life of the asset is 4 years.

Sum of the years = 1 + 2 + 3 + 4 = 10 will be taken as denominator.
Individual years, i.e., 1,2,3, and 4 (in reverse order) will be taken as numerator.
Thus, depreciation to be charged in each of the year will be:

	Rs.			Rs.
1st year	10,000	X 4/10	=	4,000
2nd year	10,000	X 3/10	=	3,000
3rd year	10,000	X 2/10	=	2,000
4th year	10,000	X 1/10	=	1,000

The journal entries are the same as those discussed under 'Methods of Treatment of Depreciation'. The Asset Account will appear as under :

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Dr. PLANT ACCOUNT Cr.

		Rs.			Rs.
1986 Jan.1	To Bank	10,500	1986 Dec.31	By Depreciation A/c	4,000
	To Erection charges	500		By Balance c/d.	7,000
		11,000			11,000
1987 Jan.1	To Balance b/d	7,000	1987 Dec.31	By Depreciation A/c	3,000
			Dec.31	By Balance c/d	4,000
		7,000			7,000
1988 Jan.1	To Balance b/d	4,000	1988 Dec.31	By Depreciation A/c	2,000
			Dec.31	By Balance c/d	2,000
		4,000			4,000
1989 Jan.1	To Balance b/d	2,000	1989 Dec.31	By Depreciation A/c	1,000
			Dec.31	By Bank A/c	850
			Dec.31	By Loss on sale of Asset A/c.	150
		2,000			2,000

Thus, you will find that under the three methods, i.e., Written Down Value Method, Double Declining Balance Method and Sum-of Years' Digits Method, the method of calculation and the amount of depreciation differ. Hence, the charge to Profit and Loss account on account of depreciation is a declining figure year after year. It is useful to find that some assets show declining efficiency as the time passes and that the three Diminishing Balance methods will be more useful than others for such assets. These methods will also be useful when the expenses on repairs are relatively small sums in the initial stages and large sums in later years.

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Check Your Progress - 2

Write the correct answer selecting from the following alternatives.

i) According to diminishing balance method of providing for depreciation is :

a) The amount on which depreciation is provided is reduced from year to year.
b) The percentage rate, at which depreciation is written off, gets reduced from year to year.
c) The percentage rate and also the amount gets reduced from year to year.

24.6 CHANGE OF METHOD

We have discussed under this unit broadly two methods. They are :

1. Fixed Instalment or Straight Line Method
2. Diminishing Balance or Reduced Instalement Method.

Sometimes, the method is changed from Fixed Instalment to one of the methods under the Diminishing Balanace System (or vice versa) with retrospective effect. In such a case the depreciation is to be calculated seperately under each of the methods from the date of acquisition to the date from which the method is to be changed. The difference is adjusted to the current value of the asset (in the asset account) by giving debit or credit to the Profit and Loss Account, so that the asset account will appear at its new value on the date of change under the changed method.

The following Illustration will make it clear :

Illustration 3

Maruti Ltd., bought a machine for Rs. 60,000 on 1-1-1986. They depreciated the same at 10% under the Written Down Value Method. On 1-1-1989 they wanted to change the method of depreciation from Diminishing Balance Method to Straight Line Method without changing the rate. Show the asset account from 1985 to 1989.

Dr. **MACHINE ACCOUNT** Cr.

		Rs.			Rs.
1986			1986		
Jan.1	To Bank A/c	60,000	Dec.31	By Depreciation A/c (10% on 60,000)	6,000
				By Balance c/d.	54,000
		60,000			60,000
1987			1987		
Jan.1	To Balance b/d	54,000	Dec.31	By Depreciation A/c (10% on 54,000)	5,400
			Dec.31	By Balance c/d	48,600
		54,000			54,000
1988			1988		
Jan.1	To Balance b/d	48,600	Dec.31	By Depreciation A/c (10% on 48,600	4,860
			Dec.31	By Balance c/d	43,740
		48,600			48,600
1989			1989		
Jan.1	To Balance b/d	43,740	Dec.31	By Depreciation A/c	6,000
			Dec.31	" (10% on 60,000)	
				" P & L A/c.	
			Dec.31	" (43,740 – 42,000)	1,740
				" Balance c/d	36,000
		43,740			43,740
1990					
Jan.1	To Balance b/d	36,000			

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Value of Machine as on 1-1-1989 under Straight line method:

	Rs.
1.1.1986 Purchase cost	60,000
Depreciation for 1986 at 10% on 60,000	6,000
Balance 1.1.1987	54,000
Depreciation for 1987 at 10% on 60,000	6,000
Balance on 1.1.1988	48,000
Depreciation for 1988 at 10% on 60,000	6,000
Balance on 1,1.1989	42,000

Thus in the illustration given above the balance of the asset on the date of change (1.1.1989) was Rs. 43,740 when Written Down Value Method was followed. However, if the Straight Line Method were followed, the balance on the above date would have been only Rs. 42,000. To bring the Asset A/c to the balance under the Straight Line method the Asset A/c. is to be credited with Rs. 1,740/-, and the Profit & Loss A/c. will be debited with the same amount.

24. 7 ANNUITY METHOD

This method takes into account not only the shrinkage in the utility value of the asset (Depreciation) but also the loss by way of interest on the capital invested in the purchase of the asset. The amount invested in the asset would have earned some interest if it was not invested in that particular asset. Thus, the loss of interest foregone is also to be taken into account. The asset account is debited every year with the annual interest of the (diminishing) value on the asset account appearing at the beginning of each year, and the value of the asset plus interest is sought to be completely written off during a given period by this method. Thus the amount written off as depreciation is the same each year, but the interest to be debited will diminish each year. The fixed amount to be charged every year as depreciation is calculated from the Annuity Table, an extract of which is given below:

Amount required to write off Re. 1/- by Annuity Method.

Years	3 percent	4 percent	5 percent
3	.353530	.360348	.367208
4	.269027	.275490	.282011
5	.218354	.224627	.230974
10	.117230	.123290	.129504
15	.083766	.089941	.096342

Thus if a lease of Rs. 3,000 is to be depreciated over a period of 5 years under the Annuity method and the interest calculated at 5% p.a., the yearly amount of depreciation is calculated in the following way. You will find from the extract of the Annuity Table that to write off a sum of Re. 1/- which is deemed to be earning 5% interest in 5 years the amount to be written off each year is Re. 0.230974. For writing off Rs. 3,000, we have to multiply Rs. 3,000 with 0.230974. Thus the annual charge comes to Rs. 692.92 (i.e., 3,000 X 0.23974).

Now we shall take up an illustration to see how the asset account would appear.

Illustration - 4

On the 1st of January, 1986 a business purchased a machine costing Rs. 10,000 the estimated life of which is 5 years. It was decided to depreciate the machine by Annuity method calculating the interest at 5 per cent per annum. According to the Annuity Table, to write off Re. 1/- at 5% interest for 5 years the annual charge is 0.230974. Give the journal entries and Machine a/c till the asset is completely written off.

Solution

The annual charge will be 10,000 X .230974 = Rs. 2309.74 or Rs. 2,310 (Aprox.)

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Date	Particulars		L.F.	Dr.	Cr.
1986 Jan. 31	Machine A/c To Bank A/c. (Being the entry for purchases of the machine)	Dr.		10,000	10,000
1986 Dec. 31	Machine A/c To Interest A/c. (Being interest on the amount of investment in the machine)	Dr.		500	500
Dec. 31	Depreciation A/c To Machine A/c (Being the depreciation on the machine written off)	Dr.		2,310	2,310
1987 Dec. 31	Machine A/c To Interest A/c. (Being the interest on the balance of investment at the beginning of the year)	Dr.		410	410
Dec.31	Depreciation A/c To Machine A/c (Being the depreciation written off)	Dr.		2,310	2,310
1988 Dec. 31	Machine A/c To Interest A/c. (Being the interest on investment on the opening balance in the Machine account)	Dr.		315	315
Dec. 31	Depreciation A/c To Machine A/c (Being the Depreciation on the machine written off)	Dr.		2,310	2,310
1989 Dec. 31	Machine A/c To Interest A/c. (Being the interest on investment on the opening balance in the Machine account.)	Dr.		215	215

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Dec. 31	Depreciation A/c To Machine A/c (Being the depreciation on the machine written off)	Dr.		2,310	2,310
1990 Dec. 31	Machine A/c To Interest A/c. (Being the interest on Investment on the opening Balance Machine a/c of at the beginning of year)	Dr.		110	110
Dec. 31	Depreciation A/c To Machine A/c (Being the depreciation on the machine written off)	Dr.		2,310	2,310

Notes :1. Every year the total depreciation (on all the fixed assets) in Depreciation Account is transferred to P & L Account by debiting P & L Account and crediting the Depreciation Account.

2. The credit balance on the Interest Account is transferred to the credit of the Profit & Loss Account every year.

3. The annual charge of Rs. 2309.74 is rounded off to Rs. 2,310/- Similarly the interest every year is also rounded off to the nearest rupee.

4. Whatever amount is there in the Asset Account as regards the previous year should be written off as depreciation. Sometimes, because of approximations such an amount may be a little less or more than the annual charge. In this problem the amount in the previous years account wasRs. 2,310 (Rs. 2,200+Rs.110) which was the exact amount of annual depreciation (See Machine Account).

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Dr. MACHINE ACCOUNT Cr.

		Rs.			Rs.
1986			1986		
Jan. 1	To Bank A/c.	10,000	Dec.31	By Depreciation A/c	2,310
Dec.31	To Interest A/c.	500	Dec.31	By Balance c/d.	8,190
		10,500			10,500
1987			1987		
Jan.1	To Balance b/d	8,190	Dec.31	By Depreciation A/c	2,310
Dec. 31	To Interest A/c.	410	Dec.31	By Balance c/d	6,290
		8,600			8,600
1988			1988		
Jan.1	To Balance b/d	6,290	Dec.31	By Depreciation A/c	2,310
Dec. 31	To Interest A/c.	315	Dec.31	By Balance c/d	4,295
		6,605			6,605
1989			1989		
Jan.1	To Balance b/d	4,295	Dec.31	By Depreciation A/c	2,310
Dec. 31	To Interest A/c.	215	Dec.31	By Balance c/d	2,200
		4,510			4,510
1990			1990		
Jan.1	To Balance b/d	2,200	Dec.31	By Depreciation A/c	2,310
Dec. 31	To Interest A/c.	110			
		2,310			2,310

This method is most useful when adopted in the cases where investment outside the business is not necessary.

The disadvantages of this method are:

1. The net charge to Profit & Loss Account (i.e., depreciation on the debit side and interest on the credit side) increases every year, because, though the depreciation is the same every year, the amount of interest credited decreases year after year.

2. Whenever additions are made to the Asset, calculations are to be made again.

3. Though the entire amount is written off the book value (inclusive of interest) in the earlier years in relation to the life of the asset will be more than the real value of the asset.

4. This method involves calculations as every year the interest is to be charged on the opening balance in the Asset account.

Though this method takes into account the amount of interest lost on the investment it is hardly used.

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24.8 DEPRECIATION FUND METHOD

This method is also known as 'Sinking Fund Method, which is explained in the Unit on 'Sinking Funds. This method is followed when provision for replacement of the asset is to be made. Under this method, a fixed amount is charged for depreciation to the Profit and Loss Account every year and credited to Depreciation Fund Account and an equal amount of money is invested in outside securities every year. These investments are allowed to accumulate at compound interest so that at the end of the life of the asset funds will be available for replacement of the used asset through the realisation of the securities. The Asset A/c. will remain at its original value in the ledger till the end of its life and closed at the end by transferring the balance in the Depreciation Fund Account to the Asset Account.

Since the securities always earn some interest, it is not necessary to write off the full amount of the cost of the asset as depreciation; something less will be adequate. Ultimately, the total depreciation written off and interest earned on securities should be equal to the original cost of the asset. Hence under this method the depreciation charge will be less than what it would be under other methods. In addition, this method has an added advantage of providing ready funds for replacement of the old asset at the end of its life.

It is necessary to refer to Sinking Fund Table to arrive at the depreciation to be provided every year, as the interest (at a fixed rate) earned on the proposed investments is also to be taken into account. An extract of Sinking Fund Table is given below:

SINKING FUND TABLE

Periodic deposit which will amount to Re. 1/-

Year	3%	4%	5%	6%
3	.323530	.320348	.317209	.314110
5	.188355	.184627	.180975	.117396
8	.112456	.108528	.104722	.101036
10	.087231	.083291	.079505	.075868
20	.037216	.033582	.030243	.027185

Supposing that Rs. 50,000 is to be written off over a period of 3 years and that the annual depreciation amount is invested in out side securities yielding 3% interest, the amount to be written off every year can be calculated as follows: From the extract given above you will find that 0.323530 is to be invested every year when the investments yield and interest at 3% for 3 years. So, for Rs. 50,000 the amount required to be written off every year is Rs. 50,000 X 0.323530 = Rs. 16,176.50.

The journal entries to be passed under this method are as follows:

1. At the end of 1st year.
   a. For writting off depreciation :

	Depreciation A/c.	Dr.			
	To Depreciation Fund A/c.				
	(Being the depreciation written off)				

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b. For investing the amount in securities :

Depreciation Fund Investments A/c.	Dr.			
To Bank A/c.				
(Being the amount invested)				

2. At the end of 2nd and subsequent years upto last but one year

a. For writing off depreciation :

Depreciation A/c.	Dr.			
To Depreciation Fund A/c.				
(Being the depreciation written off)				

b. For receipt of interest on investments as at the beginning of the year :

Bank A/c.	Dr.			
To Depreciation Fund A/c.				
(Being the interest on Depreciation Fund Investments)				

c. For investing amount in securities :

Depreciation Fund Investments A/c.	Dr.			
To Bank A/c.				
(Being the amount invested)				

3. At the end of last year of the life of the asset :

a. For writting off depreciation :

Depreciation A/c.	Dr.			
To Depreciation Fund A/c.				
(Being the depreciation written off)				

b. For receiving interest on investments as at the beginning of the year :

Bank A/c.	Dr.			
To Depreciation Fund A/c.				
(Being the interest on Depreciation Fund Investments received)				

c. For sale of investments :

Bank A/c	Dr.			
To Depreciation Fund Investments A/c.				
(Being the sale proceeds of Depreciation fund Investments)				

d. (i) For Profit on Sale of Investments :

Depreciation Fund Investments A/c.	Dr.			
To Depreciation Fund A/c.				
(Being Profit on sale of Depreciation Fund investments)				

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or

(ii) For the loss on sale of investments

	Depreciation Fund A/c. Dr.			
	To Depreciation Fund Investments A/c.			
	(Being loss on sale of Depreciation Fund Investments written off)			

e. For transferring the Depreciation Fund to Asset Account

	Depreciation Fund A/c Dr.			
	To Asset A/c.			
	(Being the depreciation provided so far transferred)			

f. For sale of Asset if there is any residual value

	Bank A/c. Dr.			
	To Asset A/c.			
	(Being sale proceeds of the Asset)			

g. (i) For transferring debit balance in the Asset Account if any :

	Profit and Loss A/c. Dr.			
	To Asset A/c.			
	(Being the entry for transfer of loss, on Asset A/c)			

(ii) For transferring credit balance in the asset account if any :

	Asset A/c. Dr.			
	To Profit and Loss A/c.			
	(Bing the entry for transfer of Profit on Asset A/c)			

Notes: 1. Every year the total amount of depreciation in Depreciation Account (on all the fixed assets) is transferred to P & L A/c. by debiting P & L A/c. and crediting Depreciation A/c.

2. Usually the annual charge of depreciation and the interest received are rounded off to the nearest rupee, unless the paise column is also maintained.

3. The amount to be invested in outside securities every year (if the amount was not invested in the previous year, since the amount was realised by the sale of investments for buying the new asset) is calculated as follows :

Amount available to the Depreciation Fund A/c. at the end of the Year	xxx
Less: amount invested till date, i.e., the balance in Depreciation Fund Investments A/c. at the beginning of period.	xxx
Net amount available for investment	xxx

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Usually the securities are available in the multiples of hundred. Hence the whole amount of net amount available for investment may not be invested, but the amount rounded off to preceding hundred may be invested. For example, if the 'net amount available for investment' is Rs. 1,564.95, only Rs. 1,500 may be invested.

Now we shall take up an illustration and see how the accounts would appear.

Illustration - 5

'Z' Acquires a lease on 1-1-1986 for Rs. 40,000 for 5 years. It was decided to provide for the amount required for the renewal of lease by following the Depreciation Fund Method. The outside securities available in multiples of hundred were expected to earn an interest of 5%. According to the Sinking Fund Tables Rs. 0.180975 invested every year at 5% p.a. will produce Re. 1/- at the end of 5 years. At the end of the 5th year the investments realised Rs. 31,050 net.

Show the Asset Account, Depreciation Fund A/c., Depreciation Fund Investments A/c. and also indicate how the items would appear in the Balance Sheet till the end of the lease.

Solution

The amount to be written off every year is Rs. 40,000 X 0.180975 = Rs. 7,239.

Dr. LEASE ACCOUNT Cr.

		Rs.			Rs.
1986			1986		
Jan. 1	To Balance b/d.	40,000	Dec. 31	By Balance c/d	40,000
1987			1987		
Jan. 1	To Balance b/d	40,000	Dec. 31	By Balance c/d	40,000
1988			1988		
Jan. 1	To Balance b/d	40,000	Dec. 31	By Balance c/d	40,000
1989			1989		
Jan. 1	To Balance b/d	40,000	Dec. 31	By Balance c/d	40,000
1990			1990		
Jan. 1	To Balance b/d	40,000	Dec. 31	By Depreciation Fund A/c. (Loss)	39,940
			"	P & L A/c.	60
		40,000			40,000

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Dr. **DEPRECIATION FUND ACCOUNT** Cr.

		Rs.			Rs.
1986 Dec. 31	To Balance c/d.	7,239	1986 Dec.31	By Depreciation A/c.	7,239
1987 Dec. 31	To Balance c/d	14,838	1987 Jan. 1	By Balance b/d	7,239
			Dec. 31	" Bank (Interest)	360
			"	" Depreciation	7,239
		14,838			14,838
1988 Dec. 31	To Balance c/d	22,817	1988 Jan. 1	By Balance b/d	14,838
			Dec. 31	" Bank (Interest)	740
			"	" Depreciation A/c	7,239
		22,817			22,817
1989 Dec. 31	To Balance c/d	31,196	1989 Jan. 1	By Balance b/d	22,817
			Dec. 31	" Bank (Interest)	1,140
			"	" Depreciation	7,239
		31,196			31,196
1990 Dec. 31	To Depreciation fund Investment A/c	50	1990 Jan. 1	By Balance b/d	31,196
			Dec. 31	" Bank (Interest)	1,555
Dec. 31	To Lease A/c	39,940	"	" Depreciation A/c	7,239
		39,990			39,990

Dr. **DEPRECIATION FUND INVESTMENTS ACCOUNT** Cr.

		Rs.			Rs.
1986 Dec. 31	To Bank A/c.	7,200	1986 Dec.31	By Balance c/d	7,200
1987 Jan. 1	To Balance b/d	7,200	1987 Dec.31	By Balance c/d	14,800
Dec. 31	To Bank A/c.	7,600			
		14,800			14,800
1988 Jan. 1	To Balance b/d	14,800	1988 Dec. 31	By Balance c/d	22,800
Dec. 31	To Bank A/c.	8,000			
		22,800			22,800
1989 Jan. 1	To Balance b/d	22,800	1989 Dec. 1	By Balance c/d	31,100
Dec. 31	To Bank A/c.	8,300			
		31,100			31,100
1990 Jan. 1	By Balance b/d	31,100	1990 Dec. 1	By BankA/c (Sale Proceeds)	31,050
			Dec. 31	"By Depreciation Fund A/c	50
		31,100			31,100

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BALANCE SHEET AS ON THE 31st OF DECEMBER, 1986

	Rs.		Rs.
Depreciation Fund	7,239	Lease	40,000
		Depreciation Fund Investments	7,200

BALANCE SHEET AS ON THE 31st OF DECEMBER, 1987

	Rs.		Rs.
Depreciation Fund	14,838	Lease	40,000
		Depreciation Fund Investments	14,800

BALANCE SHEET AS ON THE 31st OF DECEMBER, 1988

	Rs.		Rs.
Depreciation Fund	22,817	Lease	40,000
		Depreciation Fund Investments	22,800

BALANCE SHEET AS ON THE 31st OF DECEMBER, 1989

	Rs.		Rs.
Depreciation Fund	31,196	Lease	40,000
		Depreciation Fund Investments	31,100

BALANCE SHEET AS ON THE 31st OF DECEMBER 1990

	Rs.			Rs.
		Lease	40,000	
		Less: Depreciation Fund	39,990	
		Less: Loss on Investements	50	
			39,940	
		Loss written off to P & L A/c	60	
			60	----

Notes :1. The total depreciation fund at the end of the 5th year amounted to Rs. 39,990 only instead of Rs. 40,000, the reason being non-investment of the entire fund, as it was done in multiples of hundreds only.

2. The asset account would appear at its original cost through out its life in the Balance Sheet. In addition, Depreciation fund and Depreciation Fund Investments would appear on liabilities and assets side (of the Balance Sheet) respectively. The students may note that the Depreciation Fund is not deducted from the Asset A/c in the Balance Sheet under this method.

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Advantages and Dis-Advantages

The most important advantage of this method is that it provides for the required amount for the replacement of the asset. If separate provision is not made, the required funds will have to be drawn from the regular business funds which may cripple the normal working of the business financially.

Its main disadvantage is that the annual charge to the Profit and Loss Account is the same throughout the life of the asset as in the case of Fixed Instalment method, although such a charge is less than that under the Fixed Instalment system. Hence, when repairs are included, the burden on the Profit and Loss Account is disproportionate to the use of the asset being lighter in the earlier years and heavier in the later years. This method also involves some calculations every year and hence can be considered to be complicated.

In spite of the disadvantages, this method is in use in the business concerns in view of the fact that it provides for ready funds for the purchase of a new asset without putting any strain on their financial resources.

24.9 INSURANCE POLICY METHOD

We have seen earlier that the Depreciation Fund method is a little complicated. Further, the investment of funds in outside securities is somewhat time-consuming and requires knowledge of the investment market, besides the risk involved in it. Sometimes, when investments are sold, they may result in loss and hence some risk also is involved in investing funds in outside securities. Thirdly, it entails some work in connection with periodical collection of interest. To avoid the inconvenience and eliminate the risk (in the investment of outside securities), the businessman take up an (Endowment) Insurance policy and pays the annual insurance premium to the Insurance Company (instead of going in for investments). At the end of the period the Insurance Company pays the policy amount (unlike what is possible through the realisation of investments) and this amount is used for the replacement of the asset.

Thus, from the accounting point of view this method is almost similar to that of Depreciation Fund Method. However, the question of receiving interest on investment every year does not arise and at the end of the period the total assured amount is received from insurance company.

The following are the journal entries passed under this method.

During the first and subsequent years except in the last year:

a) For payment of the premium:

Depreciation Fund Policy A/c	Dr.			
To Bank A/c				
(Being the payment of premium on Depreciation Policy)				

b) For charging depreciation.

Depreciation A/c	Dr.			
To Depreciation Fund A/c				
(Being the Depreciation on the asset)				

Dr. DEPRECIATION FUND POLICY A/C Cr.

			Rs.				Rs.
1986				1986			
Jan. 1	To Bank A/c.		6,400	Dec.31	By Balance c/d		6,400
1987				1987			
Jan. 1	To Balance b/d		6,400	Dec. 31	By Balance c/d		12,800
	To Bank A/c.		6,400				
			12,800				12,800
1988				1988			
Jan. 1	To Balance b/d		12,800	Dec. 31	By Bank A/c.		20,000
Jan. 1	To Bank A/c.		6,400				
Dec.31	To Depreciation Fund A/c.		800				
			20,000				20,000

24. 10 OTHER METHODS

Depreciation and Repairs Fund Method:
We have seen that the Depreciation Fund method suffers from the following main defects:

i. Together with repairs, this method burdens the P & L Account heavily.
ii. It involves a number of calculations.

In the insurance policy method, we have overcome the above cited second difficulty. But under all the methods we have so far discussed, the difficulty at (i) above is not overcome. However, the position is slightly better under the Written Down Value Method, but not totally satisfactory. Thus, there is need for equalising the charge on the Profit and Loss Account in respect of both depreciation and repairs & renewals. Hence, some businessmen follow the Depreciation and Repairs Fund Method, which is somewhat similar to Depreciation Fund Method. Under the Depreciation and Repairs Fund Method, the total depreciation (to be written off) and the total estimated amount for repairs and renewals during the life time of the asset are added up and divided by the number of years the asset is expected to last. The resultant figure is the amount to be charged to the P & L Account and credited to Depreciation and Repairs Fund every year.

During the year if any amount is spent on repairs, it is charged to the 'Depreciation & Renewals Fund A/c' and only the remaining amount is invested in outside securities every year. If the usual annual charge is not sufficient in any year to meet the repairs, part of the investments are sold away to meet the difficulty.

The remaining procedure is similar to the one followed under the Depreciation Fund Method.

24. 10.1 Revaluation Method

This method is also known as Inventory Method'. It is adopted where the assets to be depreciated consist of a large number of small and diverse items of small unit cost. Examples are loose tools, Sacks, Boules, etc. When there are large numbers of items of small value, too much clerical work will be necessary to maintain individual accounts.

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Under this method the assets in question are revalued at the end of every year. Usually, the value at the end of the period will be less than that at the beginning of period. The difference, i.e., the fall in the value is charged as depreciation by debiting the P & L A/c and crediting the Asset A/c. It may be noted that the depreciation amount is not accumulated and credited to Depreciation Fund Account.

The following illustration will clarify the position :

Illustration – 7

M/s. Mohan Bros., had loose tools valued at Rs. 5,000 on the 1st of January, 1989. On July 1,1989 they purchased additional tools to the tune of Rs. 3,000. On December 31, 1989 the entire stock of tools was revalued at Rs. 5,500. Pass the necessary journal entries and show the Asset account for 1989.

Solution

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			Dr. Rs.	Cr. Rs.
1989 Dec. 31	Depreciation A/c. To Loose Tools A/c. (Being the depreciation on revaluation of loose tools written off)	Dr.	2,500	2,500
Dec. 31	Profit and Loss A/c. To Depreciation A/c. (Being transfer of depreciation to P & L A/c.)	Dr.	2,500	2,500

Dr. LOOSE TOOLS A/C Cr.

1989		Rs.	1989		Rs.
Jan. 1	To Balance	5,000	Dec. 31	By Depreciation A/c	2,500
Jan. 1	To Bank A/c	3,000	Dec. 31	" Balance c/d	5,500
		8,000			8,000

24.10.2 Depletion Method

This method is specially suited to mines, quarries, oil-wells, timber stands, etc., from which a certain quantity of output is expected to be raised. For example, the value of a mine depends upon the quantity of mineral that is available and obtained. Hence, it can be said that the mine depreciates according to the quantity of mineral mined. It is advisable in such cases not to calculate the depreciation in terms of years. Rather it is most appropriate to compute the cost per unit by dividing the total cost with the total quantity units that can be obtained and charge every year the depreciation based on the number of units obtained. For example, if the unit cost is Re. 1 and in a year 1,000 units are obtained, the depletion charge will be 1,000 units X Re. 1 = Rs. 1,000/-. The following illustration will clarify the position further.

Illustration – 8

Sai Timber company acquired a timber tract for Rs. 7,500 and spent Rs. 1,500 on developing the tract. The tract was estimated to contain 5 lakh board feet of timber. It was estimated that the cutover land could be sold for Rs. 500.

Calculate the depletion charge if 50,000 board feet were cut in 1989.

$$\text{Depletion} = \frac{\text{Cost} - \text{Salvage Value}}{\text{Estimated Units}}$$

$$\text{Depletion per 1000 Board feet} = \frac{\text{Rs. } 7,500 + \text{Rs. } 1,500 - 500}{500,000} \times 1,000$$

$$= \frac{8,500}{500} = \text{Rs. } 17$$

For the year 1989 depletion (i.e. depreciation) is

= Rs. 17 X 50 = Rs. 850

24. 10.3 Machine Hour Rate Method

This method will be useful in the case of machines. The life of the machine is sometimes fixed in terms of the number of hours the machine can work and the machine cost is divided by estimated total number of hours the machine can work and the hourly rate of depreciation arrived at. This rate is multiplied with the number of hours the machine had worked in a given period to arrive at the depreciation charge for that period. Suppose a machine costing Rs. 25,000 is expected to be used for 12,000 hours in all. It has scrap value of Rs. 1,000. Then the hourly rate of depreciation is

$$\text{Rs. } 2 = \left(\frac{\text{Rs. } 25,000 - \text{Rs. } 1,000}{12,000} \right)$$

If the machine has worked for 1,000 hours in a year the total depreciation to be written off that year would be Rs. 2 X 1,000 = Rs. 2,000/-.

24. 10.4 Mileage Method

This method is used in the case of Buses, Cars, Trucks, Rolling Stock, etc., whose working life depends upon the number of Kilometres they are driven/run. Suppose a car costing Rs. 75,000 was purchased and its useful life was estimated to be 50,000 Km. Then the rate of depreciation would be Rs. 1.50 per km. During a given period if the car is driven for 10,000 Km, the depreciation to be charged for that period will be Rs. 1.50 X 10,000 = Rs. 15,000.

24. 10.5 Group Depreciation

We have discussed so far the depreciation methods of individual assets. Sometimes, a group of assets is depreciated as a single unit. For example, if there are 10 similar machines, they can be made into one homogeneous group and only one (asset) account say, Machinery A/c, can be maintained for all the 10 machines. In such cases the average depreciation rate is calculated by taking into account the total cost of all the machines, their residual value and their life period.

Individual items are not recognised here as only one account is maintained. If an item is sold it is credited to the Group Asset Account. In the same manner, if a similar item is purchased, the value is debited to the Group Asset Account.

We have discussed a number of methods of charging depreciation. No one method can be regarded as the best or as the worst. Every method has its own merits and demerits. The suitability of a method of depreciation depends upon the type of the asset, the purpose of depreciation, etc.

Now it is proposed to take up a comprehensive illustration involving addition of assets and change in the method of charging depreciation.

Illustration – 9

Albert & Company purchased a machine on the 1st of January, 1986 for Rs. 38,000 and spent Rs. 2,000 on its erection. On the 1st of July, 1987 they purchased another machine for Rs. 10,000. They sold away the first machine (purchased in 1986) on the 1st July, 1988 for Rs. 28,000 and on the same date purchased another machine for Rs. 25,000. On the 1st July, 1989 the second machine purchased was sold away for Rs. 2,000/

Depreciation was provided under the straight line method at 10% of the orginal cost on the 31st of December every year. Howerver, the company switched over to the Written Down Value Method (rate of depreciation being 15%) with effect from 1987 with retrospective effect. Give the machinery account upto 1989.

Solution

Dr. MACHINERY ACCOUNT Cr.

		Rs.					Rs.
1986				1986			
Jan. 1	To Bank A/c		38,000	Dec. 31	By Depreciation A/c		4,000
Jan. 1	To Bank (Erection) A/c		2,000	Dec. 31	By Balance c/d		36,000
			40,000				40,000
1987				1987			
Jan. 1	To Balance b/d		36,000	Dec. 31	By Depreciation A/c (1)		7,850
July. 1	To Bank A/c		10,000	Dec. 31	By Balance c/d		38,150
			46,000				46,000
1988				1988			
Jan. 1	To Balance b/d		38,150	July. 31	By Bank (Sale Proceeds)		28,000
				July. 1	By Depreciation A/c(2)		2,168
July. 1	To Profit & Loss A/c (Profit) (3)		1,268	Dec. 31	By Depreciation A/c (4)		3,263
July. 1	To Bank A/c		25,000	Dec. 31	By Balance c/d		30,987
			64,418				64,418
1989				1989			
Jan. 1	To Balance b/d		30,987	July. 1	By Bank A/c		2,000
				July.	By Depreciation A/c (5)		590
				July. 1	By P & L A/c (loss on sale of Asset) (6)		5,272
					By Depreciation A/c (7)		3,469
			Dec. 31		By Balance c/d		19,656
			Dec. 31				
			30,987				30,987
1990							
Jan. 1	To Balance b/d		19,656				

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1.	Depreciation to be charged on the 1st machine for 1986		
	@ 15% on 40,000 under the Written Down Value Method	6,000	
	Depreciation actually charged in 1986	4,000	
	Difference to be charged in 1987 on the 1st machine	2,000	
	Depreciation @ 15% on 34,000 (40,000 – 6,000) on the 1st machine	5,100	
	Depreciation on the 2nd machine @ 15% on 10,000 for 1/2 year	750	
			7,850
2.	Depreciation on the 1st Machine @ 15% on 28,900		
	(40,900 – 6000 – 5,100) for 1/2 year		2,168
3.	Depreciation value of the 1st Machine (40,000 – 6000 – 5,100 – 2,168)		26,732
	Sale proceeds		28,000
	Profit on sale of the 1st machine		1,268
4.	Depreciation on the 2nd Machine @ 15% on 9,250 (10,000 – 750)		1,388
	Depreciation on the 3rd Machine @ 15% on 25,000 for 1/2 year		1,875
			3,263
5.	Depreciation on the 2nd Machine for 1/2 year @ 15% on Rs. 7,862		
	(10,000 – 750 – 1,388)		590
6.	Depreciated value of the 2nd Machine		
	(10,000 – 750 – 1,388 – 590		7,272
	Sale proceeds on the 2nd Machine		2,000
	Loss on sale of the 2nd Machine		5,272
7.	Depreciation on the 3rd Machine @ 15% on 25,125 (25,000 – 1,875)		3,469

24. 11. SUMMING UP

There are two main methods of treating the depreciation in the books of account. Under the first method, the depreciation method, the asset account would appear at its depreciated value every year. Under the second method, the depreciation provision method, the depreciation is accumulated every year and only at the end of the life of the asset, the accumulated provision is transferred to the asset account and till then the asset account would appear at its original cost.

There are different methods of calculating depreciation. They vary from asset to asset depending on their nature and also from concern to concern. Under the fixed instalment method, an equal amount is charged as depreciation every year. Under the diminishing balance method, a fixed percentage of the balance on the asset account (at the beginning of each year) is charged to the Profit and Loss Account. Thus depreciation charged will be diminishing year after year. There are three methods falling under the diminishing balance systems. They are the written down value method, the double declining balance method and the sum-of -years digits method.

Business concerns can switch over from one method of depreciation to another during the life time of the asset. This requires the calculation of depreciation according to both the methods and the bringing down of the asset to appear at its new value according to the changed method.

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Under the Annuity method the interest foregone on the amount invested in the asset is also taken into consideration and an equal amount is charged over the life of the asset. Under the depreciation fund method provision is made for replacement of the asset (When the time comes for discarding the existing asset) by investing the depreciation amount in outside securities.

Under the insurance policy method the risk involved in investing the funds in outside securities is overcome while retaining the advantages of depreciation fund method. When a large number of small items are to be depreciated the fall in the value of such assets is ascertained by the use of the revaluation method and charged to the Profit & Loss Account.

Certain assets like mines get exhausted depending upon the output raised. Such assets are depreciated taking into account the quantity obtained under the depletion method. When the life of the asset is expressed in terms of working hours; the hourly rate of depreciation is computed and depreciation charged according to the number of hours during which the asset is put to use. Sometimes, the life of an asset is expressed in terms of kilometres they can run/are driven. Such assets are depreciated on the basis of the kilometres driven during the period.

However, no single method can be regarded as the best method. The method to be followed depends upon the type of the asset and the purpose of charging depreciation.

24. 12. ANSWERS TO CHECK YOUR PROGRESS

1. Depreciation = $\frac{\text{(Cost of Asset + Errection charges) — Residual value)}}{\text{Life of the asset in terms of years.}}$

2. The amount on which depreciation provided is reduced from year to year.

24. 13. MODEL EXAMINATION QUESTIONS

A. Short Answer Questions

1. What is written down Value ?
2. How is annual depreciation calculated under fixed instalment method ?
3. What is diminishing balance method ?
4. How is the depreciation determined under fixed instalment method ?
5. What are the different methods based upon diminishing balances ?
6. In what ways the Sum- of- years digits method differs from the written down value method?
7. What is machine hour rate ?
8. What is depreciation fund ?
9. What is depletion method ?
10. What is meant by machine hour rate method ? How is it different from mileage method ?
11. What do you understand by annuity method ?
    How is it different from depreciation fund method ?

B. Essay Answer Questions

12. How are the Diminishing Balance Methods superior to the Fixed Instalment Method ?
13. Why is straight line method so called ? What are its advantages and limitations ?
14. What are the methods based upon diminishing balances ? Discuss, the differences between these methods in calculating depreciation.
15. What is depreciation fund policy method ? How does it differ from depreciation fund method ?

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16. What is depreciation fund ? In what ways is the depreciation fund method superior to the diminishing balance method ?
17. What is meant by effluxion of time ? Which method do you suggest for the replacement of an asset which is subject to wear and tear due to effluxion of time ?
18. Which method would you recommend to depreciate the following assets and why ?
    a) Free-hold building, b) Loose Tools, c) Lease-hold land.
19. What is depreciation fund method ? What are its advantages and limitations ?

Problems

1. An asset was purchased on the 1st of January, 1986 for Rs. 50,000/- Show the Asset account under (a) The Straight Line Method and (b) the Written Down Value Method for the first three years, if the same is depreciated at 20%.

   (Answer: Balance at the end of 3 years under Straight Line Method Rs. 20,000;
   under W.D.V. Method Rs. 25,600)

2. On the 1st of Jan. 1986 a lease was acquired for 5 years at a cost of Rs. 40,000. In addition, the annual rent is payable, which (is Rs. 3,000) increase by Rs. 800 every year. State what the amount to be written off in first three years, in according to your opinion.

   Hint: Total amount to be written off = 40,000 + 3,000 + 3,800 + 4,600 + 5,400 + 6,200 = Rs. 63,000
   (Answer : Annual depreciation under the fixed instalment method =
   Rs. 63,000 ÷ 5 Rs. 12,600/-)

3. [illegible] purchased a machine on the 1st of January, 1986 for Rs. 12,000 and spent Rs. 500 on [illegible]. The scrap value of the machine at the end of 5 years of its life was estimated to be Rs. 2,500. If depreciation to be charged equally every year, what will be the balance at the end of 3 years in the Machine account? Show the Machine A/c.
   (Answer: Rs. 4,000/-)

4. Madhu Ltd. purchased a machine on the 1st of March, 1986 for Rs. 80,000 and spent Rs. 4,000 on its erection, which was completed on 31-3-1986. The Machine was put to use on 1-4-1986. If the machine is to be depreciated under the Fixed Instalment Method, at Rs.8,400 per annum, show the asset account for the first 4 years.

   (Answer: Depreciation written off 1st year; Rs.6,300 2nd, 3rd and 4th years; Rs. 8,400 each)

5. Smith Ltd., depreciate their machinery under the Straight Line Method at 10% per annum. The balance on Machinery on the 31st of December, 1979 after writing off depreciation for that year was Rs. 19,515. The total cost price of the machinery was Rs. 35,800 (including plant purchased in 1969 for Rs.8,900.)

   During January, 1980 another machine was purchased for Rs. 2,950 and one machine which had cost Rs. 550 in 1966 was sold for Rs. 35.

   During January, 1981 another machine was bought for Rs. 1,800 and a machine which had cost Rs. 700 in 1977 was sold for Rs. 350. Write the Machinery account for 1980 and 1981.

   (Answer: Machinery A/c Balance: 1980 Rs. 19,480, 1981 Rs. 17,765.)

6. Esviess Ltd. depreciate their plant and machinery at 15% under the W.D.V. Method and close their accounts on the 30th of September each year. The book value of the Plant and Machinery on the 30th of September, 1988 was Rs. 8,59,870 and on the 31 st of Dec. 1988, another machine was added at a cost of Rs. 8,500 and on the 31st of Dec. 1989 yet another machine was added at

a cost of Rs. 28,800. On the 30th of June, 1989 a machine whose book value on the 30th of September 1988 was Rs.9,600, was sold for Rs. 6,850. Write up the Plant and Machinery Account for the year ending on the 30th of Sept. 1990.

(Answer : Loss on the sale of machine: Rs.1,670, Balance on the 30th of Sept., 1990; Rs.6,52,928).

7. Modern wines Ltd., purchased a cold storage plant for Rs. 8,400 on the 1st of Jan. 1985 whose estimated life is 6 years. You are required to show the asset account for the first three years when depreciation is charged under the Sum-of-Years' Digits method.

(Answer: Balance at the end of 3rd year; Rs. 2,400).

8. ABC Ltd., purchased a machine for Rs. 50,000 on the 1st of Jan, 1980. They close their books every year as per the calender year. On the 1st of July, 1981 they bought another machine for Rs. 10,000. Yet another machine was acquired for Rs. 16,061 on the 1st of January, 1984. The machine which was purchased for Rs. 10,000 on the 1st of July, 1981 was sold for Rs.5,000 on the 30th of June, 1983.
Give the machinery account writing down the depreciation at 10% under W.D.V. Method.

(Answer: Loss on sale of Machine:Rs.3,122/-) Balance as on 31-12-1984; Rs.43,980/-)

9. Atmaram Ltd., acquired a lease costing Rs.30,000 for a period of 5 years. As per the Annuity tables, in order to write off at 5% interest per annum, the amount to be written off amounts to Rs.6,929.25. Prepare the Lease a/c for the 5 years under the Annuity Method and show the annual net charge to the P & L A/c. for all the 5 years.

(Answer:Balance of lease a/c. at the end of 1st year: Rs. 24,570.75, and 2nd year:Rs.18,870.03,3rd year: Rs.12,884.28, 4th year: Rs.6,599.25, 5th year: nil).

10 Cauvery Papers Ltd., purchased a machine (whose estimated life was 4 years) on 1-1-1986 for Rs. 50,000. It is decided to provide for the replacement of the asset under the Depreciation Fund Method, where the investments are expected to fetch 4% p.a. According to the Sinking Fund Tables, Re.0.235490 invested each year will produce Re. 1/- at the end of 4 years at 4% p.a. On the 31st of Dec. 1989 the investments were sold for Rs.49,699.93 and on the 1st of Jan. 1990 a new machine was bought for Rs. 55,000.
Show the relevant ledger accounts.

(Answer:Loss on sale of investments; Rs.300.06).

11. Avinash Timber Company acquired a timber tract for Rs.21,000 and spent Rs.1,000 on its development. The tract is estimated to contain 5 lakh board feet of timber and is expected that the cut over the land can be sold for Rs. 2,000. Calculate the depletion for hundred board feet; and the depletion if 80,000 board feet were cut in 1988.

(Answer:Rs.4 per 100 board feet; Rs. 3,200/-).

12. Kiran Limited purchased a machine on the 1st of July, 1986 for Rs. 1,80,000. It has an estimated life of 4 years. An insurance policy was taken out with an annual premium of Rs. 41,000 (the 1st premium payable on the 31st of July, 1986) to provide funds for the replacement of the machine. At the end of 4 years a new machine was acquired for Rs. 2,00,000. Write up the accounts for the period.

(Answer:Profit on policy;Rs.16,000).

13. Suresh Bearings Ltd., purchased tools on the 1st of January, 1988 for Rs. 2,000. During the year additions were made to the extent Rs. 400. On the 31st of December, 1988 the tools were valued at Rs.2,200 and at the end of 1989 at Rs. 1,800. Prepare the Loose Tools account for 1988 and 1989.

(Answer: Depreciation under Revaluation method 1st year: Rs. 200; 2nd year : Rs.400).

14. Messrs. Deccan Ceramics, Ltd, purchased a machine on the 1st of Jan, 1987 which was to last for 3 years, for Rs. 1,00,000. It is estimated that the machine will have a residual value of Rs. 12,500. If outside securities carry an interest of 5% p.a., and the amount to be set aside annually towards depreciation is Rs. 27,769, maintain the necessary accounts under the Depreciation Fund method assuming that the investments realised is Rs. 87,150.

(Answer : Loss on sale of investments : Rs. 350).

15. Rama Pulp and Papers Ltd. purchased a machine for 10,000 and paid Rs. 500 for its installation. At the time of purchase, the machine's life was estimated to be 15 years and it was decided to make provision for replacement of the same by investing in outside securities under the Depreciation Fund method. Before the expiry of its life, it was dismantled to be replaced with a sophisticated one. The dismantling charges amounted to Rs.100. The new machine was bought for Rs. 11,500. The old machine fetched an amount of Rs. 625. On the date of dismantling the machine, the Depreciation Fund A/c. showed a balance of Rs. 8,250 and the securities representing the same were sold for Rs. 7,800. Write up the concerned accounts.

(Answer:Loss on dismantled machine amounting to Rs. 2,175 is to be written off to the Profit & Loss acount).

24.14. GLOSSARY

1. Annuity	:	Annual amount by investing which at a given rate of interest a stated sum will accumulate after a given period.
2. Annual Charge	:	Amount debited to the Profit & Loss Account every year.
3. Break-up Value	:	The value that may be realised from an asset at the end of its useful life.
4. Depreciation Fund	:	A fixed sum charged to the profit and loss account, as depreciation is accumulated in this account.
5. Depreciation Policy	:	An endowment insurance policy taken for the purpose of replacement of an asset by investing annual amounts of depreciation as premia.
6. Diminishing Balance	:	Balance that diminishes with the passage of time.
7. Effluxion of Time	:	Passage of time.
8. Equal Instalment	:	Equal amounts of instalment.
9. Fixed Instalment	:	Amount of instalment is fixed. It does not vary over the years.
10. Machine Hour Rate	:	A rate per hour arrived at by taking into account the total number of working hours of a machine during the whole of its effective estimated life.
11. Mileage Method	:	A method used for those asets whose useful life depends upon the number of kilometres (earlier measured as miles) they are driven or run.
12. Reducing Balance	:	Balance which gets reduced with the passage of time.
13. Replacement	:	The act of eliminating or removing an old asset and replacing it with a new asset or putting a new one in its place.
14. Residual Value	:	Amount that may be realised by the sale of the discarded asset after its useful working life is over.
15. Revaluation Method	:	Process of charging the fall in value of the asset from the value at the beginning of the period.
16. Salvage	:	Amount that may be realised on the sale of discarded asset after its useful economic life is over.
17. Scrap Value	:	Value that may be realised from a discarded asset after its useful economic life is over.
18. Sinking Fund	:	A fund in which periodical amounts are allowed to accumulate as to have ready money after a particular period.
19. Sum of Years	:	The total of the individual years in the life span of an asset.

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UNIT - 25 : CONSIGNMENT ACCOUNTS - I

Contents

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25.2 Meaning of Consignment
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25.0 AIMS AND OBJECTIVES

The aims of this unit are to discuss :

i) the meaning and features of consignment;
ii) the difference between consignment and sale;
iii) the accounting treatment in the books of consignor and consignee.

On having studied and worked through this unit you would be able to :

- describe the meaning and features of consignment ;
- distinguish between consignment and sale,
- solve the problems.

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25.1 INTRODUCTION

Every businessman, a producer or a trader, tries his best to expand his business. To achieve it he tries to introduce his products at places other than his own where there is likely to be a demand for them. If he has to sell his products at different places, one method available to him is to open a network of branches and sell the goods through them. But the opening of branches involves lot of expenditure, both capital as well as revenue. All business establishments may not be able to open branches at different places. Therefore, those businessmen who cannot either afford to open their branches or those who want to test the saleability of their products, appoint agents at other places through whom goods are sold. The businessman sends his goods to the agent to be sold by the latter on behalf of and at the risk of the former.

25.2 MEANING OF CONSIGNMENT

The person who sends goods is known as 'Consignor (Principal) and the person to whom goods are sent is known as 'Consignee' (Agent). If X sends goods to Y for sale, X is known as Consignor and Y Consignee. The process of sending goods by one person to another for sale is known as 'consignment'. The transactions that take place between the consignor and consignee are known as 'consignment transactions'.

As the consignee is only an agent of the consignor and as the goods are sold by him on behalf of his principal (consignor) these transactions are also known as Agency transactions'. The agent will have to dispose of the goods according to the instructions given to him by his principal. The agent gets commission for services rendered by him. Therefore, the consignment is a special type of business in which a producer or a trader forwards his products to a selling agent appointed at some other place to sell them on his behalf for an agreed commission. Thus, the consignment is neither sale from the point of view of consignor nor purchase from consignee's point of view.

Check Your Progress - 1

Fill in the blank taking from alternatives given below :

i) Consignor is : - - -

25.4 EXPLANATION OF CERTAIN TERMS

Pro-forma Invoice

When the consignor sends goods to the consignee, a forwarding letter or note is invariably sent which is known as Pro-forma invoice. This note contains particulars as to nature, quantity and price of the goods despatched, and it is mainly meant for the information of the consignee. It is drawn up in the form of an invoice and it is called Pro-forma invoice, i.e., invoice for the sake of form.

The following is a specimen of a pro-forma invoice.

Branches : 21, Mount Road, Madras. 34, Station Road, Guntur.	HYDERABAD TRADERS M.G.Road, Hyderabad - 1.	Grams : Hytraders Date : 1st Jan., 1989
Consigned to : Mahajan & Co., Bombay.		
Marks A-1 HY-T	10 Cases, each case containing 1 dozen A-1 Quality single band transistors @ Rs.100/- per transistor.	Rs. 12,000
E & O.E		For Hyderabad Traders Bhajanlal Managing Partner

Commission

It is the remuneration or reward payable by the consignor to the consignee for the services rendered. It is usually paid at a certain fixed percentage on gross sales i.e., the total sales as per the terms agreed upon by them. The commission earned by the consignee depends on the volume of sales made by him. The higher the sales the more will be the commission. Besides the normal commission as stated above, the consignee may also be allowed extra and special commissions in some cases.

Del credere Commission

This is a special commission allowed to the agent in consideration of the consignee agreeing to bear the risk of bad debts arising out of any credit sales made by him. When the consignee is allowed this commission, he becomes responsible for all losses arising on account of the non-recovery of debts. This commission is also allowed on gross sales unless it is stipulated that it will be allowed only on credit sales.

Overriding Commission

This is an extra commission allowed over and above the normal commission and is generally offered when

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the agent is required to put in hard work either in introducing a new product in the market or where he is entrusted with the work of supervising the performance of other agents in a particular area. This commission is also calculated on the basis of the total sales effected.

Advance on Consignment

It is common for the consignor to demand some advance from the consignee as a security for the goods despatched to him. The consignee usually sends a bank draft or accepts a Bill drawn on him by the consignor for a part of the value as an advance against the consignment in anticipation of sales in his hands. The consignee deducts this amount from the gross sale proceeds and remits the balance due to the consignor.

Account Sales

This is a statement sent periodically by the cosignee to the consignor showing the following details :

i) Gross sale proceeds,
ii) Expenses incurred at the time of taking delivery and in the course of selling the goods,
iii) Commission charged by the consignee ;
iv) Advance if any, given by the consignee ;
v) Remittance, if any, sent by the consignee along with the Account Sales,
vi) Unsold stock of goods lying with the consignee.

Th fcllowing is a specimen of an Account Sales

Mahajan & Co.
P.B.No. 101, Bombay.

Dt. 15th February, 1989

Ref: Consignment of 120 HY-T transistors received from Hyderabad Traders, Hyderabad, for sale on their account and risk :

ACCOUNT SALES

	Rs.	Rs.
50 transistors @ Rs. 120	6,000	
70 transistors @ Rs. 130	9,100	
		15,100
Less Charges :		
Cartage	30	
Storage	120	
Insurance	200	
Commission @ 10%	1,510	
		1,860
		13,240
Less : Advance (our draft dt. 2nd Jan. 1989)		5,000
Balance due remitted as per draft enclosed		8,240

For Mahajan & Co.
Sohanlal
Mg. Partner

E& O.E.
Encl. Sight draft for Rs.8,240/-

25.5 ACCOUNTING TREATMENT

Consignment transactions are recorded by both the parties in their books (as part of their books), but for different objectives. The consignor is interested in ascertaining the profit or loss on the consignment,

besides finding out whether any amount is due from or due to his agent. The consignee will be interested in ascertaining whether any amount is due to or due from his principal after taking account of the sales of consignment goods, expenses on consignment and his commission. Accordingly, the objectives stated above are reflected in the accounting treatment.

Books of Consignor

The consignor opens the following important accounts in his books for recording the consignment transactions :

i) Consginment Account ;
ii) Consignee's Personal Account ;
ii) Goods sent on Consignment Account.

Besides the above mentioned important accounts, he may have to open Bills Receivable Account, Consignment Stock Account, Consignment Stock Reserve Account depending upon the circumstances.

(i) *Consignment Account*: The object of opening this account is to find out whether the consignment has resulted in a profit or loss. This is a nominal account and it is just like a Trading and Profit & Loss A/c, exclusively opened for this consignment. All the expenses incurred on consignment, whether they be by the consignor or by the consignee, as well as the cost of goods sent on consignment are debited to this account. Expenses incurred are directly debited to this account and not to the nominal accounts concerned, as is usually the case. The income relating to consignment (sale proceeds of consignment goods) as well as the value of unsold stock with the consignee are credited to this account. Sometimes, there may be an opening stock of goods with the consignee as at the beginning of the period, which will appear on the debit side of this account. The goods returned, if any, by the consignee is credited to this account. The net result of these transactions, profit or loss, is transferred to the Profit and Loss account and the account is closed. It is usual to add the name of the place or town in the heading of this account in order to distinguish one consignment from another particularly when the consignor appoints different agents at different places. For example, if a consignor at Hyderabad sends goods on consignment to an Agent at Bomaby, the heading of this Account will be "Consignment to Bombay Account". The consignor may also add the name of the agent, if it is necessary, and he may also give a number to distinguish one account from another.

(ii) *Consignee's Personal Account* : This is the second important account opened by the consignor. The object is to ascertain the amount due from the consignee from time to time. All the sales effected by the consignee are debited to this account. The various expenses incurred by the consignee, the commission charged by him as well as the advance remitted by him are credited to this account. This account usually shows debit balance indicating the amount due from the consignee. At times, it may show credit balance, if the advance given by the consignee is more than the sales effected by him. The balance revealed by this account is shown in the Balance Sheet of the consignor - debit balance on the assets side, and credit balance on liabilities side - unless the account is settled by the required remittance.

(iii) *Goods sent on Consignment Account* : This is a real account. This account is credited with the value of goods sent on consignment. As the consignee is not purchasing the goods and as he is receiving the goods as an agent for the purpose of sale on behalf of the consignor, the question of crediting the sales account doesnot arise and, therefore, this account is credited. When the goods are returned by the consignee this account is debited. This account is closed by transfer to the Trading Account in the case of manufacturing concerns or to the Purchases Account in the case of trading concerns, at the time of preparing final accounts. But the usual practice is to transfer this account to the Trading Account.

Specimen Entries in the books of Consignor :

(i) When goods are sent on consignment :

Consignment to ..... Account	Dr.	With the value of goods
To Goods sent on consignment Account.		sent on consignment

(ii) When consignment goods are returned :

Goods sent on Consignment to ..... Account	Dr.	With the value of goods returned by the consignment.
To Consignment ..... Account		

(iii) When expenses are paid while sending goods on consignment :

Consignment to ..... Account	Dr.	With the amount of expeneses paid.
To Cash A/c. or Bank Account		

(iv) When an advance is received from the consignee :

Bank Account or Bills Receivable Account	Dr.	With the amount of Bank draft or amount of Bill drawn on consignee.
To Consignee's Personal Account.		

(v) When the Bill received from consignee is discounted with Bankers:

Bank Account	Dr.	(With the amount realised)
Discount Account	Dr.	(With the discount)
To Bills Receivable Account.		(With the amount of the Bill)

The entries mentioned above are made as soon as the goods are sent on consignment and the advance is received. The consignor will have to wait for some time till the goods are sold by the consignee and the Account Sales is received from him. He has to ascertain the following particulars from the Account Sales and then make a record of them in his books :

a) Gross sales effected by the consignee ;
b) Expenses incurred by consignee ;
c) Commission charged by the consignee ;
d) Unsold stock, if any, with the consignee ;
e) Remittance, if any, sent by the consignee.

vi) With the amount of gross sale proceeds:

Consignee's Personal Account	Dr.
To Consignment to... Account	

vii) With the amount of expenses incurred by the consignee:

Consignment to ..... Account	Dr.
To Consignee's Personal Account	

viii) With the amount of commission charged by the consignee:

Consignment to ..... Account	Dr.
To Consignee's Personal Account	

ix) With the value of unsold stock, if any, with the consignee

Stock on consignment Account	Dr.
To Consignment to ..... Account	

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x) With the amount remitted by the consignee along with the Account Sales:

Bank Account ..... Dr.
To Consignee's Personal Account

At this stage, the Consignment Account, when balanced, reveals profit or loss. If the total of credit is more than the total of debits, it is profit and if the total of debits is more than the total of credits, it is loss. The profit or loss is transferred to the Profit and Loss Account and the Consignment Account is closed.

xi) a) For transferring Profit:

Consignment to .... Account Dr.
To Profit & Loss Account

b) For transferring loss:

Profit & Loss Account Dr.
To Consignment to ..... Account

xii) Goods sent on consignment account is closed by transferring it to the Trading Account at the time of preparing the final accounts. The entry required is

Goods sent on Consignment Account Dr.
To Trading Account.

Books of Consignee

The important account opened in the books of the consignee is the Consignor's personal account. As the consignee is only the agent of the consignor he receives various amounts and also spends the amounts on behalf of his principal, i.e., the consignor. Therefore, he records all such amounts relating to the consignment in the consignor's account. This account is debited with all the expenses on consignment, the advance given to the consignor and also the consignee's commission, while it is credited with the sale proceeds of consignment goods. This account, when balanced at the end of a specified period, usually shows a credit balance indicating the amount due to the consignor. Occasionally, it may show a debit balance when the sale proceeds are less than the advance given and the expenses incurred.

Besides, the account mentioned above the consignee also opens (i) Bills Receivable account, (ii) Commission account, in order to record the Bills accepted in favour of consignor and the commission earned by him.

Specimen entries in the books of the Consignee:

i) When goods are received from the consignor:

No entry is recorded in the books of account as he is not purchasing goods, nor is he required to pay for them before they are sold. He may write the details of the goods received in a register which is not one of the financial books

ii) When he incurs expenses on the goods received on consignment, at the time of taking delivery or in the process of storing them :

	Consignor's Personal Account To Cash/Bank Account	Dr	
iii)	When any advance is given to the Consignor: Consignor's Personal Account To Bank/Bills Payable Account	Dr.	With the amount of the Bank Draft or with the amount of the Bill accepted

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iv) When consignment goods are sold:

a) if they are sold for cash

Cash/Bank Account	Dr.	
To Consignor's Personal Account		

b) if they are sold on credit

Consignment Debtors Account	Dr	
To Consignor's Personal Account		

v) When commission is charged on sales:

Consignor's Personal Account	Dr.	With the total commission including Del credere Commission
To Commission Account		

If the consignee desires to record Del credere commission separately the entry given above will be as follows:

Consignor's Personal Account	Dr	
To Commission Account		(With ordinary commission)
To Del credere Commission Account		(With Del credere Commission)

vi) When the amount is collected from consignment debtors:

Bank Account	Dr.	
To Consignment Debtors Account.		

vii) If there are any irrecoverable debts which are to be written off:

a) When Del credere commission is not allowed:

Consignor's Personal Account	Dr.	
To Consignment Debtors Account		

b) When Del credere commission is allowed:

Bad Debts Account	Dr	
To Consignment Debtors Account		

NOTE: Bad debts account representing the loss from consignment debtors will be transferred to Del credere commission account (or commission account as the case may be), in order to ascertain the net gain on commission. The entry will be:

Del credere Commission Account/Commission Account	Dr.	
To Bad Debts Account		

viii) When the Bills payable accepted in favour of consignor is met on the due date:

Bills Payable Account	Dr	
To Bank		

BRAOU

ix) When the consignor's account is settled or when some remittance is sent:

Consignor's Personal Account Dr
To Bank

There will not be any entry for profit or loss on consignment as the consignee is not concerned with it. Similarly, he will not record any entry for unsold stock with him just as he does not record receipt of goods.

Illustration - 1

Ramlal of Hyderabad sent on Consignment 100 packages of goods @ Rs.200 per package to Shyamlal of Bangalore. He paid Rs.1,400 towards freight and insurance. Ramlal had drawn a Bill of Rs.10,000 on Shyamlal as advance against consignment and immediately discounted the same for Rs.9,800. Three months later, the following Account Sales was received from Shyamlal:

	Rs.	Rs.
Sales of 60 packages @ Rs.300 per package		18,000
Sales of 40 packages @ Rs. 350 per package		14,000
		32,000
Less: Charges:		
Cartage	200	
Godown rent	300	
Insurance	100	
Commission @ 10%	3,200	
		3,800
		28,200
Less: Advance given (Bill accepted)		10,000
Balance due remitted as per draft enclosed		18,200

Record the transactions in the books of both the Parties

Books of Ramlal(Consignor)

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Date	Particulars	L.F	Dr	Cr
			Rs.	Rs.
	Consignment to Bangalore A/c Dr. To Goods sent on consignment A/c (Being the 100 packages of goods @ Rs.200 per package sent on consignment to Ramlal of Bangalore)		20,000	20,000
	Consignment to Bangalore A/c Dr. To Cash A/c (Being Freight and insurance paid)		1,400	1,400
	Bills Receivable A/c Dr. To Shyamlal A/c (Being the Bill drawn on Shyamlal as advance against consignment)		10,000	10,000

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Bank A/c	Dr.		9,800	
Discount A/c	Dr.		200	
To Bills Receivable A/c				10,000
(Being the Bill discounted with bankers)				
Shyamlal's A/c	Dr.		32,000	
To Consignment to Bangalore A/c				32,000
(Being the sale proceeds of 100 packages as per Account Sales received from Shyamlal)				
Consignment to Bangalore A/c	Dr.		600	
To Shyamlal's A/c				600
(Being the expenses paid by Shyamlal, the consignee)				
Consignment to Bangalore A/c	Dr.		3,200	
To Shyamlal's A/c				3,200
(Being the Commission charged by Consignee)				
Bank A/c	Dr.		18,200	
To Shyamlal's A/c				18,200
(Being the balance due from Shyamlal received by bank draft)				
Consignment to Bangalore A/c	Dr.		6,800	
To Profit & Loss A/c				6,800
(Being the profit on consignment transferred to Profit & Loss a/c)				
Goods sent on consignment A/c	Dr.		20,000	
To Trading A/c				20,000
(Being the goods sent on consignment closed by transferring to Trading A/c)				

LEDGER

Dr. CONSIGNMENT TO BANGALORE ACCOUNT Cr.

	Rs.		Rs.
To Goods sent on Consignment A/c	20,000	By Shyamlal's A/c	32,000
To Cash A/c(Expenses)	1,400		
To Shyamlal's A/c(Expenses)	600		
To Shyamlal's A/c(Commission)	3,200		
To Profit & Loss A/c(profit)	6,800		
	32,000		32,000

Dr. GOODS SENT ON CONSIGNMENT ACCOUNT Cr.

	Rs.		Rs.
To Trading A/c	20,000	By Consignment to Bangalore A/c	20,000
	20,000		20,000

BRAOU

Dr. BILLS RECEIVABLE ACCOUNT Cr.

	Rs.		Rs.
To Shyamlal A/c	10,000	By Bank A/c	9,800
		By Discount A/c	200
	10,000		10,000

Dr. SHYAMLAL'S ACCOUNT Cr.

	Rs.		Rs.
To Consignment to Bangalore A/c	32,000	By Bills Receivable A/c	10,000
		By Consignment to Bangalore A/c	600
		By Consignment to Bangalore A/c	3,200
		By Bank A/c	18,200
	32,000		32,000

Books of Shyamlal (Consignee)

JOURNAL

Date	Particulars	L.F	Dr	Cr
			Rs.	Rs.
	Ramlal's A/c Dr.		10,000	
	To Bills Payable A/c			10,000
	(Being the Bill drawn by Ramlal,consignor, accepted as advance against consignment)			
	Ramlal's A/c Dr.		600	
	To Cash A/c			600
	(Being cartage, godown rent etc., paid)			
	Bank A/c Dr.		32,000	
	To Ramlal's A/c			32,000
	(Being the sales proceeds of consignment goods)			
	Ramlal's A/c Dr.		3,200	
	To Commission A/c			3,200
	(Being the Commission at 10% charged on gross sale proceeds)			
	Ramlal's A/c Dr.		18,200	
	To Bank A/c			18,200
	(Being the balance due to Ramlal remitted by Bank draft)			
	Bills Payable A/c		10,000	
	To Bank A/c			10,000
	(Being the Bill met on due date)			

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Dr. RAMLAL'S ACCOUNT Cr.

	Rs.		Rs.
To Bills Payable A/c	10,000	By Bank A/c	32,000
To Cash A/c	600		
To Commission A/c	3,200		
To Bank A/c	18,200		
	32,000		32,000

Dr. BILLS PAYABLE ACCOUNT Cr.

	Rs.		Rs.
To Bank	10,000	By Ramlal's A/c	10,000
	10,000		10,000

Unsold Stock with the consignee

In the illustration given above, the consignee could sell all the goods consigned to him. But often at the time of closing the books of the consignor, a part of the goods sent on consignment may remain unsold with the consignee. Such unsold stock, though lying with the consignee, belongs to the consignor and it is broght into account before ascertaining the profit or loss on consignment. For this purpose, entry No.IX given in specimen entries in the books of consignor is passed.

Check Your Progress - 2

i) In case del credere commission is given the amount of bad debts has to be borne by .....

a) the consignee; b) the consignor

ii) In the books of the consignee, on despatch of goods by the consignor the entry would be:

a) Consignment Account Dr.
To Consignor Account

b) Consignment Account Dr.
To Goods sent on Consignment A/c

c) No entry

25.6. VALUATION OF UNSOLD STOCK

The unsold stock with the consignee has to be valued by applying the general principle of valuation of stock, i.e., cost price or market price, whichever is less. The meaning of "cost price" in this case should be noted carefully. It includes, besides the invoice price of the goods, the proportionate expenses incurred till the goods reach the place of business of the consignee, i.e., till the goods are made ready for sale. All expenses like freight, insurance in transit, customs duty, octroi duty and cartage are treated as part of the cost. These expenses are known as direct expenses or non-recurring expenses. Expenses incurred after the goods reach the consignee's place such as rent and insurance of godown, advertising, and other selling

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expenses do not add to the value of goods and as such they are not considered for valuing unsold stock. Such expenses are known as indirect expenses or recurring expenses. Therefore, all direct expenses only should be taken into account while ascertaining the cost price of unsold stock of goods with the consignee but not the indirect expenses. Another important point to be noted here is that the nature of expenditure incurred on the goods is to be considered rather than the person who has incurred the expenditure. It is immaterial whether the consignor or the consignee incurs, the expenditure. If the expenditure is of direct nature, it will be added to the invoice price of the goods and the cost price of the unsold goods ascertained. In the absence of details of expenditure incurred by the consignee, the expenses incurred by him are to be taken as indirect expenses. The cost price so ascertained is compared with the market price and the stock is valued at the lower price. Supposing 'A' has sent Rs.10,000 worth of goods on consignment to B, and while sending the goods A has paid Rs.600/- for packing and Rs.400/- for insurance in transit , B has cleared the goods by paying Rs.1,000 towards freight and he also paid Rs.200 towards unloading and cartage, Rs.300 for Godown rent, Rs.200 for insurance of the godown, and other selling expenses amounting to Rs.400. If by the time the consignor(A) has closed his books the consignee(B) has sold three fourths of the goods for Rs.18,000, the remaining one-fourth of the goods unsold will be valued as follows:

		Rs.
One-fourth of the cost of the goods sent (10,000 X 1/4) =		2,500
Add: Proportionate Direct Expenses:		
	Rs.	
Incurred by consignor:		
Packing	600	
Insurance in transit	400	
Incurred by consignee:		
Freight	1,000	
Unloading and cartage	200	
	2,200	
One-fourth of the total direct expenses(2,200 X 1/4) =		550
Total Cost price		3,050

As three- fourths of the goods are sold for Rs.18,000 by the consignee, the market price of one-fourth of the goods can be taken as 18,000/3 = Rs.6000. As the cost price Rs.3,050 is lower than the market price Rs.6,000 the value of the unsold stock is to be taken as Rs.3,050/-

Illustration - 2

Ali Brothers of Hyderabad sent 100 cases of Unani medicines to Reddy & Co., of Nellore at Rs.1,000 per case. They paid Rs.3,000 towards freight and Rs.1,000 towards insurance. Reddy & Co., were working as Del credere agents and their ordinary commission was 5% and del credere commission 7.5%. Reddy & Co., sent Rs.50,000 by cheque as an advance to Ali Bros., immediately on receipt of the consignment.

Just before Ali Bros., closed thier books, an Account sales was received from Reddy & Co., showing the following particulars:

		Rs.	Rs.
i) Sale proceeds:			
	60 cases for cash	1,20,000	
	15 cases on credit	32,000	
			1,52,000
ii) Stock of unsold cases	25		
iii) Commission charged at agreed rates....			

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iv) Reddy & Co.'s selling expenses amounted to Rs.1,200

v) A bank draft was sent by Reddy & Co., for the amount due from them along with the account sales.

Reddy & Co., could not collect from one of the customers, to whom goods were sold on credit, Rs.750 and it proved ultimately to be bad.

Give the necessary journal entries and ledger accounts in the books of Ali Bros., and Reddy & Co.

Solution

Books of Ali Bros. (Consignor)

JOURNAL

Date	Particulars	LF	Dr.	Cr.
			Rs.	Rs.
	Consignment to Nellore Account Dr. To Goods sent on Consignment Account (Being 100 cases of medicines @ Rs.1,000 per case sent on consignment to Reddy & Co. of Nellore)		1,00,000	1,00,000
	Consignment to Nellore Account Dr. To Bank Account (Being freight, and insurance paid on the consignment)		4,000	4,000
	Bank Account Dr. To Reddy & Co.'s Account (Being the advance received from consignee)		50,000	50,000
	Reddy & Co.'s Account Dr. To Consignment to Nellore Account (Being the sale proceeds of 75 cases as per account sales)		1,52,000	1,52,000
	Consignment to Nellore Account Dr. To Reddy &Co.'s Account (Being the expenses paid by Reddy & Co.)		1,200	1,200
	Nellore Consignment Account Dr. To Reddy & Co. Account (Being the ordinary commission 5% Del Credere commission 7 1/2% charged at agreed rates)		19,000	19,000
	Stock on Consignment Account Dr. To Consignment to Nellore Account (Being the value of unsold stock with the consignees)		26,000	26,000
	Bank Account Dr. To Reddy & Co. Account (Being the draft received from Reddy & Co., for the amount due from them).		81,800	81,800

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Consignment to Nellore Account	Dr.		53,800	
To Profit & Loss Account				53,800
(Being the Profit on consignment transferred to Profit & Loss A/c)				
Goods sent on Consignment Account	Dr.		1,00,000	
To Trading Account				1,00,000
(Being the goods sent on consignment a/c closed by transfer to Trading A/c)				

LEDGER

Dr. CONSIGNMENT TO NELLORE ACCOUNT Cr.

	Rs.		Rs.
To Goods sent on Consignment A/c	1,00,000	By Reddy & Co.'s A/c	1,52,000
To Bank A/c	4,000	By Stock on Consignment A/c	26,000
To Reddy & Co.'s A/c	1,200		
To Reddy & Co.'s A/c	19,000		
To Profit & Loss A/c	53,800		
	1,78,000		1,78,000

Dr. GOODS SENT ON CONSIGNMENT ACCOUNT Cr.

	Rs.		Rs.
To Trading A/c	1,00,000	By Consignment to Nellore A/c	1,00,000

Dr. REDDY & CO'S ACCOUNT Cr.

	Rs.		Rs.
To Consignment to Nellore A/c	1,52,000	By Bank A/c	50,000
		By Consignment to Nellore A/c	1,200
		By Consignment to Nellore A/c	19,000
		By Bank A/c	81,800
	1,52,000		1,52,000

Dr. STOCK ON CONSIGNMENT ACCOUNT Cr.

	Rs.		Rs.
To Consignment to Nellore A/c	26,000	By Balance c/d	26,000
To Balance b/d	26,000		

BRAOU

NOTE : (i) **Valuation of unsold stock :**

		Rs.
25 cases @ Rs. 1,000 per case		25,000
Add : Proportionate direct expense :		
Freight Rs. 3,000		
Insurance Rs. 1,000		
Total $\frac{4,000 \times 25}{100}$	=	1,000
Value of unsold stock	=	26,000

(ii) Stock on consignment account showing debit balance would be shown on the assets side of the balance sheet of M/s. Ali Bros. At the beginning of the following year it would be transferred to Consignment to Nellore Account by passing the following journal entry.

Consignment to Nellore Account	Dr.	26,000	
To Stock on Consignment Account			26,000

Books of Reddy & Co. (Consignee)

JOURNAL

Date	Particulars	LF	Dr.	Cr.
			Rs.	Rs.
	Ali Brothers Account Dr.		50,000	
	To Bank Account			50,000
	(Being the amount sent by cheque to Ali Brothers as advance)			
	Bank Account Dr.		1,20,000	
	Consignment Debtors Account Dr.		32,000	
	To Ali Brothers Account			1,52,000
	(Being the sale proceeds of 60 cases for cash and 15 cases on credit)			
	Ali Bros. Account Dr.		19,000	
	To Commission Account			19,000
	(Being the commission earned 5% ordinary and 7 1/2% del credere)			
	Ali Brothers Account Dr.		1,200	
	To Bank Account			1,200
	(Being the expenses paid)			
	Bank Account Dr.		31,250	
	Bad Debts Account Dr.		750	
	To Consignment Debtors A/c			32,000
	(Being the amount collected from debtors, Rs.750 which could not be collected debited to bad debts account)			
	Commission Account Dr.		750	
	To Bad Debts Account			750
	(Being the loss on account of bad debts set off against commission)			
	Commission Account Dr.		18,250	
	To Profit & Loss Account			18,250
	(Being net income on commission transferred to Profit & Loss A/c)			
	Ali Brothers Account Dr.		81,800	
	To Bank Account			81,800
	(Being the amount sent by draft to Ali Brothers of the amount due to them).			

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LEDGER

Dr. ALI BROTHERS ACCOUNT Cr.

	Rs.		Rs.
To Bank A/c	50,000	By Reddy & Co.'s A/c	1,20,00
To Commission A/c	19,000	By Stock on	
To Bank A/c	1,200	Consignment A/c	32,00
To Bank A/c	81,800		
	1,52,000		1,52,000

Dr. CONSIGNMENT DEBTORS ACCOUNT Cr.

	Rs.		Rs.
To Ali Bros. A/c.	32,000	By Bank A/c	31,250
		By Bad Debts A/c	750
	32,000		32,000

Dr. COMMISSION ACCOUNT Cr.

	Rs.		Rs.
To Bad Debts A/c	750	By Ali Bros. A/c	19,000
To P & L A/c	18,250		
	19,000		19,000

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NOTE: As the consignee is allowed Del credere commission any loss on account of non-recovery of cash from debtors is to be borne by him. Therefore, the amount not recovered from one of the customers, Rs.750, is debited to Bad Debts account and then it is transferred to Commission account to arrive at the net income on commission. The net commission is, then transferred to Profit & Loss Account.

Illustration - 3

Vijaya & Company of Hyderabad consigned to Naresh of Warangal 50 mopeds, each moped costing Rs.5,000 on the 10th of January, 1989. They incurred the following expenses: Packing : Rs. 3,000 ; Freight and Insurance : Rs.2,000. Naresh took delivery of the mopeds on the 12th of January and immediately accepted a draft for Rs.1,00,000 at two months as advance on the consignment in favour of Vijaya & Co. He found 2 mopeds to be defective and sent them back to Vijaya & Co., by paying Rs. 200 towards freight, etc. Naresh was entitled to a commission of 5% on Rs.6,000, which was the minimum sale price of the moped and 20% of any surplus price realised by him. By the 31st March, 1989 he sold all the mopeds at an average price of Rs.6,200 per moped, some of the sales were on credit. He could not recover Rs.400 from a customer which had to be written off as bad. He incurred the following expenses: Godown Rent : Rs.450/-, Advertising and other selling expenses : Rs.350/-. He also met his acceptance on the due date.

Give the necessary ledger accounts in the books of Vijaya & Co., assuming that the amount due from Naresh has been duly received and that the books are closed by Vijaya & Co. every year on the 31st of March.

Solution

Books of Vijaya & Company (Consignor)

LEDGER

Dr. CONSIGNMENT TO WARANGAL ACCOUNT Cr.

1989		Rs.	1989		Rs.
Jan.10	To Goods sent on Consignment A/c	2,50,000	Jan.12	By Goods sent on Consignment A/c (Mopeds returned)	10,000
"	To Bank A/c Freight & Ins. 2,000 Packing 3,000	5,000	Mar.31	By Naresh's A/c (sale proceeds of 48 mopeds @ Rs. 6,200)	2,97,600
Jan.12	To Naresh's A/c (Expenses mopeds returned)	200			
Mar.31	To Naresh's A/c (Expenses 450+350)	800			
"	To Naresh's A/c (commission)	16,320			
"	To Naresh's A/c (Bad Debts)	400			
"	To Profit & Loss A/c (Profit)	34,880			
		3,07,600			3,07,600

Dr. GOODS SENT ON CONSIGNMENT ACCOUNT Cr.

1989		Rs.	1989		Rs.
Jan.12	To Consignment to Warangal A/c	10,000	Jan.10	By Consignment to Warangal A/c	2,50,000
Mar.31	To Trading A/c	2,40,000			
		2,50,000			2,50,000

Dr. BILLS RECEIVABLE ACCOUNT Cr.

1989		Rs.	1989		Rs.
Jan.12	To Naresh's A/c	1,00,000	Mar.15	By Bank A/c	1,00,000

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Dr. NARESH'S ACCOUNT Cr.

1989		Rs.	1989		Rs.
Mar.31	To Consignment to Warangal A/c (Sale Proceeds)	2,97,600	Jan.12	By Bills Receivable A/c	1,00,000
			"	By Consignment to Warangal A/c (expenses on mopeds returned)	200
			Mar.31	By Consignment to to Warangal A/c (exp.)	800
			"	By Consignment to Warangal A/c (Commission)	16,320
			"	By Consignment to Warangal (Bad debts)	400
			"	By Bank A/c (amount received in settlement)	1,79,880
		2,97,600			2,97,600

NOTE: i) Commission payable to consignee is calculated as follows :

No. of Mopeds sold X Minimum sale price = 48 x 6,000 = 2,88,000

.. 5 % on 2,88,000 is Rs. 14,400

20% surplus price realised on each moped. 200 x 48

= 9,600 x 20% = Rs. 1,920

Total commission = Rs. 16,320

ii) As the consignee is not entitled to Del credere commission he cannot be responsible for bad debts. The amount which could not be recovered by him is debited to the Consignment Account.

25.7 LOSS OF GOODS

When goods are sent on consignment from one place to another place, it is possible that a part of the goods are lost or damaged. The loss may take place either in transit or when stored in a godown. Loss may also arise on account of some inherent quality of the goods sent or at times by operation of certain external forces. Therefore, the accounting treatment to be given for the loss of goods depends upon the type and nature of loss. This loss may be of two types : i) Normal Loss ii) Abnormal Loss.

i) Normal loss

Loss is said to be normal when it is natural, unavoidable and is due to some inherent quality in the goods. In the case of some goods, a certain quantity is lost due to handling, loading and unloading operations. Examples of such goods are coal, cement etc. Some goods may be spoiled when they are stored for a long time : e.g., Vegetables. Loss may arise on account of leakage in the case of oils. These losses mainly arise on account of the inner characteristics of the goods and, therefore, are normal. For this loss, there is no need to write a separate entry. If the consignee could sell all the goods (excluding the goods lost) and if there is no unsold stock left with him, there is absolutely no need to consider this loss. But if a part

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of the goods are left unsold with the consignee, for the purpose of valuing such unsold stock, this loss must be taken into account. Here, it is to be assumed that the total cost is incurred on the total stock as reduced by the normal loss and thus is taken into account indirectly. Then the stock unsold is valued in the same proportion as the total stock (after deducting normal loss) bears to total cost. Suppose, 1,000 tonnes of coal is sent on consignment, each tonne costing Rs.100 including freight. If the consignee could sell 800 tonnes and if the normal wastage is 2%, then the stock left with the consignee will be 1,000 — 800 — 20 (2% on 1,000) = 180 tonnes. The total cost.(1,000 tonnes X Rs. 100 per tonne) Rs. 1,00,000 is taken to be the cost of 980 tonnes (1,000 — 20 tonnes normal wastage) and then the value of 180 tonnes of coal unsold is arrived at : Therefore, the value of unsold stock will be:

$$\frac{\text{Rs. } 1{,}00{,}000}{980} \times 180 = \text{Rs.}18{,}367.34.$$

ii) Abnormal loss

The loss which is not natural, not unavoidable, but which arises on account of the operation of certain external forces is termed 'Abnormal Loss'. This loss does not arise on account of any inherent quality of the goods. The abnormal loss is usually caused by theft of goods, loss of goods by fire, abnormal damage etc. As such a loss is not incidental to the consignment business, it has to be specially shown in the books of account, but the price of unsold stock is not inflated as in the case of normal loss. In the absence of this abnormal loss, the stock at the end would have been more. Therefore, this loss is credited to consignment account and debited to Abnormal Loss Account. Abnormal Loss is calculated in the same manner as the stock at the end is calculated by adding proportionate direct expenses. After calculating the loss, the following entries are made in the books of the consignor :

i) Abnormal Loss Account Dr.
To Consignment to... Account

ii) For transferring the abnormal loss to Profit & Loss Account :
Profit & Loss Account Dr.
To Abnormal Loss Account

Instead of writing the two entries given above only one entry can be made as under :

Profit & Loss Account Dr.
To Consignment Account

In case the stock is insured and if the insurance company agrees to pay for the loss, the following entries are made :

i) Where the insurance company agrees to pay the full amount of claim :
Insurnace Claim Account Dr.
To Consignment to...A/c

ii) Where the insurance company agrees to pay only a part of the claim amount

Insurance Claim Account	Dr.	(With the amount agreed to be paid by Insurance Co.)
Profit & Loss A/c.	Dr.	(With the amount not agreed to be paid by Insurance Co.)
To Consignment to.. A/c.		

However, the total abnormal loss is credited to Consignment account and debit is given to Insurance Claim Account or Profit and Loss Account depending upon the circumstances.

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Example : 1 : Pyarelal of Hyderabad consigned goods costing Rs.20,000 to Maniklal of Bombay. Pyarelal paid Rs.1,000 towards freight and Rs.600 towards insurance. One-fourth of the consignment was totally lost by fire in transit, and the insurance company agreed to settle the claim at Rs.3,500. Calculate the Abnormal Loss and give entries to record the same :

Solution

i) Calculation of Abnormal Loss :

			Rs.
Cost of 1/4 of the consignment 20,000 x 1/4		=	5,000
Add: Proportionate Direct Expenses:			
a) Freight	Rs. 1,000		
b) Insurance	Rs. 600		
	Rs. 1,600	1,600 x 1/4 =	400
Total Loss			5,400

ii) The entry for recording the loss :

Insurance claim Account	Dr.	3,500	
Profit & Loss Account	Dr.	1,900	
To Consignment to Bombay A/c			5,400

As the Insurance Company agreed to pay Rs.3,500, the excess of loss over the claim amount is debited to the Profit & Loss Account.

Example : 2 : Hyderabad Radio Company consigned 100 single band transistors to their agent at Madras. The cost price of each transistor was Rs.75. The consignors paid freight of Rs.200 : cartage of Rs.50 and insurance Rs.400. 5 transistors were totally destroyed in transit and the consignee took delivery of 95 transistors only. The consignee incurred the following expenses : clearing charges : Rs.190 ; cartage : Rs.95 ; warehousing and insurance : Rs.250 ; other selling expenses : Rs.150 and he sold 80 transistors and was left with 15 unsold transistors. You are required to calculate the value of the unsold stock and the amount of abnormal loss.

Solution

i) **Calculation of the value of unsold stock :**

			Rs.
Cost price of 15 transistors @ Rs.75 per transistor			1,125
Add : Proportionate Expenses paid by consignor :			
Freight	-	200	
Cartage	-	50	
Insurance	-	400	
Expenses on 100 transistors	-	650	
Expenses on 15 transistors = $\frac{650}{100}$ x 15		=	97.50
Add: Proportionate direct expenses incurred by consignee :			
Clearing charges	=	190	
Cartage	=	95	
Expenses on 95 transistors		285	

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Dr. **GOODS SENT ON CONSIGNMENT ACCOUNT** **Cr.**

	Rs.		Rs.
To Trading A/c	35,000	By Consignment to Madras A/c	35,000

Dr. **STOCK ON CONSIGNMENT ACCOUNT** **Cr.**

	Rs.		Rs.
To Consignment to Madras A/c	3,775.50	By Balance c/d	3,775.50
To Balance b/d	3,775.50		

Dr. **MADRAS CHEMICAL TRADERS ACCOUNT** **Cr.**

	Rs.		Rs.
To Consignment to Madras A/c (Sale proceeds)	52,800	By Consignment to Madras A/c (Exp. and Commission)	5,576
		By Bank Account (Sight Draft)	40,000
		By Balance c/d	7,224
	52,800		52,800
To Balance b/d	7,224		

NOTE : **Calculation of Value of the Unsold Stock :**

a) Quantity of chemicals left unsold :

	Kg.
Total quantity sent on consignment	1,000
Less : Normal loss	20
Balance quantity	980
Less : Quantity sold	880
Quantity in stock	100

b) Value of 100 kg. in stock:

	Rs.
Cost of the chemicals consigned	35,000
Freight charges paid by consignor	1,000
Insurance in transit paid by consignee	1,000
Total Cost :	37,000

$$\frac{\text{Total Cost}}{\text{Total quantity — Normal loss}} \times \text{Quantity in Stock}$$

$$= \frac{37,000}{1,000 - 20 \text{ kg.}} \times 100 \text{ Kg.} \quad = \quad \frac{37,000}{980 \text{ kg.}} \times 100 \quad = \text{Rs.}3,775.50 \text{ (approx.)}$$

PRADUN

Expenses on 15 transistors = $\frac{285}{95}$ x 15 = 45.00

Value of unsold stock 1,267.50

ii) Calculation of Abnormal Loss :

Cost Price of 5 transistors @ Rs. 75 per transistor		375.00
Add: Proportionate Expenses paid by consignor	$\frac{650 \times 5}{100}$ =	32.50
Total Abnormal Loss =		407.50

NOTE: i) For calculating proportionate expenses, the consignor's expenses are divided by 100 and the expenses on 15 sets is calculated, as the consignor has incurred expenses on all the 100 transistors sent by him. Whereas the consignee has taken delivery of 95 transistors only he has incurred expenses only on 95 transistors ; therefore his expenses are on 95 transistors and accordingly expenses on 15 transistors is calculated.

ii) For calculating loss, the consignee's expenses are not taken into account, as the loss had taken place before he took delivery and spent any amount.

Illustration - 4

Hyderabad Chemicals Ltd., consigned to their agents Madras Chemical Traders 1,000 Kgs., of a chemical, the cost and freight per kg., respectively being Rs.35 and Re.1

After 3 months an Account Sales was received from the consignees stating that they had sold 880 kgs at Rs.60 per kg. and that they had paid selling expenses @ Re.1/- per kg., and Brokerage at 2%. They had paid Rs.1,000/- towards insurance in transit and charged their commission at 5%. They also reported a shortage of weight to the tune of 20 kgs on the entire consignment which was due to certain inherent quality of the chemical. A sight draft for Rs.40,000 was enclosed by the consignee.

You are required to give the necessary ledger accounts in the books of Hyderabad Chemicals, Ltd., showing clearly the valuation of the unsold stock. Also show Hyderabad Chemicals, Ltd., account in the books of Madras Chemical Traders.

Solution

Books of Hyderabad Chemicals Ltd.

LEDGER

CONSIGNMENT TO MADRAS ACCOUNT

Dr.	Rs. P.s		Cr. Rs. Ps.
To Goods sent on Consignment A/c	35,000.00	By Madras Chemical Traders A/c (Sale proceeds of 880 kg. @ 60 per Kg.	52,800.00
To Bank A/c (freight)	1,000.00		
To Madras Chemical Traders A/c :		By Stock on Consignment A/c (37,000 x 100) / 980	3,775.50
Selling Exps. 880			
Brokerage 2% 1,056			
Insurance in transit 1,000			
Commission 2,640			
	5,576.00		
To Profit & Loss A/c (Profit)	14,999.50		
	56,575.50		56,575.50

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Books of Madras Chemical Traders

Dr. HYDERABAD CHEMICAL LTD'S ACCOUNT Cr.

	Rs.		Rs.
To Bank A/c :		By Bank A/c	
Selling Exps. 880		(Sale Proceeds)	52,800
Brokerage 1,056			
Insurance 1,000			
	2,936		
To Commission A/c			
(5% on 52,800)	2,640		
To Bank A/c			
(Sight draft)	40,000		
To Balance c/d	7,224		
	52,800		52,800
		By Balance b/d	7,224

NOTE : The consignee is not at all concerned with the loss. Hence no treatment need be given for the loss in his books.

Illustration -5

Mahendra sent 10 scooters to Narendra of Bombay on consignment basis. The cost of each scooter was Rs.9,000. Mahendra paid Rs.700 towards freight and Rs.300 towards insurance. During transit one scooter was completely destroyed and the insurance company settled the claim for Rs.8,000, which was duly received by Mahendra. Narendra sold 8 scooters at Rs.12,000 each and incurred Rs.400 for storage, Rs.50 for insurance of godown and Rs.450 for clearing charges. It was agreed that Narendra should be allowed a commission of 5%. Narendra sent a draft for Rs.90,000. Give consignment account and Narendra's account in the books of Mahendra showing clearly the calculation of abnormal loss and value of unsold stock.

Solution

Books of Mahendra

LEDGER

Dr. CONSIGNMENT TO BOMBAY ACCOUNT Cr.

	Rs.		Rs.
To Goods sent on		By Bank A/c	
Consignment A/c	90,000	(Insurance claim)	8,000
To Bank A/c (Exps.)	1,000	By Abnormal Loss A/c	1,100
To Narendra's A/c (Exps.)	900	By Narendra's A/c	
To Narendra's A/c		(Sale proceeds of 8	
(Commission at 5% on		scooters at Rs.12,000/-	
Rs.96,000/-)	4,800	each)	96,000
To Profit & Loss A/c		By Stock on Consignment A/c	9,150
(Profit)	17,550		
	1,14,250		1,14,250

BPARDU

Dr. NARENDRA'S ACCOUNT Cr.

	Rs.		Rs.
To Consignment to Bombay A/c	96,000	By Consignment to Bombay A/c (Exps.)	900
		By Consignment to Bombay A/c (Com.)	4,800
		By Bank A/c (draft)	90,000
		By Balance c/d	300
	96,000		96,000
To Balance b/d	300		

Working Notes :

i) Calculation of Abnormal Loss :

	Rs.
Cost of 1 scooter destroyed	9,000
Add : 1/10 of freight Rs. 700 =	70
Add : 1/10 of insurance Rs. 300 =	30
Total Cost	9,100
Less : Insurance claim received	8,000
Abnormal loss :	1,100

ii) Value of unsold stock :

			Rs.
Total scooters sent on consignment	10		
Less : 1 scooter destroyed in transit	1		
	9		
Less : 8 scooters sold by the consignee	8		
Unsold scooter in stock	1		
Cost of the scooter in stock		=	9,000
Add : Proportionate direct expenses :			
i) Paid by consignor ;			
Freight 700			
Insurance 300	1,000 x 1/10	=	100
ii) Paid by consignee			
Clearing charges 450 x 1/9		=	50
Value of unsold stock		=	9,150

NOTE : As the consignee took delivery of 9 scooters only, the clearing charges paid by him must be on 9 scooters only.

Illustration - 6

Suraj Oil Mills of Hyderabad consigned 500 Tins of Refined Oil of Venktesh Brothers of Kurnool. Each Tin cost Rs.248 @ Rs. 16 per kg. Suraj Oil Mills paid Rs. 100 as carriage, Rs.500 as freight and Rs.400 as insurance in transit. During transit 10 Tins were accidentally damaged for which the insurance company paid Rs.1,350 directly to the consignors. The damaged tins were sold by Venkatesh Bros. at Rs.900/-.

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Venkatesh Bros. reported, 3 months after the date of consignment that they had sold 420 tins at an average price of Rs.280 per tin and that their expenses were as follows : Godown Rent : Rs.1,200 ; Insurance of godown : Rs.300. The consignees charged commission at 4% plus 1% Del credere on all sales. They had also reported a loss of 31 kgs of oil due to leakage.

Show the necessary accounts including Abnormal loss account in the books of Suraj Oil Mills Assuming that the consignees had remitted the amount due by bank draft. Also show Suraj Oil Mills account and Commission account in the books of Venkatesh Brothers.

Solution

Books of Suraj Oil Mills

Ledger

Dr. CONSIGNMENT TO KURNOOL ACCOUNT Cr.

	Rs.		Rs.
To Goods sent on Consignment A/c	1,24,000.00	By Abnormal Loss A/c (1,25,000x10/500)	2,500.00
To Bank A/c (Exps.)	1,000.00	By Venkatesh Bros A/c (Sale proceeds of 420 tins @ Rs.280 per tin)	1,17,600.00
To Venkatesh Bros.A/c (Exps.)	1,500.00	By Stock on Consignment A/c	17,069.67
To Venkatesh Bros A/c. (5% Commission on Rs. 1,17,600)	5,880.00		
To Profit & Loss A/c (Profit)	4,789.67		
	1,37,169.67		1,37,169.67

Dr. VENKATESH BROTHERS' ACCOUNT Cr.

	Rs.		Rs.
To Consignment to Kurnool A/c (Sale Proceeds)	1,17,600	By Consignment of Kurnool A/c(Exp.)	1,500
To Abnormal Loss A/c (Sales of damaged tins)	900	By Consignment to Kurnool A/c (Commission @ 5% on 1,17,600)	5,880
		By Abnormal Loss A/c (Commission on sales of damaged tins)	45
		By Bank A/c	1,11,075
	1,18,500		1,18,500

Dr. GOODS SENT ON CONSIGNMENT ACCOUNT Cr.

	Rs.		Rs.
To Trading A/c	1,24,000	By Consignment to Kurnool A/c	1,24,000

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Dr. **ABNORMAL LOSS ACCOUNT** **Cr.**

	Rs.		Rs.
To Consignment to Kurnool A/c	2,500	By Bank A/c (Insurance claim)	1,350
To Venkatesh Bros. A/c (Commission at 5% on Rs.900)		By Venkatesh Bros A/c (Sales of damaged tins)	900
		By Profit & Loss A/c (Net abnormal loss transferred)	295
	2,545		2,545

Working Notes :

i) Calculation of Quantity of oil in each tin :

Cost of 1 tin is Rs. 248 and cost of 1 kg of oil is Rs. 16

Therefore, the quantity of oil in 1 tin (248/16) = 15.5 kg.

ii) Calculation of Abnormal loss :

		Rs.
Cost of 500 tins sent on consignment 500 X 248=		1,24,000
Add : Direct Expenses :		
Carriage	100	
Freight	500	
Insurance	400	
		1,000
Total cost of 500 tins		1,25,000
Therefore cost of 10 tins accidentally damaged = $\frac{1,25,000}{500}$ x 10 =		2,500
Cost of 490 tins		1,22,500

iii) Value of unsold stock :

No. of tins sent on consignment	500 tins
Less : No. of tins damaged in transit	10
	490 tins
Less : No. of tins of oil lost by normal leaskage (31 kg.) = 2 tins / 15.5 kg.	2 tins
No. of tins available for sale	488
Less No. of tins sold	420
No. of tins in stock	68

The cost of 490 tins, i.e., Rs.1,22,500, is to be taken as the cost of 488 tins.

Therefore, the value of 68 tins in stock is = $\frac{1,22,500}{488}$ X 68

= Rs.17,069.67

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Books of Venkatesh Brothers

LEDGER

Dr. SURAJ OIL MILLS ACCOUNT Cr.

	Rs.		Rs.
To Bank A/c (Exp.)	1,500	By Bank A/c (Sales of 420 tins)	1,17,600
To Commission A/c (5% on 1,17,600)	5,880	By Bank A/c (sale of 10 damaged tins)	900
To Commission A/c (5% on Rs.900)	45		
To Bank A/c(draft)	1,11,075		
	1,18,500		1,18,500

Dr. COMMISSION ACCOUNT Cr.

	Rs.		Rs.
To Profit & Loss A/c - (transfer)	5,925	By Suraj Oil Mills A/c	5,880
		By Suraj Oil Mills A/c	45
	5,925		5,925

25.8 SUMMING UP

The process of sending goods by one person to another to be sold by the latter on behalf of and at the risk of the former is known as 'Consignment'. The person who sends goods on consignment is known as the 'Consignor', and the person to whom goods are sent is known as the 'Consignee'. The relationship between the two parties is that of principal and an agent. The agent is rewarded by payment of commission. Consignment is different from sale. In consignment mere possession is transferred from the consignor to the consignee but in sale not only the possession but also the title to the goods and all other risks connected with it are transferred from the seller to the buyer.

The consignor while sending the goods sends a note known as 'Proforma Invoice' and the consignee periodically submits statements known as 'Account Sales'. The important accounts opened by the consignor are Consignment Account, Consignee's Personal Account, Goods sent on Consignment Account, etc. Consignment account is a nominal account, consignee's account is a personal account and goods sent on consignment is a real account. The only important account opened by the consignee is the consignor's personal account in order to find out what is due to the consignor.

Unsold stock with the consignee at the end of the accounting year has to be brought into account after valuing it on the basis of cost price or market price, which-ever is lower. While ascertaining the cost price, the proportionate direct expenses incurred until the goods are ready for sale are to be added to the invoice price of the goods, irrespective of who has incurred them. Some times goods sent on consignment may be subjected to loss. This loss may be normal or abnormal. Normal loss arises on account of certain inherent quality in the goods, whereas abnormal loss arises on account of the operation of certain external forces. These losses require different treatments to be given in the books of the consignor. The consignee is not at all concerned with these losses.

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25.9 ANSWERS TO CHECK YOUR PROGRESS

1. i) Consignor is Principal

2. i) The amount of bad debts has to be borne by the Consignee

   ii) No entry.

25.10 MODEL EXAMINATION QUESTIONS

A) Short Answer Questions

1. What is consignment ? Who are the parties to a consignment?
2. What is overriding commission?
3. What is the nature of consignment account?
4. What Acounts are opened in the books of the consignee?
5. Discuss the features of consignment?
6. What is a proforma invoice? Give a specimen of the same?
7. What is del credere commission ?
8. What is Account Sales ? Give a specimen of Account Sales?
9. Discuss briefly the accounts opened in the books of the consignor?
10. How do you value unsold stock with the consignee?
11. What is 'normal loss'? Discuss the treatment of normal loss.

B. Essay Answer Questions

12. Distinguish between consignment and sale
13. What is abnormal loss ? Discuss the accounting treatment for abnormal loss in the books of the consignor.
14. Explain the method of valuing unsold stock on consignment.

PROBLEMS

1. Ram of Ramnagar consigned to Shyam of Shamnagar goods of the value of Rs.10,000 and paid Rs.1,000 towards freight and Rs.200 towards insurance. Shyam cleared the goods by paying Rs.100 as clearing charges and incurred another Rs.100 towards cartage. He then accepted a Bill for Rs.6,000 as advance which was immediately discounted by Ram for Rs.5,850.

   Shyam reported by the close of the accounting year that half of the goods had been sold for Rs.8,000 in cash and the other half remaining on credit for Rs. 4,200 and that his selling expenses including godown rent amounted to Rs. 250. He charged commission at 7 1/2%, and 2 1/2% Del credere on all sales. He also enclosed a bank draft for the balance due from him.

   Give journal entries and ledger accounts in the books of both the parties, assuming that Shyam has met his acceptance on the due date.

   (Answer: Profit on consignment — Rs.2,180).

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2. On 1-7-1989 Krishna of Madras consigned to Kamat of Bangalore 100 cases of soap costing Rs.180 per case, and paid Rs.800 for freight and Rs.100 for insurance. Kamat accepted a Bill drawn on him at 3 months for Rs.8,000 which was immediately discounted by Krishna at a discount of 5%.

Kamat returned 10 damaged cases by spending Rs.100. He sold 60 cases at the rate of Rs.220 per case in cash and 20 cases at Rs.225 per case on credit. One of the customers became insolvent and Rs.150 could not be recovered from him.

Kamat is entitled to a commission of 5% and 2 1/2% Del credere on all sales. He submitted the Account Sales by 31-12-1989 and remitted the amount due by enclosing a draft. He also met his acceptance on the due date.
Give ledger accounts in the books of both the parties.

(Answer: Profit on Consignment - Rs. 1,062-50).

3. Sen Brothers of Calcutta consigned sports materials costing Rs.20,000 to their agents, Idris & Co., of Hyderabad. Sen Brothers paid Rs. 1,000 for freight and Rs.200 for insurance etc. The consignees took delivery of goods by paying Rs.200 towards non-recurring expenses.

Exactly after 3 months, they sent an Account Sales showing that 40% of the stock realised Rs.10,800 in cash and 50% of the stock sold on credit Rs.12,400. One customer from whom Rs.400 was due became insolvent and only 50% of the debt could be recovered. The Consignees were entitled to a commission of 5% on sales. They remitted the balance after deducting commission and selling expenses amounting to Rs.300.

Show Consignment account, Consignees account in the books of Sen Brothers. Also show the valuation of stock.

(Answer: Profit on Consignment - Rs. 2,280).

4. Ananthan of Cochin consigned 1,000 kgs of coconut oil costing Rs.20 per kg. to Bharat of Bombay. He incurred Rs.2,000 for freight and insurance.

Bharat took delivery of oil, spent Rs.600 on advertisement and Rs.400 towards selling expenses. He sold 800 kgs of oil at Rs.26 per kg. He was entitled to Commission of 5% on sales and 10% on the excess money realised above Rs.22 per kg. He reported a loss of 50 kgs due to leakage, which was considered normal. You are required to give the necessary ledger accounts in the books of Ananthan, showing clearly the valuation of unsold stock with the consignee.

(Answer: Loss on Consignment - Rs. 86-32)

5. Assam Tea Company consigned 500 boxes of tea costing Rs.200 per box to their agents, King & Co. of Calcutta and paid Rs.1,500 towards freight, Rs.500 towards insurance, and other charges amounting to Rs.250. They received a Bill duly accepted by the agents for Rs.25,000 which was discounted by them for Rs.24,600.

An Account Sales was received from King & Co., showing that 400 boxes were sold at Rs.250 per box, and their expenses which were cartage amounting to Rs.245 and Sundry selling expenses amounting to Rs.130. King & Co., was to receive commission at 3% on gross proceeds. King & Co., intimated in their covering letter that they had taken delivery of 490 boxes only, 10 boxes having been lost in transit. Assam Tea Co., claimed the amount from the Insurance Co. and the claim was settled at Rs.1,500. King & Co., forwarded a sight draft for the balance due from them. You are requred to show ledger accounts in the books of both the parties.

(Answer: Profit on Consignment - Rs. 14,870; Abnormal Loss excluding insurance claim Rs. 545; Value of unsold stock Rs.18,450).

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6. Tapuria Oil Mills consigned 5,000 kg. of coconut oil to Oil Traders, Mangalore, on the 1st of January, 1989. The cost price of oil was Rs.32 a kg. The consignors paid Rs.5,000 towards freight and Rs.2,500 towards insurance in transit. During transit 500 kg Oil was lost by theft for which the insurance claim was settled for Rs.15,000.

   By the 31st of March, 1989, Oil traders reported that 3,400 kg. of Oil was sold @ Rs.36 per kg. and that there was a shortage of 100 kg of oil due to leakage. The consignees had spent Rs. 300 as godown rent and Rs.500 for advertisement and other selling expenses. They charged commission at 4% plus 2% Del credere on sales. The balance due was remitted by bank draft.

   Show the ledger accounts in the books of the consignors and give the journal entries in the books of the consignees. Also show the calculations regarding closing stock and abnormal loss.

   (Answer: Loss on Consignment = Rs. 2,310.33; Abnormal loss before insurance claim Rs.16,750; Value of unsold stock = Rs.34,183.67).

25.11 GLOSSARY

1. Abnormal Loss	:	The loss which arises on account of the operation of external forces and which is avoidable. Examples of such losses are loss by theft, loss by fire, etc. .
2. Account Sales	:	Periodical statement submitted by the consignee to the consignor showing the details of transactions effected by him.
3. Agent	:	The person who represents another person and who acts on behalf of the other person called 'principal'.
4. Commission	:	Reward for the services rendered which is paid by the principal to the agent.
5. Consignment	:	Refers to the process of sending goods for sale from one place to another place.
6. Consignee	:	The person who receives the goods on consignment and sells them on behalf of the consignor.
7. Consignor	:	The person who sends goods on consignment to be sold by the consignee
8. Del credere Commission	:	Extra commission allowed for giving guarantee of debts, when goods are sold on credit.
9. Normal Loss	:	Arises on account of inherent quality in the goods which is unavoidable.
10. Principal	:	Person who appoints an agent and who is represented by such an agent.
11. Pro-forma Invoice	:	Notes sent by the consignor to the consignee indicating the particulars of goods sent on consignment. It is in the form of an invoice.

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UNIT - 26 : CONSIGNMENT ACCOUNTS - II

Contents

26.0 Aims and Objectives
26.1 Introduction
26.2 Accounting Treatment
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26.0 AIMS AND OBJECTIVES

This unit aims at discussing the accounting treatment when the consignor sends the goods to the consignee, marking them at a price higher than the cost price.

By the end of this unit, you will be able to :

- understand the accounting treatment when the consignor sends the goods at a price higher than the cost price;
- calculate loading;
- solve the problems.

26.1 INTRODUCTION

Sometimes, the consignor while sending the goods to the consignee may mark the goods at a price higher than the cost price in the proforma invoice sent to the consignee. The purpose may be not to let the consignee know the actual cost of the goods or the actual profit made by him on the consignment. The consignor may, at times, even direct the consignee to sell the goods only at the price mentioned in the invoice and as such the price mentioned will become the selling price of the goods. Therefore, the invoice price in such a case will be more than the actual cost price of the goods and the Consignment account prepared in the books of the consignor stands debited with that higher price. Suppose a consignor sends goods costing Rs. 10,000 to a consignee charging them at Rs. 12,000 in the invoice. The invoice price Rs. 12,000 will be debited to Consignment account and this would have the effect of reducing the profit, if no adjustment is made before ascertaining the profit. Similarly the unsold stock remaining with the consignee at the end is brought into account at the invoice price and it is credited to the Consignment account and this would have the effect of inflating the profit if no adjustment is made.

Therefore, at the end of every balancing period, necessary adjustments have to be made with regard to enhancement ('loading') in the invoice price in respect of goods sent, unsold stock, etc., The excess of invoice price over the actual cost price of the goods sent on consignment is technically called 'Loading'.

26.2 ACCOUNTING TREATMENT

The following adjustment entries are made in the books of the consignor to remove the effect of invoice price being higher than the cost price.

i) For adjustment of the excess amount of invoice price over the cost price of the goods sent on consignment.

Goods sent on Consignment Account	Dr.	(With the loading in the invoice
To Consignment to ....Account		price of the goods sent on consignment)

The entry given above is the reverse of the very first entry made in the books of the consignor. As the consignment account was given excess debit when goods were sent on consignment, that excess debit would now be removed by crediting the consignment account. Similarly, goods sent on Consignment account which was credited with a bigger amount now is debited with such excess.

ii) For adjustment of the excess of invoice price over the cost price of goods remaining unsold with the consignee:

Consignment to..... Account	Dr.	(With the loading in the invoice
To Stock Suspense or Reserve Account		price of the stock on consignment.)

The effect of this entry would be to remove the excess in the invoice price of unsold stock with the consignee. As the consignment account was given excess credit with the invoice price of Stock on Consignment, the Consignment account would now be debited with that excess and credit given to Stock Reserve account. The Stock on Consignment will now appear thus in the Balance Sheet.

BALANCE SHEET

LIABILITIES		ASSETS		
	Rs.			Rs.
		Stock on Consignment	xxx	
		Less: Stock Reserve	xxx	xxx

In the ledger, Stock on Consignment Account will be showing debit balance and Stock Reserve Account will be showing credit balance. At the beginning of the next period, Stock on Consignment account will be closed by transfer to Consignment account. The entry for this is:

Consignment to ..... Account	Dr	(With the invoice value of
To Stock on Consignment Account		stock on consignment.)

Similarly, the Stock Reserve Account is also closed by transfer to the Consignment account to remove the loading, at the close of the accounting year by making the following entry:

Stock Reserve Account	Dr.
To Consignment to..... Account.	

Therefore, when goods are sent to the consignee at invoice price which is more than the cost price and when there is opening stock with the consignee, three adjustment entries are necessary for removing the loading before ascertaining the profit on consignment: (1) for removing loading in opening stock (2) for removing loading in goods sent on consignment, and (3) for removing loading in closing stock. The other entries given in the previous unit will remain unchanged. If goods are returned by the consignee, the loading in the goods sent is to be calculated and removed from the net amount of goods sent on consignment.

As far as the books of the consignee are concerned, there is no need for making any adjustments as he is

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not at all affected by the higher price and as he does not make any entries when goods are received as also for the closing stock with him.

26.3 CALCULATION OF LOADING

The students should note that the loading in the invoice price may be given in different ways in the examination. Sometimes, the cost price is given and it may be said that the goods are invoiced by adding a certain percentage to the cost price. But usually only invoice price is given and it will be stated that it is higher by a certain percentage over and above the cost price. The following are the different ways in which a question on 'loading' may be set:

I. When Cost price is given in the Problem:

(a) the invoice price is fixed at a certain percentage above the cost price.
(b) the invoice price is fixed so as to give a certain percentage of profit on selling price.

II When invoice price is given in the problem :

(a) the invoice price is fixed at a certain percentage on the cost price.
(b) the invoice price is fixed so as to give a certain percentage of profit on the selling price

The following procedure is to be adopted for ascertaining the loading in different cases.

I. (a) When cost price is given and the invoice price is fixed at a certain percentage above the cost price:

In this case only the cost price is given in the problem. We have to add the percentage mentioned to arrive at the invoice price. The percentage added is loading : For example, X consigned 100 boxes of goods costing Rs. 150 each at an invoice price of 20% above the cost.

Then:

The cost price is (100 X 150)	=	Rs. 15,000
Add: Loading, i.e., 20% over the cost 15,000 X 20 / 100	=	Rs. 3,000
Invoice price is	=	Rs. 18,000

Thus, the loading is Rs. 18,000 – Rs. 15,000= Rs. 3,000 and the proportion of loading in the invoice price is one-sixth 3,000/18,000. In other words, when Rs. 100 is the cost, Rs. 20 (i.e., 20%.) is added to it to arrive at the invoice price and thus the invoice price becomes Rs. 120. Out of Rs. 120, the excess is Rs. 20. Therefore, the proportion of excess is 20 /120 =1/6.

I. (b) When cost price is given and the invoice price is fixed so as to give a certain percentage of profit on the selling price:

In this case, the invoice price is to be taken as selling price. As only the cost price is given in the problem, the invoice price is to be first ascertained. Then the loading is calculated. For example, X consigned 100 boxes of goods costing Rs. 150 each at an invoice price so as to give 20% profit on selling price.

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Then.

If the selling price is Rs: 100, it gives a profit of Rs. 20. Therefore, the cost price must be (100–20)= 80. When cost price is Rs. 80 , Rs.20 is added to arrive at the invoice price. Therefore, the loading is 20/80 i.e., 1/4 of the cost or loading in the invoice price is 20/100 ie., 1/5 of the invoice price.

In the example, as the cost price is 100 X 150 = 15,000, 1/4 of it, i.e., (15,000 X 1/4)= 3,750 is added to it to get the invoice price.. The invoice price becomes 15,000 + 3,750. The proportion of loading in the invoice price is 1/5: (18,750 X 1/5) = Rs. 3,750/-.

II. (a) When the invoice price is given and it is fixed at a certain percentage on the cost price:

Problems are usually set on this method.

In this case, only the invoice price is given in the problem but not the cost price.. The loading is to be ascertained on the basis of the percentage mentioned. For example, X consigned 100 boxes of goods at an invoice price of Rs. 180 per box which is 20% above the cost

Then.

If the cost price is Rs. 100, Rs. 20 (20%) is added to it to arrive at the invoice price. Therefore, the invoice price is Rs. 100+20=120. Now, the loading in the invoice price is (120–100) = 20. The proportion of loading in the invoice price is 20/120 =1/6th. In the example, the invoice price is 100 X180
Rs. 18,000. The loading in this invoice price is 1/6 th of Rs. 18,000, i.e., Rs. 3,000(18,000 X 1/6).

II. (b) When the invoice price is given and it is fixed so as to give a certain percentage of profit on the selling price:

In the case, the invoice price is to be taken as the selling price. Here also the invoice price only is given in the problem but not the cost price. The loading is to be calculated taking into account the proportion of excess in the invoice price. For example, X consigned 100 boxes of goods at an invoice price of Rs. 180 per box. The invoice price is fixed so as to give him 20% profit on the selling price. Then,

If the selling price is Rs. 100, the profit will be Rs. 20. Then the cost price is (100–20)= Rs. 80. There fore, the loading on the cost price is 1/4 (20/80) and the loading in the invoice price is (20/100) = 1/5th.
In the example, the invoice price is (100 X 180)= 18,000 and the loading is 1/5 of 100
18,000= Rs. 3,600. The cost price is (18,000 — 3,600) = Rs. 14,400, and 1/4 of Rs. 14,400 is 3,600/- which is the loading.

When the invoice price and the cost price both are given in the problem, the difference between the invoice price and the cost piree is to be taken as loading.

The most important point to be noted is that the price on which the percentage of loading is fixed should always be taken as 100 on the basis of which the loading is to be calculated.

Illustration - 1

Sewing machines Limited, Hyderabad, consigned 100 sewing machines to their agents, Rakesh &Co., Bombay. The cost of each machine was Rs. 1,000, but invoiced the same at 20% above the cost. The consignors paid Rs. 50 on each machine for packing and insurance.

Rakesh & Co., took delivery of the machines after paying Rs. 2,000 towards Railway freight and spent Rs. 200 for carriage to their godown. They immediately accepted a Bill for Rs. 50,000 at 3 months as advance which was discounted by the Sewing machines Ltd., at 10%.

Before closing the books, the consignors received an Account Sales from the consignees showing the following details:

Sales of 30 machines @ Rs. 1,250/- in cash ... Rs. 37,500
Sales of 50 machines @ Rs. 1,300/- on credit ... Rs. 65,000

Godown Rent: Rs. 600; Insurance: Rs. 200 and Commission charged at 10% on invoice price and 20% on excess price realised.

Give journal entries and the necessary ledger accounts in the books of the consignors showing the details of working:

Books of Sewing Machines Limited

JOURNAL

Date	Particulars	L.F	Dr.	Cr.
			Rs.	Rs.
	Consignment to Bombay Account Dr To Goods sent on Consignment Account (Being 100 sewing machines consigned to Rakesh & Co. Bombay at an invoice price of Rs. 1,200 per machine)		1,20,000	1,20,000
	Consignment to Bombay Account Dr. To Bank Account (Being packing and insurance charges paid)		5,000	5,000
	Bills Receivable Account Dr. To Rakesh & Company's Account (Being the Bill accepted by Rakesh & Co. at three months' advance)		50,000	50,000
	Bank Account Dr. Discount Account Dr. To Bills Receivable Account (Being the Bill discounted at 10% p.a.)		48,750 1,250	50,000
	Rakesh & Company's account Dr. To Consignment to Bombay Account (Being the sale proceeds of 80 machines: 30 machines @ Rs. 1,250 and 50 machines @ Rs. 1,300)		1,02,500	1,02,500

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Consignment to Bombay Account Dr To Rakesh & Co's Account (Being the expenses, freight, carriage, godown rent, insurance, paid by Rakesh & Co)		3,000	3,000
Consignment to Bombay Account Dr. To Rakesh & Co's Account (Being the commission charged by consignees)		10,900	10,900
Stock on Consignment Account Dr. To Consignment to Bombay Account (Being the vaule of 20 machines in stock with the consignees)		25,440	25,440
Goods sent on Consignment Account Dr. To Consignment to Bombay Account (Being the adjustment of loading in the invoice price of goods sent on consignment)		20,000	20,000
Consignment to Bombay Account Dr. To Stock Reserve Account (Being the adjustment of loading in the invoice price of stock on consignment)		4,000	4,000
Consignment to Bombay Account Dr. To Profit & Loss Account (Being the profit on Consignment transferred to Profit & Loss A/c)		5,040	5,040
Goods sent on Consignment Account Dr. To Trading Account (Being the goods sent on Consignment closed by transfer to the Trading A/c)		1,00,000	1,00,000

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Dr. CONSIGNMENT TO BOMBAY ACCOUNT Cr.

	Rs.		Rs.
To Goods sent on Consignment A/c	1,20,000	By Rakesh & Co. A/c (Sale proceeds)	1,02,500
To Bank A/c (Expenses)	5,000	By Stock on Consignment A/c 24,000	
To Rakesh & Co.s A/c (Exp.)	3,000	Add: Prop. Exps. 1,440	25,440
To Rakesh & Co.s A/c (Commission)	10,900	By Goods sent on Consignment A/c (Loading)	20,000
To Stock Reserve A/c (Loading)	4,000		
To Profit & Loss A/c (Profit transferred)	5,040		
	1,47,940		1,47,940

Dr. GOODS SENT ON CONSIGNMENT ACCOUNT Cr.

	Rs.		Rs.
To Consignment to Bombay A/c	20,000	By Consignment to Bombay A/c	1,20,000
To Trading A/c	1,00,000		
	1,20,000		1,20,000

Dr. RAKESH & CO'S ACCOUNT Cr.

	Rs.		Rs.
To Consignment to Bombay A/c	1,02,500	By Bills Receivable A/c	50,000
		By Consignment to Bombay A/c	3,000
		By Consignment to Bombay A/c	10,900
		By Balance c/d	38,600
	1,02,500		1,02,500
To Balance b/d	38,600		

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Dr **BILLS RECEIVABLE ACCOUNT** **Cr**

	Rs.		Rs.
To Rakesh & Co. A/c	50,000	By Bank A/c	48,750
		By Discount A/c	1,250
	50,000		50,000

Dr. **STOCK ON CONSIGNMENT ACCOUNT** **Cr.**

	Rs.		Rs.
To Consignment to Bombay A/c	25,440	By Balance c/d	25,440
	25,440		25,440
To Balance b/d	25,440		

Dr. **STOCK RESERVE ACCOUNT** **Cr.**

	Rs.		Rs.
To Balance c/d	4,000	By Consignment to Bombay A/c	4,000
	4,000		4,000
		By Balance b/d	4,000

Working Notes:

i) Value of Closing Stock

			Rs.
Invoice price of 20 unsold machines (20 X 1,200)			24,000
Add: Proportionate expenses:			
a) Paid by Consignor - Packing & Insurance		5,000	
b) Paid by Consignee - Freight		2,000	
- Carriage		200	
Total non-recurring expenses on 100 machines		7,200	
Proportionate expenses on 20 machines	7,200 x 20/100		1,440
Value of closing stock at invoice price			25,440

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ii) Calculation of Commission:

Invoice price of 80 machines sold (80 X 1,200)	96,000	
10% commission on the invoice price of goods sold 96,000 X 10/100		9,600
Excess price realised (1,02,500 — 96,000) = 6,500		
20% commission on excess price realised 6,500 x 20/100 =		1,300
Total commission payable to the consignee		10,900

iii) Calculation of loading:

a) In goods sent on consignment:

Cost price of each sewing machine	1,000
Invoice price is 20% above cost (1,000 X 120/100)	1,200
Loading in the invoice price is 1,200 —1,000	200

Proportion of loading or excess in the invoice price 200/1,200 = 1/6th

Invoice price of 100 machines sent (1,200 X 100) = 1,20,000

Therefore the loading in the value of goods sent = 1,20,000 x 1/6 = Rs.20,000

b) In stock on consignment:

Invoice price of 20 machines unsold (20 X 1,200) = 24,000

Loading = 24,000 X 1/6 = Rs.4,000

NOTE: Loading is to be calculated only in the invoice price of stock on consignment but not on the value of unsold which will include proportionate expenses. There is no excess in proportionate expenses.

Illustration - 2

Toys Manufacturing Company of Hyderabad consigned to Pillai of Madras 100 boxes of toys, each box costing Rs.20 but invoiced the same so as to get 20% profit on selling price. They paid Rs.400 for packing and freight.

Exactly after 3 months an Account Sales was received from the consignee showing the following details:

i) 75 boxes of toys sold add realised Rs.2,000

ii) Expenses on storage etc., Rs.100

iii) Commission charged at 10%

5 of the boxes with the consignee were shopsoiled and they are to be valued at 50% depreciation. Show Consignment account in the books of the Toys Manufacturing Company giving details of working.

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Solution

Books of Toys Manufacturing Company

Dr. CONSIGNMENT TO MADRAS ACCOUNT Cr.

	Rs.			Rs.
To Goods sent on Consignment A/c (invoice price)	2,500	By Pillai's A/c (sale proceeds)		2,000
To Bank A/c (Exps)	400	By Stock on consignment		
To Pillai's A/c (Exps.)	100	Invoice price of 25 boxes	625	
To Pillai's A/c (Commission)	200	Less: Depreciation 50% on the cost of 5 boxes	50	
To Stock Reserve A/c (loading)	125		575	
		Add: Prop.Exp.	100	
				675
		By Goods sent on consignment A/c (loading)		500
		By P & L A/c (Loss transferred)		150
	3,325			3,325

Working Notes:

i) Calculation of Invoice Price:

As the loading is fixed on the selling price the invoice price should be taken as Rs.100 and loading of 20% is to be calculated. When the invoice price is Rs.100 it gives a profit of 20. Therefore, the cost price is (100 — 20) = Rs.80. When the cost price is Rs.80, Rs.20 is added to get the invoice price. The proportion of loading on the cost price is 20/80 = 1/4
Proportion of loading in the invoice price is 20/100 = 1/5

The cost price of each box is Rs.20
Loading is 20 X 1/4 = Rs.5/-
Invoice price is (20+5) = Rs.25 per box.

ii) Calculation of value of unsold stock:

25 boxes in stock at the invoce price (25 X 25)			625
Less: Depreciation @ 50% on the cost price of 5 boxes shopsoiled (5 X 20 = 100 X 50/100)	=		50
			575
Note: Depreciation is always calculated on the cost price.			
Add: Proportionate Expenses (Direct)			
i) Paid by the consignor Freight and Packing		400	
ii) Paid by consignee Expenses on 100 boxes		nil	
		400	
Expenses on 25 boxes = 400 x 25/100	=		100
Value of unsold stock			675

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iii) Calculation of loading:

i) In goods sent on consignment :

Invoice price of 100 boxes sent on consignment (100 X 25)	2,500
Proportion of loading in the invoice price is 1/5	
Loading is (2,500 X 1/5) = Rs.500	

iv) In stock on consignment:

Invoice price of unsold stock of 25 boxes	Rs.625
Loading in the invoice price is (625 X 1/5)	Rs.125

Illustration - 3

On the 1st of October, 1989 National Transistors Ltd., Delhi, consigned 200 transistors to their agents, Ravi & Co., of Hyderabad, at an invoice price of Rs.200 per transistor. The invoice price is 25% above the cost price. The consignors paid packing amounting to Rs.400; insurance Rs.200; and freight Rs.400.

Before the 31st of December, 1989. When National Transistors Ltd. closed their books, Ravi & Co. informed them that they had sold 180 transistors for Rs.42,600 and that their expenses amounted to Rs. 1,240. Ravi & Co. charged commission at 5% and 2.5% del credere commission on sales. They have enclosed a sight draft for Rs. 30,000. Prepare Ledger accounts in the books of the consignors and show how the particulars of the consignment appear in their Balance Sheet on the 31st of Dec. 1989.

Solution

Books of National Transistors Ltd

LEDGER

Dr. CONSIGNMENT TO HYDERABAD ACCOUNT Cr.

1989		Rs.	1989		Rs.
Oct. 1	To Goods sent on Consignment A/c	40,000	Dec.31	By Ravi & Co. A/c (Sale proceeds)	42,600
"	To Bank A/c (Exps)	1,000	"	By Stock on Consignment (20 X 200) 4,000	
Dec.31	ToRavi & Co.A/c (Exps.)	1,240		Add:Prop. Exp 100	
"	ToRavi & Co.A/c (Commission)	3,195			4,100
"	To Stock Reserve A/c (loading)(4,000 X 1/5)	800			
"	To P & L A/c (Profit transferred)	8,465	"	By Goods sent on Consignment A/c (loading) (40,000X1/5)	8,000
		54,700			54,700

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Dr. GOODS SENT ON CONSIGNMENT ACCOUNT Cr.

		Rs.			Rs.
1989			1989		
Dec. 31	To Consignment to Hyderabad A/c(Loading)	8,000	Oct.1	By Consignment to Hyderabad A/c	40,000
"	To Trading A/c	32,000			
		40,000			40,000

Dr. RAVI & CO'S ACCOUNT Cr.

		Rs.			Rs.
1989			1989		
Dec. 31	To Consignment to Hyderabad A/c (Sale proceeds)	42,600	Dec.31	By Consignment to Hyderabad A/c(Exp)	1,240
				By Consignment to Hyderabad A/c (Commission)	3,195
				By Bank A/c (draft received)	30,000
				By Balance c/d	8,165
		42,600			42,600
1990					
Jan. 1	To Balance b/d	8,165			

Dr. STOCK ON CONSIGNMENT ACCOUNT Cr.

		Rs.			Rs.
1989			1989		
Dec.31	To Consignment to Hyderabad A/c	4,100	Dec.31	By Balance c/d	4,100
		4,100			4,100
1990					
Jan.1.	To Balance b/d	4,100			

Dr. STOCK RESERVE ACCOUNT Cr.

		Rs.			Rs.
1989			1989		
Dec.31	To Balance c/d	800	Dec.31	By Consignment to Hyderabad A/c	800
		800			800
			1990		
			Jan.1	By Balance b/d	800

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BALANCE SHEET
as on the 31st of Dec. 1989

Liabilities	Rs.	Assets		
		Stock on Consignment	4,100	
		Less: Stock Reserve	800	3,300
		Ravi & Company's A/c		8,165

Working Notes:

i) Value of unsold stock:

Out of 200 transistors sent on consignment 180 transistors had been sold and 20 were in stock.

The invoice price of 20 transistors (20 X 200)			4,000
Add: Proportionate direct expenses:			
i) Paid by the Consignor:			
Packing	400		
Insurance	200		
Freight	400		
		1,000	
ii) Paid by the consignee		Nil	
Total		1,000	
Expenses on 20 transistors= 1,000X1/10 =			100
Value of unsold stock			4,100

ii) Calculation of commission:

The consignee is entitled to a commission of 5% and 2.5% del credere.
Therefore, the total 7.5% is to be claculated on total sales.
Total sales effected by the consignee = Rs.42,600
Commission = 42,600 x 7.5/100= Rs.3,195.

iii) Calculation of Loading:

The invoice price is 25% above cost price. If the cost price is Rs.100, 25% is added. The invoice price is (100 + 25) = 125.
When the invoice price is 125, the excess in the invoice price is (125— 100)=25.
The proportion of loading in the invoice price is 25/125 = 1/5

a) Loading in goods sent on Consignment
40,000 X 1/5 = Rs.8,000
b) Loading in Stock on Consignment
4,000 X 1/5 = Rs.800

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Illustration -4

Modi Textiles of Ahmedabad consigned 100 boxes of cut-piece goods to Chandmal of Nizamabad at an invoice price of Rs.1,000 per box. The invoice price is fixed so as to give an profit of 25% on the selling price. On the same day they paid Rs.5,000 for freight and Rs.1,000 towards insurance.

After 3 months Chandmal sent Account Sales which disclosed the foilowing:

Sales of 75 boxes		97,500
Less:Expenses:		
Clearing charges	1,000	
Selling Expenses	750	
	---	1,750
		95,750
Less: Commission at 10%		9,750
Balance remitted by Bank draft		86,000

Ascertain profit on consignment showing ledger accounts in the books of the consignors.

Solution

Books of Modi Textiles

LEDGER

Dr. CONSIGNMENT TO HYDERABAD ACCOUNT Cr.

	Rs.			Rs.
To Goods sent on consignment A/c	1,00,000	By Chandmal's A/c (Sale proceeds)		97,500
To Bank (Exps)	6,000	By Stock on consignment	25,000	
To Chandmal's A/c (Exps.)	1,750	Add:Prop. Exp.	1,750	
To Chandmal's A/c (Commission)	9,750			26,750
To Stock Reserve A/c (loading) (4,000 x 1/5)	6,250	By Goods sent on Consignment A/c (Loading)		25,000
To P & L A/c (Profit transferred)	25,500			
	1,49,250			1,49,250

Dr. GOODS SENT ON CONSIGNMENT ACCOUNT Cr.

	Rs.		Rs.
To Consignment to Nizamabad A/c	25,000	By Consignment to Nizamabad A/c	1,00,000
To Trading A/c	75,000		
	1,00,000		1,00,000

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Dr. CHANDMAL'S ACCOUNT Cr.

	Rs.		Rs.
To Consignment to Nizamabad A/c (Sale proceeds)	97,500	By Consignment to Nizamabad A/ c(Exp)	1,750
		By Consignment to Nizamabad A/c (Commission)	9,750
		By Bank	86,000
	97,500		97,500

Dr. STOCK ON CONSIGNMENT ACCOUNT Cr.

	Rs.		Rs.
To Consignment to Nizamabad A/c	26,750	By Balance c/d	26,750
	26,750		26,750
To Balance b/d	26,750		

Dr. STOCK RESERVE ACCOUNT Cr.

	Rs.		Rs.
To Balance c/d	6,250	By Consignment to Nizamabad A/c	6,250
	6,250		6,250
		By Balance b/d	6,250

Working Notes:

i) Value of unsold stock.

Out of 100 boxes consigned 75 boxes have been sold and 25 boxes remain in stock.

		Rs.
Invoice price of 25 boxes (25 X 1,000)		25,000
Add: Proportionate Direct Expenses		
a) Paid by consignor:		
Freight	5,000	
Insurance	1,000	
b) Paid by Consignee		
Clearing charges	1,000	
Total direct expenses on 100 boxes	7,000	
Proportionate expenses on 25 boxes: 7,000 X 25/100		1,750
Value of unsold stock		26,750

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ii) Calculation of Loading

In this case the invoice price is fixed so as to get a profit of 25% on the selling price. if the selling price is taken as Rs.100, the profit will be Rs.25. Then the cost price will be (100 – 25) = 75.

The proportion of loading in the invoice price is 25/100 = 1/4

a) Loading in goods sent on Consignment:
1,00,000 X 1/4 =Rs.25,000

b) Loading in Stock on Consignment:
25,000 X 1/4 = Rs. 6,250

Illustration - 5

Ramesh & Co., of Hyderabad sends regular consignments to Mukesh & Co., of Visakhapatnam at an invoice price which is cost plus 25%. Mukesh & Co. receives commission at 5% on all sales and 2.5% Del credere on credit sales.

On the 1st January, 1989 the Consignee had in stock with them Rs.10,000 worth of goods at invoice price. During the year that ended on the 31st of Dec. 1989 the following transactions took place.

1) Invoice price of the goods sent on consignment Rs.1,00,000
2) Freight, insurance, etc., paid by the consignors: Rs. 5,000
3) Advances remitted by the consignees: Rs. 60,000
4) Sales made by the consignees - 3/4 of the goods consigned during the year together with the opening stock had been sold at Rs.95,000 out of which Rs.20,000 sales were sold on credit
5) Selling Expenses paid by consignees Rs.1,000 and discount allowed by him to the customers Rs.300
6) Out of the credit sales Rs.400 was irrecoverable and the agents considered it bad

Show Ledger accounts recording the above transactions in the books of Ramesh & Co.

Solution

Books of Ramesh & Co.

LEDGER

Dr. CONSIGNMENT TO VISAKHAPATNAM ACCOUNT Cr.

		Rs.			Rs.
1989 Jan. 1	To Goods sent on Consignment A/c	10,000	1989 Jan.1	By Mukesh & Co. A/c (Sale proceeds)	95,000
Jan. 1 to Dec.31	To Goods sent on Consignment A/c	1,00,000	Dec.31		
"	To Bank A/c (Exps)	5,000	Dec.31	By Stock on Consignment (1/4 of 1,00,000)= 25,000 Add:Prop. Exp (1/4 of 5,000) = 1,250	26,250
"	To Mukesh& Co.A/c (Selling Exps. and Disc.)	1,300		By Stock ReserveA/c (Loading – Opening Stock)	2,000
"	To Mukesh& Co.A/c (Comm.) Ordinary: 4,750 Del credere 500	5,250	"	By Goods sent on Consignment A/c (Loading)	20,000
"	To Stock Reserve A/c (loading) (Closing Stock)	5,000			
"	To P & L A/c (Profit transferred)	16,700			
		1,43,250			1,43,250

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Dr. GOODS SENT ON CONSIGNMENT ACCOUNT Cr.

		Rs.			Rs.
1989			1989		
Dec 31	To Consignment to Visakhapatnam A/c (Loading)	20,000	Jan 1	By Consignment to Visakhapatnam A/c	1,00,000
"	To Trading A/c	80,000			
		1,00,000			1,00,000

Dr. MUKESH & CO'S ACCOUNT Cr.

		Rs.			Rs.
1989			1989		
Jan. 1 to Dec.31	To Consignment to Visakhapatnam A/c (Sale proceeds)	95,0000	Jan.1 to Dec.31	By Bank A/c. (Advance received)	60,000
			Dec.31	By Consignment to VisakhapatnamA/c (Expenses)	1,300
				By Consignment to Visakhapatnam A/c (Commission)	5,250
				By Balance c/d	28,450
		95,000			95,000
1990					
Jan 1	To Balance b/d	28,450			

Dr. STOCK ON CONSIGNMENT ACCOUNT Cr.

		Rs.			Rs.
1989			1989		
Jan 1	To Balance b/d	10,000	Jan 1	By Consignment to Visakhapatnam	10,000
1989					
Dec.31	To Consignment to Visakhapatnam	26,250	Dec.31	Balance c/d	26,250
1990					
Jan.1	To Balance b/d	26,250			

Dr. STOCK RESERVE ACCOUNT Cr.

		Rs.			Rs.
1989			1989		
Dec.31	To Consignment to Visakhapatnam	2,000	Jan.1	By Balance b/d	2,000
1989			1989		
Dec.31	To Balance c/d	5,000	Dec.31	By Consignment to Visakhapatnam A/c	5,000
		5,000			5,000
			1990		
			Jan.1	By Balance b/d	5,000

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Working Notes

i) Calculation of Commission

The consignee is entitled to 5% commission on all sales and 2.5% Del credere commission on credit sales

Total sales affected by consignees -	95,000	
Ordinary commission = 95,000 x 5/100		4,750
Del credere commission on credit sales made by the consignee 20,000 X 5/200		500
Total Commission		5,250

ii) Value of Stock on Consignment

Opening Stock with the consignee had been sold and also three-fourths of the goods consigned during the year had been sold. Therefore, the Stock remaining unsold with the consignee would be 1/4 of Rs.1,00,000 = 25,000

Invoice price of the Stock on Consignment	25,000
Add: Proportionate Direct Expenses	
i) By Consignor 5,000 X 1/4	1,250
ii) By Consignee	nil
Value of unsold stock	26,250

iii) Calculation of Loading

Invoice price is cost plus 25% when cost is 100, 25% is added. Therefore, the invoice price becomes Rs.125/-. Out of 125 the excess is (125 — 100) = 25. The proportion of excess in the invoice price is 25/125 = 1/5

a) Loading in Opening Stock 10,000 X 1/5	2,000
b) Loading in goods sent on Consignment 1,00,000 X 1/5	20,000
c) Loading in Closing Stock 25,000 X 1/5	5,000

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26.4 SUMMING UP

In this unit you have learnt the accounting treatment, when the consignor sends the goods to a consignee marking them at a price higher than the cost price.

The consignor may mark the goods at a price higher than the cost price. Its object may be to prevent the consignee from knowing about the actual profit made by the consignor. necessary adjustments have to be made by the consignor regarding the loading in the invoice value of the goods-opening stock with the consignee, goods sent on consignment and closing stock with the consignee before ascertaining the profit or loss on consignment.

26. 5 MODEL EXAMINATION QUESTIONS

A. Short Answer Questions

1.What is meant by 'loading'?

2. Why the goods are sent at a price higher than the cost price?

3. How do you value unsold stock when goods are marked at a price higher than the cost?

B. Essay Answer Questions.

4. Discuss the adjustments which are necessary when the goods are consigned at a price higher than the cost.

Problems

1. Bharat Cycles Ltd., consigned on the 1st of January, 1989, 100 bycles to Ratanlal of Hyderabad. The cost of each bicycle was Rs.500 but the invoice price was Rs.600. The consignors paid Rs.2,000 on freight and insurance and recieved Rs.20,000 as advance from the consignee. Ratanlal paid Rs.500 as octroi and carriage, Rs. 250 as insurance and Rs.500 as godown rent. By the 30th of April, 1989 when the books of the consignors were closed, Ratanlal had disposed of 80 bicycles for Rs.54,000. The consignee was entitled to a commission at 5% on invoice price and 25% of any surplus price realised. He remitted the amount due by bank draft.
You are required to give journal entries and ledger accounts in the books of both the parties.

(Answer: Profit on Consignment = 7,350)

2. Vijay Electricals Ltd., of Hyderabad consigned 100 of their Vijay brand ceiling fans at an invoice price of Rs.500 per fan to their agents, Jyoti Emporium of Vijayawada. The invoice price was made up of cost plus 25%. The consignors paid Rs. 500 towards freight and Rs.250 as insurance charges. The Consignees were entitled to a commission of 10% on sales.

5 fans were badly damaged in transit and the insurance company settled the claim of Rs.1,600 which was duly received by the consignor. The consignees took delivery of the rest of the fans and spent Rs.190 for clearing and cartage and reported that they had sold 80 fans at an average price of Rs.530 per fan and that their selling expenses were Rs.160. They enclosed a draft for the balance after deducting their commission and expenses.

Give the necessary ledger accounts in the books of Vijay Electricals Ltd., showing clearly the valuation of unsold fans with the consignees.

(Answer: Profit on Consignment = 5,240 ; Abnormal Loss excluding insurance claim Rs. 437.50; stock at invoice price Rs.7,642.50).

3. Raghavendra Flour Mills sent 100 bags (each bag containing 50 Kgs.) of flour at an invoice price of Rs.250 per bag to M/s Jagdish Stores of Kurnool to be sold by them on commission basis. The invoice price was made up so as to give 20% profit on the selling price. The consignors spent Rs.15 per bag towards freight , insurance, etc., . The consignees were entitled to a commission of 10% on sales.

The Account Sales received from the consignees revealed that they had sold 84 bags at Rs.275 per bag and that they spent Rs.200 as godown rent, Rs.400 as selling and miscellaneous expenses. They also reported that there was a shortage of 50 kgs of flour due to loading, unloading, weighment, etc., which was not abnormal. A bank draft for the balance due was duly enclosed.

You are required to show the important ledger accounts in the books of Raghavendra Flour Mills, giving clearly the claculation of the value of Stock on Consignment.

(Answer: Profit on Consignment = 1,955.15; Value of Stock on Consignment at invoice price = Rs.4,015 .15).

4. Vijay Cotton Merchants of Guntur have as their selling agents M/s Champaklal & Co. at Ahmedabad to whom they send regular consignments of cotton bales to be sold by them on commission basis.

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On the 1st January,1989 the cotton bales in stock with the consignees were 10 at an invoice price of Rs.600 per bale, which was made up of cost plus 20%. During the year 1989, the consignors despatched 1,000 bales at an invoice price of Rs.660 per bale. The Consignor's expenses included freight amounting to Rs.15,000 and insurance amounting to Rs.5,000. Champaklal & Co. were entitled to a commission of 5% on sales.

During the year they had sold 980 bales including those in stock at the beginning of the year at an average price of Rs.675 per bale. The various amounts remitted by the consignees during the year totalled Rs.5,50,000. They incurred Rs.5,000 towards godown rent and another Rs.3,000 towards other selling expenses. The consignees were also entitled to 1% incentive commission when the sales exceeded Rs.5,00,000 which was to be allowed on total sales.

You are required to give the necessary ledger accounts in the books of both the parties.

(Answer: Profit on Consignment = Rs.55,910;
Amount due from Consignees = Rs.63,810).

Writer : C.Mallikarjuna Rao.

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UNIT - 27 : JOINT VENTURES

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27. 0 AIMS AND OBJECTIVES

The aims of this unit are to discuss :

i) the meaning, definition and features of joint venture,
ii) differences between joint venture and partnership, joint venture and consignment;
iii) the accounting procedure followed in joint venture transactions.

On having studied and worked through this unit, you would be able to :

- describe the meaning and features of joint venture;
- distinguish between joint venture and partnership;
- distinguish between joint venture and consignment;
- become familiar with the accounting procedure;
- solve the problems, according to different methods of joint venture.

27. 1 INTRODUCTION

In the previous two units we have discussed Consignment Accounts. In this unit we shall consider Joint Venture Accounts.

Two or more persons may come together to undertake some business activity. This association may take the form of either a full fledged partnership or a joint venture. In the case of partnership the association is of a continuous nature and of a longer duration than that in the case of a joint venture which is relatively for a short period and for only a specific purpose or a particular business deal. Here, we shall deal with joint ventures.

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27. 2 MEANING AND FEATURES

A joint venture is an association of two or more persons for the undertaking of a particular venture. They contribute capital and share profit or loss resulting from the venture in an agreed ratio. As soon as the venture is completed their association will come to an end.

Jont venture agreements are generally made when a trader falls short of funds or wants to share the risk involved with one or more persons. For example, A and B, two independent contractors, may come together and undertake the construction of a building for a college for a certain Sum of money. They will together meet the expenses incurred in connection with the construction. After the completion of the work the contract price is received. The profit or loss arising from the venture would now be shared by A and B in the agreed ratio and the venture is woundup . It is not necessary that they should continue to take up building contracts in future. Their association is only for the construction of the particular building they have contracted for, and it comes to an end as soon as the construction of that building is over. It is an association of a temporary nature involving no further liability to either of the parties after the venture is completed. Similarly, two or more persons may join hands to under write the issue of shares or debentures of a joint stock company, joint consignment of goods, purchases and sale of specific property. etc.

In the light of the discussion presented above the characteristic features of a joint venture agreement may be stated as follows :

1) There is an agreement between two or more persons.
2) The agreement is for the undertaking of a specific venture.
3) The agreement comes to an end with the completion of the specific venture for which it has been contracted.
4) The profit or loss resulting from the venture is shared by co-venturers in the agreed ratio. In the absence of any agreement between the venturers, profits or losses are to be shared equally.

27.3 JOINT VENTURE AND PARTNERSHIP

According to the Indian Partnership Act, partnership is "the relation between persons who have agreed to share the profits of a business carried on by all or any of them acting for all". In other words, Partnership is an agreement between two or more persons to carry on a business together and to share the profits or losses arising from it. The parties to the agreement are called individually 'Partners' and collectively a firm. They carry on business in the firm's name. The joint venture is regarded as a temporary partnership. Both in the partnership and the joint venture there is some business activity and the result of the activity is shared by two or more persons. The points of distinction between the two are as follows:

1) A partnership firm carries on business in its firm name. In a joint venture, there is no firm name as such.

2) Partnership is of a continuous nature and not confined to a particular venture or job. It covers a series of transactions spread over a long period. A joint venture is of a temporary nature, confined to a particular venture or work. It is for a limited purpose, sought to be achieved within a short period. For this reason, the joint venture is sometimes called 'temporary partnership' or 'Partnership for a specific venture' or 'Particular partnership'.

3) Partnership does not come to an end after the completion of a particular activity or operation. It is a continuous process whereas a joint venture comes to an end soon after the work for which it is undertaken is completed.

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4) In the case of partnership a separate set of books must be maintained. As joint ventures are of temporary nature, it is not always necessary to maintain a separate set of books for the joint venture. Co-venturers can record the transactions in their own books. However, if the venture involves large amounts and is likely to run for a longer period, they may maintain separate books for the joint venture.

27.4 JOINT VENTURE AND CONSIGNMENT

In the previous units we have discussed Consignment Accounts. As you know, the term, 'Consignment' is used for such transactions where a manufacturer or trader sends goods to an agent to be sold by the agent on behalf of the trader. The person who sends the goods is called 'Consignor' or 'Principal' and the person to whom the goods are sent is called 'Consignee' or 'Agent'.

1) 'Joint Venture' resembles 'Consignment' in the cases where one venturer sends goods to another venturer to be sold by him at the best possible price. The point to be noted here is that the other veneturer is not merely an agent, but a partner also. In the case of joint venture, the relation between the co-venturers is like that of partners.

2) The profit or loss on the venture is shared by the co-venturers. But in the case of consignment, the relationship of the parties is that of principal and agent. The agent does not bear the risk. He does not share the profit or loss arising out of consignment. He only gets commission for the work done by him. In the case of joint venture also sometimes commission may be paid to a co-venturer, but it is in addition to his share of profit.

3) Joint Venture business may be for sale of goods or for some other activity such as the underwriting of shares or debentures or purchase or sale of some property etc. Consignments are meant for sale of goods only.

27.5 ACCOUNTING PROCEDURE

Now, let us discuss the different methods of recording joint vneture transactions. There are three ways of keeping joint venture accounts.

27.5.1. Where Separate Books are maintained :

Under this method a separate set of books is kept for recording the transactions relating to a joint venture. The accounts are kept according to the usual accounting system. Under this method, co-venturers do not keep the records individually.

27.5.2. Where no separate books are kept :

Under this method, joint venture transactions are recorded in the books of each co-venturer, as a part of his general business transactions. Separate books are not maintained for the business or the venture undertaken by the co-venturers.

27.5.3. Memorandum Joint Venture Method :

This method is an alternative to the above method.

27.5.4. Where only one party maintains the books :

This method is followed when most of the buying and selling of transactions relating to the venture are managed by one co-venturer only. Other co-venturers only contribute their share of investment in the joint venture. In this case all the transactions are recorded in the books of the co-venturer managing the business. Now let us discuss each method in detail.

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27.5.1 Where separate books are maintained

Under this method, accounts relating to the joint venture are not maintained separately in the individual books of the co-venturers. Instead, a separate set of books is kept for recording joint venture transactions. The books are maintained according to the Double Entry System as in the case of any other business. Under this method the following accounts are opened.

1) Joint Bank Account,
2) Joint Venture Account, and
3) Personal Accounts of Co-venturers.

The Joint Bank Account is the nature of personal account. It is opened in the Joint names of all co-venturers to record transactions. All amounts contributed by the co-venturers and the amounts received towards the Joint Venture (such as contract price and sale proceeds of shares, debentures, etc.) are recorded on the debit side and payments towards the joint venture are recorded on the credit side. After the venture is completed, this account is closed by making the final payment to the co-venturers.

The Joint Venture Account is in the nature of ordinary Profit and Loss account and is opened to ascertain the profit or loss on the venture. Expenses are recorded on the debit side and income on the credit side. The profit or loss in respect of the venture is ascertained and transferred to the personal accounts of the co-venturers in the agreed ratio.

A personal account may also be opened in the name of each co-venturer. It is credited with the contribution made by him, expenses incurred by him in respect of the joint venture and his share of profit and debited with goods or any other joint venture property taken over by him and his share of loss, if any. The balance left in the account after the transfer of profit or loss of the joint venture is the amount due to him or from him and is settled through the Joint Bank Account.

The entries to be recorded in this method are as follows :

1. When cash is brought in by the co-venturers to finance a joint venture and deposited in the Joint Bank Account :

Joint Bank Account	Dr.	
To Personal Account of each Co-Venturer.		

2. When cash purchases are made for the joint venture :

Joint Venture Account	Dr.	
To Joint Bank Account		

Note : It is worth noting that whenever purchases are made for the Joint venture, it is the Joint Venture Account and not the Purchases Account, which is debited. In the ordinary course of business whenever purchases are made the Purchase Account is debited and then at the end of the financial year, it is transferred to the Trading Account. But in case of joint venture as the number of transactions is not large, purchases made for the venture are directly debited to the Joint Venture Account.

3. For Credit purchases made for the venture :

Joint Venture Account	Dr.	
To Supplier's Account		

4. For goods suplied or expenses incurred by a Co-venturer :

Joint Venture Account Dr.
To Co-Venturer's Personal Account

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5. For expenses incurred on account of the Joint venture :

Joint Venture Account Dr.
To Joint Bank Account

---

6. For goods sold or contract price received (and the proceeds are deposited in Joint Bank A/c)

Joint Bank Account Dr.
To Joint Venture Account

Note : If a part of the contract price is received in shares or debentures, then Shares or Debentures Account, as the case may be, should be debited and the Joint Venture Account credited.

7. For the goods sold on credit :

Debtor's Account
(or Customer's Account) Dr.
To Joint Venture Account

---

8. For cash paid to or for acceptance of Bill Payable drawn by the supplier :

Supplier's Account Dr.
To Joint Bank Account/Bills Payable Account.

---

9. For receipt of cash or Bill Receivable from a Debtor:

Joint Bank Account/
Bills Receivable Account Dr.
To Debtor's Account (or Customer's A/c).

---

10. For unsold stock taken over by Co-Venturer :

Co-Venturer's Personal Account Dr.
To Joint Venture Account

Note : If shares/debentures received as a part of contract price, are sold or taken over by co-venturer at an agreed price the Joint Bank Account or the Personal Account of the co-venturer, taking over them should be debited and Shares/Debentures account should be credited with the amount received on sale or the value at which they are taken over.

The Profit or loss on the sale of Shares/Debentures should be transferred to the Joint Venture Account. They entry is as follows :

For transferring profit :

Shares / Debenturers Account Dr.
To Joint Venture Account

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For transferring loss :

Joint Venture Account Dr.
To Shares/Debentures Account

---

11. For any commission, salary, interest, etc., payable to any co-venturer :

Joint Venture Account Dr.
To Co-Venturer's Personal Account

---

12. After passing the above entries the profit or loss on the venture should be ascertained and transferred to the Personal accounts of the co-venturers. The entry is :

In the case of Profit :

Joint Venture Account Dr.
To Co-Venturer's Personal Accounts

In the case of loss :

Co-Venturers' Personal Accounts Dr.
To Joint Venture Account

---

13. Finally, the amount due to each co-venturer is to be ascertained by finding out the balance and final payment made. The entry is :

Co-Venturers' Personal Accounts Dr.
To Joint Bank Account.

In case the co-venturers' account shows a debit balance, it means that he owes some amount to the business. When such amount is received, the entry will be :

Joint Bank Account Dr.
To Co-Venturer's Account.

Note : As a result of the above mentioned entry. The Joint Bank Account and the personal accounts of co-venturers are closed. There will not be any balance left in any account.

Illustration - 1

Rajagopalan and Chinoy doing business separately as building contractors undertook jointly to construct a building for a newly started college for a contract price of Rs.1,25,000. A Bank Account was opened in their joint names, Rajagopalan paying in Rs.30,000 and Chinoy Rs.20,000. They agreed to share profits and losses equally, after providing for interest on capital at 10% p.a.

The following expenses were incurred and paid for from the Bank Account.

	Rs.
Materials	55,000
Wages	20,000

In addition, Rajagopalan supplied materials valued at Rs.3,000 and Chinoy paid architects fees amount to Rs.2,500.

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The contract was completed in six months time. Due to certain defects, the contractee deducted Rs.5,000 from the agreed payment ; Payments were made in instalments. Chinoy took over the unused materials at an agreed value of Rs.3,000.

Pass journal entries and prepare the necessary Ledger accounts in the separate books of the joint venture.

Solution

Journal Entries in the separate books of the Joint Venture

Date	Particulars		LF	Debit	Credit
				Rs.	Rs.
	Joint Bank Account	Dr.		50,000	
	To Rajagopalan's Account				30,000
	To Chinoy's Account				20,000
	(Being amount contributed by Rajagopalan and Chinoy deposited in their Joint Bank Account)				
	Joint Venture Account	Dr.		75,000	
	To Joint Bank Account				75,000
	(Being expenses towards, Joint Venture paid from the Joint Bank Account)				
	Joint Venture Account	Dr.		3,000	
	To Rajagopalan's Account				3,000
	(Being materials supplied by Rajagopalan for the Joint Venture)				
	Joint Venture Account	Dr.		2,500	
	To Chinoy's Aecount				2,500
	(Being architects fees paid by Chinoy in respect of the Joint Venture)				
	Joint Bank Account	Dr.		1,20,000	
	To Joint Venture Account				1,20,000
	(Being the contract price received, from contractee after deducting Rs.5,000 from the contract price)				
	Chinoy's Account	Dr.		3,000	
	To Joint Venture Account				3,000
	(Being the unused materials taken over by Chinoy)				
	Joint Venture Account	Dr.		2,500	
	To Rajagopalan's Account				1,500
	To Chinoy's Account				1,000
	(Being interest charged to the Joint venture on the amount contributed by Rajagopalan and Chinoy for six months)				
	Joint Venture Account	Dr.		40,000	
	To Rajagopalan's Account				20,000
	To Chinoy's Account				20,000
	(Being the profit made on the venture transferred to Rajagopalan and Chinoy in their profits sharing ratio)				

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Rajagoplana's Account	Dr.		54,500	
Chinoy's Account	Dr.		40,500	
To Joint Bank Account				95,000
(Being the joint venture closed by paying the amount due to the venturers)				

LEDGER ACCOUNTS

Dr. **JOINT BANK ACCOUNT** Cr.

	Rs.		Rs.
To Rajagopalan's Account (amount contributed)	30,000	By Joint Venture Account:	
To Chinoy's Account (amount contributed)	20,000	Materials : 55,000	
To Joint Venture Account (contract price received)	1,20,000	Wages : 20,000	75,000
		By Rajagopalan's Account (final settlement)	54,500
		By Chinoy's Account (final settlement)	40,500
	1,70,000		1,70,000

Dr. **JOINT VENTURE ACCOUNT** Cr.

	Rs.		Rs.
To Joint Bank Account		By Joint Bank Account (contract price)	1,20,000
Materials 55,000		By Chinoy's Account (Materials taken over)	3,000
Wages 20,000	75,000		
To Rajapogalan's Account (materials supplied)	3,000		
To Chinoy's Account (Architects' fees paid)	2,500		
To Rajagopalan's Account (Interest)	1,500		
To Chinoy's Account (Interest)	1,000		
To Profit transferred to Rajagopalan's Account (1/2 share) 20,000			
Chinoy's Account (1/2 share) 20,000	40,000		
	1,23,000		1,23,000

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Dr. CHINOY'S ACCOUNT Cr.

	Rs.		Rs.
To Joint Venture Account (materials taken over)	3,000	By Joint Bank Account (amount contributed)	20,000
To Joint Bank Account (final settlement)	40,500	By Joint Venture Account (architects' fees)	2,500
		By Joint Venture Account (Interest)	1,000
		By Joint Venture Account (1/2 share of profit)	20,000
	43,500		43,500

Dr. RAJAGOPALAN'S ACCOUNT Cr.

	Rs.		Rs.
To Joint Bank Account (final settlement)	54,500	By Joint Bank Account	30,000
		By Joint Venture Account (materials supplied)	3,000
		By Joint Venture Account (Interest)	1,500
		By Joint Venture Account (1/2 share of profit)	20,000
	54,500		54,500

Illustrtion - 2

Hashim Ali and Chandrasekhar doing business separately as building contractors, undertook jointly to construct a building for a newly started joint stock company for a contract price of Rs.2,00,000 of which Rs. 1,50,000 is payable by instalments in cash and the remaining Rs.50,000 in fully paid shares of the company. A bank account was opened in their joint names, Hashim Ali paying in Rs.60,000 and Chandrasekhar Rs.40,000. They were to share profits and losses in proportion of 2/3rd and 1/3rd respectively. The following payments were made from the Bank account.

Materials	Rs. 75,000
Wages	Rs. 35,000
Plant	Rs. 50,000

In addition, Hashim Ali suplied materials worth Rs. 8,000 and Chandrasekhar paid the archietct's fees amounting to Rs.5,000.

The contract was completed in a year's time and the price was duly received. The plant was to be depreciated by 20%. Half of the plant was taken over by Chandrasekhar, and the other half was sold for Rs.23,000. Shares were taken over by Hashim Ali at an agreed valuation of Rs.40,000.

Show the necessary Ledger accounts when separate books are maintained for the Joint Venture.

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Solution

Ledger Accounts in the separate books of the Joint Venture

Dr. JOINT VENTURE ACCOUNT Cr.

		Rs.		Rs.
To Joint Bank Account :			By Joint Bank Account (contract price received in cash)	1,50,000
Materials	75,000		By Shares Account (contract price received in shares)	50,000
Wages	35,000		By Chinoy's Account (1/2 plant taken over)	20,000
Plant	50,000	1,60,000	By Joint Bank Account (1/2 plant sold)	23,000
To Hashim Ali's Account (Materials supplied)		8,000		
To Chandrasekhar's Account (architect's fees paid)		5,000		
To Shares Account (loss on sale of shares)		10,000		
To Profit transferred to Hashim Ali's Account (2/3rd share)	40,000			
To Chandrasekhar's Account (1/3rd share)	20,000	60,000		
		2,43,000		2,43,000

Dr. JOINT BANK ACCOUNT Cr.

		Rs.		Rs.
To Hashim Ali's Account (amount contributed)		60,000	By Joint Bank Account :	
To Chandrasekhar's Account (amount contributed)		40,000	Materials	75,000
To Joint Venture Account (contract price)		1,50,000	Wages	35,000
To Joint Venture Account (1/2 plant sold for cash)		23,000	Plant	50,000 1,60,000
			By Hashim Ali's Account (Final settlement)	68,000
			By Chandrasekhar's Account (Final settlement)	45,000
		2,73,000		2,73,000

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Dr. **SHARES ACCOUNT** Cr.

	Rs.		Rs.
To Joint Venture Account (part of contract price)	50,000	By Hashim Ali's Account (shares taken over)	40,000
		By Joint Venture Account (loss on sale of shares transferred to Joint Venture Account)	10,000
	50,000		50,000

Dr. HASHIM ALI'S ACCOUNT Cr.

	Rs.		Rs.
To Shares Account (shares taken over)	40,000	By Joint Bank Account (amount contributed)	60,000
To Joint Bank Account (Final settlement)	68,000	By Joint Venture Account (materials supplied)	8,000
		By Joint Venture Account (2/3rd share of profit)	40,000
	1,08,000		1,08,000

Dr. CHANDRASEKHAR'S ACCOUNT Cr.

	Rs.		Rs.
To Joint Venture Account (1/2 plant taken over)	20,000	By Joint Bank Account (amount contributed)	40,000
To Joint Bank Account (Final settlement)	45,000	By Joint Venture Account (architects fees paid)	5,000
		By Joint Venture Account (1/3rd share of profit)	20,000
	65,000		65,000

Note : 1. Though the plant is an asset, it is debited to the Joint Venture Account as is generally done in the case of contract business. The contract was completed after one year. It was to be depreciated by 20%, the depreciated value was Rs.40,000. Half of the plant at its closing value was taken over by Chandrasekhar. Hence, Chandrasekahar's Account is debited and the Joint Venture Account credited with Rs.20,000. The other half of the plant was sold for cash, for Rs.23,000. For this the Joint Bank Account is debited and the Joint Venture Account credited with Rs.23,000. There is no need to pass any entry for depreciation and for profit or loss on the sale of plant as this gets automatically adjusted in the Joint Venture Account.

2. Shares of the value of Rs.50,000 were received as part of the contract price. The Shares Account is debited and the Joint Venture Account is credited with Rs.50,000. These shares

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were taken over by Hashim Ali for Rs.40,000. Hashim Ali's Account is debited and shares account credited with Rs.40,000. There was a loss of Rs.10,000 on the sale of shares, this is transferred to the Joint Venture Account by debiting the Joint Venture Account and crediting the Shares Account.

Illustration - 3

Pankaj and Manoj entered into a joint venture to purchase and develop certain lands as an industrial estate. For that purpose a Joint Bank Account was opened wherein Pankaj deposited Rs.1,50,000 and Manoj Rs.1,00,000. A piece of land measuring 25,000 square yards was purchased at Rs.10 per sq. yard. The following expenses were paid :

	Rs.
Cost of levelling the land	25,000
Compensation paid for vacating possession	10,000
Municipal taxes paid	2,000
Cost of fencing - paid by Pankaj	3,000
Architects fees - paid by Manoj	4,000
Stamp duty and solicitor's fees - paid by Pankaj	6,000

It was decided to sell the land in smaller plots of 500 sq. yards each. One-fifth of the area was left over for public roads. 15 plots were sold at Rs.20 per sq. yard through land brokers who were paid 2% brokerage on the sale price. Pankaj retained two plots for his personal use at an agreed price of Rs.15,000. The remaining plots were sold for Rs.1,80,000 directly to the buyers. There was an income from the sale of timber worth Rs.8,000. Pankaj and Manoj agreed to share profit or loss on the venture in proportion of the amounts invested by them. all transactions have been effected through the Bank. Prepare Joint Venture Account, Joint Bank Account and accounts of Pankaj and Manoj assuming that all accounts are settled.

Solution

Ledger Accounts in separate books of Joint Venture

Dr. JOINT VENTURE ACCOUNT Cr.

	Rs.		Rs.
To Joint Bank Account :		By Joint Bank Account :	
Cost of land 2,50,000		i) Sale of 15 plots @ Rs.20 per sq. yard 15 x 500 x 20 1,50,000	
Cost of levelling 25,000		Less : brokerage @ 2 % 3,000	
Compensation paid 10,000			1,47,000
Municipal taxes 2,000		ii) Sale of other plots	1,80,000
	2,87,000		3,27,000
To Pankaj's Account :		iii) Sale of timber	8,000
Cost of fencing 3,000			3,35,000
Stamp duty and Solicitor's fee 6,000		By Pankaj's Account (value of plots taken over)	15,000
	9,000		
To Manoj's Account (Architects fees)	4,000		
To Profit (transferred to Pankaj's Account) 3/5th share 30,000			
Manoj's Account 2/5th share 20,000	50,000		
	3,50,000		3,50,000

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Dr. **JOINT BANK ACCOUNT** **Cr.**

	Rs.		Rs.
To Pankaj's Account (amount contributed)	1,50,000	By Joint Venture Account Rs.	
To Manoj's Account (amount contributed)	1,00,000	Cost of land 2,50,000	
To Joint Venture A/c (sale proceeds of		Cost of levelling 25,000	
i) 15 plots 1,47,000		Compensation paid 10,000	
ii) other plots 1,80,000		Municipal taxes paid 2,000	
iii) timber 8,000			2,87,000
	3,35,000	By Pankaj's Account (final settlement)	1,74,000
		By Manoj's Account (final settlement)	1,24,000
	5,85,000		5,85,000

Dr. **PANKAJ'S ACCOUNT** **Cr.**

	Rs.		Rs.
To Joint Venture Account (Plot taken over)	15,000	By Joint Bank Account (amount contirbuted)	1,50,000
To Joint Bank Account (final settlement)	1,74,000	By Joint Venture Account Rs.	
		Cost of fencing 3,000	
		Stamp duty & solicitors' fees 6,000	
			9,000
		By Joint Venture Account (3/5th share of profit)	30,000
	1,89,000		1,89,000

Dr. **MANOJ'S ACCOUNT** **Cr.**

	Rs.		Rs.
To Joint Bank Account (final settlement)	1,24,000	By Joint Bank Account (amount contributed)	1,00,000
		By Joint Venture Account (architects' fees paid)	4,000
		By Joint Venture Account (2/5th share of profit)	20,000
	1,24,000		1,24,000

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Illustration - 4

Ajay, Vijay and Sanjay entered into a Joint Venture to purchase and sell goods and to divide profits equally. They bought goods from dinesh for Rs.1,78,000 and from Vijay for Rs.40,000. Ajay contributed Rs.60,000, Vijay Rs.50,000 and Sanjay Rs.80,000 which amounts were banked in a joint account. They settled their account with Dinesh by cheque and paid for carriage and other expenses amounting to Rs.8,000. They sold goods, for cash, for Rs.1,03,000 and to Uday on credit for Rs.2,15,000, who acccepted a Bill for the amount. The Bill was discounted for Rs.2,13,000. Ajay was allowed 5% commission on sales for effecting the transactions.

Pass journal entries and open accounts, assuming that the final settlement between parties was made by cheque.

Solution

JOURNAL ENTRIES

Date	Particulars		LF	Debit	Credit
				Rs.	Rs.
	Joint Venture Account	Dr.		2,18,000	
	To Dinesh's Account				1,78,000
	To Vijay's Account				40,000
	(Being cost of goods purchased on credit)				
	Joint Bank Account	Dr.		1,90,000	
	To Ajay's Account				60,000
	To Vijay's Account				50,000
	To Sanjay's Account				80,000
	(Being the amount contributed by Venturers and deposited in Bank account)				
	Dinesh's Account	Dr.		1,78,000	
	To Joint Bank Account				1,78,000
	(Being the payment made to Dinesh)				
	Joint Venture Account	Dr.		8,000	
	To Joint Bank Account				8,000
	(Being the carriage and other expenses paid)				
	Joint Bank Account	Dr.		1,03,000	
	Unday's Account	Dr.		2,15,000	
	To Joint Venture Account				3,18,000
	(Being goods sold for cash and to Uday on credit)				
	Bills Receivable Account	Dr.		2,15,000	
	To Uday's Account				2,15,000
	(Being Bill drawn on Uday)				
	Joint Bank Account	Dr.		2,13,000	
	Discount Account	Dr.		2,000	
	To Bills Receivable Account				2,15,000
	(Being the Bill discounted)				
	Joint Venture Account	Dr.		2,000	
	To Discount Account				2,000
	(Being the discount charged to Joint Venture Account)				

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Joint Venture Account	Dr.	15,900		
To Ajay's Account				15,900
(Being commission due to Ajay on sales)				
Joint Venture Account	Dr.	74,100		
To Ajay's Account				24,700
To Vijay's Account				24,700
To Sanjay's Account				24,700
(Being the distribution of joint venture profit equally among the venturers)				
Ajay's Account	Dr.	1,00,600		
Vijay's Account	Dr.	1,14,700		
Sanjay's Account	Dr.	1,04,700		
To Joint Bank Account				3,20,000
(Being the final settlement among the venturers)				

Dr. JOINT BANK ACCOUNT Cr.

	Rs.		Rs.
To Ajay's Account (amount contributed)	60,000	By Dinesh's Account (payment)	1,78,000
To Vijay's Account (amount contributed)	50,000	By Joint Venture Account (carriage and other exp.)	8,000
To Sanjay's Account (amount contributed)	80,000	By Ajay's Account (final settlement)	1,00,600
To Joint Venture Account (cash sales)	1,03,000	By Vijay's Account (final settlement)	1,14,700
To Bills Receivable Account	2,13,000	By Sanjay's Account (final settlement)	1,04,700
	5,06,000		5,06,000

Dr. JOINT VENTURE ACCOUNT Cr.

	Rs.		Rs.
To Dinesh's Account (goods purchased)	1,78,000	By Joint Bank Account (cash sales)	1,03,000
To Vijay's Account (goods supplied)	40,000	By Uday's Account (credit sales)	2,15,000
To Joint Bank Account (carriage and other exp.	8,000		
To Ajay's Account (commission @ 5% on sale	15,900		
To Discount Account	2,000		
To Profit transferred to :			
Ajay's A/c 24,700			
Vijay's A/c 24,700			
Sanjay's A/c 24,700			
	74,100		
	3,18,000		3,18,000

BRAND

Dr. DINESH'S ACCOUNT Cr.

To Joint Bank Account		Rs. 1,78,000	By Joint Venture Account		Rs. 1,78,000
		1,78,000			1,78,000

Dr. BILLS RECEIVABLE ACCOUNT Cr.

To Uday's Account (Bill drawn)		Rs. 2,15,000	By Joint Bank Account		Rs. 2,13,000
			By Discount Account		2,000
		2,15,000			2,15,000

Dr. DISCOUNT ACCOUNT Cr.

To Bills Receivable Account		Rs. 2,000	By Joint Venture Account (transferred)		Rs. 2,000
		2,000			2,000

Dr. UDAY'S ACCOUNT Cr.

To Joint Venture Account (credit sales)		Rs. 2,15,000	By Bills Receivable Account		Rs. 2,15,000
		2,15,000			2,15,000

Dr. AJAY'S ACCOUNT Cr.

To Joint Bank Account (final settlement)		Rs. 1,00,600	By Joint Bank Account (amount contributed)		Rs. 60,000
			By Joint Venture Account (commission)		15,900
			By Joint Venture Account (1/3rd share of profit)		24,700
		1,00,600			1,00,600

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Dr. VIJAY'S ACCOUNT Cr.

	Rs.		Rs.
To Joint Bank Account (final settlement)	1,14,700	By Joint Bank Account (amount contributed)	40,000
		By Joint Venture Account (goods supplied)	50,000
		By Joint Venture Account (1/3rd share of profit)	24,700
	1,14,700		1,14,700

Dr. SANJAYA'S ACCOUNT Cr.

	Rs.		Rs.
To Joint Bank Account (final settlement)	1,04,700	By Joint Bank Account (amount contributed)	80,000
		By Joint Venture Account (1/3rd share of profit)	24,700
	1,04,700		1,04,700

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27.5.2 Where No Separate Books Are Maintained

Under this system a separate set of books is not maintained for recording joint venture trasactions but the transactions are recorded in the books of each co-venturer as a part of his general business transactions. Such a system is generally followed, when co-venturers are not staying at one and the same place. Each venturer gives information to the other regarding the expenses incurred and income received by him towards the joint venture. On the basis of this information, the profit or loss on the venture can be ascertained and final settlement made.

Each venturer maintains (1) Joint Venture Account and (2) Other Co-Venturer's Account.

As stated earlier, The Joint Venture Account is in the nature of a nominal account. It is debited with expenses incurred and credited with income received. One point to be noted here is that if the Joint Venture Account is debited or credited in one venturer's book, it is also debited or credited in the books of the other co-venturer. Any expense incurred by one venturer is an expense for the joint venture, hence it is to be debited in the books of both the parties. Similarly, the income received by one venturer is an income for venture and hence Joint Venture Account should be credited in the books of both the venturers.

As we all know, a person will not open his own account in his own books. He will open the account of the other person to know how much amount he has to pay or receive from the other party. A venturer will also open in his books the account of the other co-venturer to know the amount payable by him or to him. The co-venturer's account is credited with the expenses incurred by him, his share of profit and debited with goods or joint venture property taken over by him and his share of loss, if any.

The entries to be passed under this method are explained in an illustrative manner.

Suppose A and B enter into a joint venture. Then A will open in his books a joint venture account and B's account. Similarly, B will open in his books a Joint Venture Account and A's account. The entries to be passed in their respective books will be as follows :-

1. When expenditure is incurred by A towards Joint Venture :

In the Books of A		In the Books of B	
Joint Venture Account To Cash Account/Bank Account or To Purchases Account (if goods belonging to A are supplied for the venture)	Dr.	Joint Venture Account To A's Account	Dr.

---

2. When expenditure is incurred by B on account of Joint Venture :

Joint Venture Account To B's Account	Dr.	Joint Venture Account To Cash Account/Bank Account or Purchases Account (if goods are supplied by B)	Dr.

---

3. If advance is received from B, say, in the form of Bill of Exchange :

Bills Receivbale Account To B's Account	Dr.	A's Account To Bills Payable Account	Dr.

---

4. If the Bill Receivable received from B is discounted:

Bank Account	Dr.	
Discount Account	Dr.	No Entry
To Bills Receivable Account		

---

5. The disocunt on the bills discounted should be charged to Joint Venture Account. It is to be treated as a loss of Joint Venture. The entry is:

Joint Venture Account To Discount Account	Dr.	Joint Venture Account To A's Account	Dr.

---

6. When money or income is received on account of joint venture by A :

Cash Account To Joint Venture Account	Dr.	A's Account To Joint Venture Account	Dr.

---

7. When income on account of Joint Venture is received by B :

B's Account To Joint Venture Account	Dr.	Cash Account/ Bank Account To Joint Venture Account	Dr.

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8. If any special commission is payable to B on account of Joint Venture :

Joint Venture Account	Dr.	Joint Venture Account	Dr.
To B's Account		To Commission Account	

---

9. If any interest is payable to A on account of Joint Venture ;

Joint Venture Account	Dr.	Joint Venture Account	Dr.
To Interest Account		To A's Account	

---

10. i) Sometimes some goods are left unsold and one of the parties takes them. Suppose the stock is taken over by A.

Purchases Account	Dr.	A's Account	Dr.
To Joint Venture Account		To Joint Venture Account	

---

ii) If the unsold stock is taken over by B :

B's Account	Dr.	Purchases Account	Dr.
To Joint Venture Account		To Joint Venture Account	

---

11. Now, the Joint Venture Account will show a profit or loss. It will be divided amongst the co-venturers in the agreed ratio. The entry is :

Joint Venture Account	Dr.	Joint Venture Account	Dr.
To B's Account		To A's Account	
(with B's share of profit)		(with A's share of profit)	
To Profit and Loss Account		To Profit and Loss Account	
(with A's share of profit)		(with B's share of profit)	

In case of loss, the above entry is reversed.

Note : One may have a doubt as to why in A's books A's share of Profit is transferred to the Profit and Loss Account and not to his personal account. As stated earlier, in A's books we do not open A's account. Hence, the profit is directly transferred to his Profit and Loss Account. At the end of the accounting period, the net profit made during the period including the profit on joint venture will be transferred to his capital account.

After passing the above entries, the amount payable by one venturer to the other venturer will be ascertained by finding out the balances in their respective books. If in 'A's books, B's account shows a debit balance, say of Rs.5,000 then in the books of B, 'A's account should show the same amount as a credit balance. In other words, the amount due from B(as shown by A's books) must be equal to the amount payable to A (as shown by B's books). Generally, the account is settled on the completion of the venture, and the venturer who has to make payment will pay the amount due to the other party. As a result of this, the personal accounts in their respective books will also be closed.

Illustration - 5

A bought goods of the value of Rs.8,000 and consigned them to B to be sold by him as joint venture, profits being divided in the ratio of 2/3rds and 1/3rds. ' A' also paid Rs.600 for freight and insurance and drew a Bill on B for Rs.5,000 on account. The Bill was discounted by A for Rs.4,800. B paid Rs.300 towards

dock dues, and Rs.400 towards rent. The sales realised amounted to Rs.16,000. B forwarded a sight draft for the balance due to A after charging 5% commission on sales.

Give journal entries and necessary ledger accounts in the books of A and B.

Solution

Journal entries in the Books of A

Date	Particulars		LF	Debit	Credit
				Rs.	Rs.
	Joint Venture Account	Dr.		8,600	
	To Bank Account				8,600
	(Being the cost of the goods purchased and expenses incurred towards Joint venture)				
	Bills Receivable Account	Dr.		5,000	
	To B's Account				5,000
	(Being a Bill drawn on B on account)				
	Bank Account	Dr.		4,800	
	Discount Account	Dr.		200	
	To Bills Receivable Account				5,000
	(Being the Bill discounted with the bank)				
	Joint Venture Account	Dr.		200	
	To Discount Account				200
	(Being the discount charged to Joint Venture Account)				
	Joint Venture Account	Dr.		700	
	To B's Account				700
	(Being the expenses incurred by B towards Joint Venture)				
	B's Account	Dr.		16,000	
	To Joint Venture Account				16,000
	(Being the sale proceeds on joint Venture received by B)				
	Joint Venture Account	Dr.		800	
	To B's Account				800
	(Being the commission due to B on sales at the rate of 5%)				
	Joint Venture Account	Dr.		5,700	
	To B's Account				1,900
	To Profit and Loss Account				3,800
	(Being the profit on joint venture transferred to B's account - 1/3rd share and 2/3rd to self, transferred to the Profit and Loss A/c)				
	Bank Account	Dr.		7,600	
	To B's Account				7,600
	(Being the draft received from B in settlement of this account)				

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Dr. JOINT VENTURE ACCOUNT Cr.

		Rs.		Rs.
To Bank A/c	Rs.		By B's Account - Sales	16,000
Purchases	8,000			
Freight and Insurance	600			
		8,600		
To Discount - discount on Bills discounted		200		
To B's Account				
Dock dues	300			
Rent	400			
		700		
To B's Account : Commission @ 5% on sales		800		
To Profit transferred to				
B - 1/3	1,900			
Profit and Loss A/c 2/3	3,800			
		5,700		
		16,000		16,000

Dr. B'S ACCOUNT Cr.

	Rs.		Rs.
To Joint Venture Account Sales	16,000	By Bills Receivable Account Advance	5,000
		By Joint Venture Account :	
		Dock dues 300	
		Rent 400	
			700
		By Joint Venture Account - Commission	800
		By Joint Venture Account : 1/3rd profit	1,900
		By Bank - final settlement	7,600
	16,000		16,000

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Journal Entries In The Books of B

Date	Particulars	LF	Debit	Credit
			Rs.	Rs.
	Joint Venture Account Dr.		8,600	
	To A's Account			8,600
	(Being the cost of the goods purchased and expenses incurred by A)			
	A's Account Dr.		5,000	
	To Bills Payable Account			5,000
	(Being a Bill drawn by A accepted)			
	Joint Venture Account Dr.		200	
	To A's Account			200
	(Being the discount on Bill discounted by A, charged to Joint Venture)			
	Joint Venture Account Dr		700	
	To Bank Account			700
	(Being expenses incurred towards joint Venture)			
	Bank Account Dr.		16,000	
	To Joint Venture Account			16,000
	(Being the sale proceeds received on account of joint venture)			
	Joint Venture Account Dr.		800	
	To Commission Account			800
	(Being the Commission due on sales charged to Joint venture.)			
	Joint Venture Account Dr.		5,700	
	To A's Account			3,800
	To Profit and Loss Account			1,900
	(Being the profit on joint venture transferred to A -2/3 rd and to self - 1/3rd, transferred to profit and loss account)			
	A's Account Dr.		7,600	
	To Bank Account			7,600
	(Being the amount remitted to A in settlement)			
	Bills Payable Account Dr.		5,000	
	To Bank Account			5,000
	(Being the Bill payable honoured on the due date)			

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Ledger Accounts

Dr. JOINT VENTURE ACCOUNT Cr

		Rs.		Rs.
To A's Account:			By Cash Sales	16,000
purchases	8,000			
Freight and Insurance	600			
		8,600		
To A's Account Discount		200		
To Bank Account:				
Dock Dues	300			
Rent	400			
		700		
To Commission		800		
To Profit transferred to:				
A 2/3rd share	3,800			
Profit & Loss Account 2/3 rd share	1,900			
		5,700		
		16,000		16,000

Dr. A'S ACCOUNT Cr

	Rs.		Rs.
To Bills Payable		By Joint Venture Account :	16,000
Advance	5,000		
To Bank Account final settlement	7,600	Purchases 8,000	
		Freight and Insurance 600	
			8,600
		By Joint Venture Account Discount	200
		By Joint Venture Account - 2/3rd profit	3,800
	12,600		12,600

Illustration - 6

Ram and Shyam entered into a speculative venture of underwriting the subscriptions at par of the entire share capital of the Kranti Mills, Ltd., consisting of 10,000 shares of Rs. 10 each and to pay all expenses upto allotment. The profits were to be shared by them in the proportion of 3/5ths and 2/5ths. The consideration in return for the guarantee was 1,500 other shares of Rs. 10 each fully paid to be issued to them.

Ram provided the funds for Registration Fees of Rs. 2,000; Advertising: Rs.1,500; Printing and distribution of prospectus: Rs.1,200 and other expenses; Rs.500. Shyam contributed towards the payment of office rent of Rs. 800; Legal charges: Rs.1,800; salaries of clerical staff: Rs.2,900.

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The prospectus was issued and the applications fell short of the full issue by 1,000 shares. Ram took these over on joint account and paid for the same in full. They received the 1,500 fully paid shares as underwriting commission. They sold their entire holding at Rs. 12 per share. The net proceeds were received by Ram for 1,500 shares and Shyam for 1,000 shares. Give the necessary accounts in the books of both the parties.

Solution

Ledger Accounts in the Books of Ram

Dr. JOINT VENTURE ACCOUNT Cr

	Rs.	Rs.		Rs.
To Bank A/c :			By Bank A/c	
Registration Fees	2,000		Sale proceeds of 1,500 shares @	
Advertising	1,500		Rs. 12 per share	18,000
Printing and distribution of Prospects	1,200		By Shyam's A/c	
Other expenses	500		Sale Proceeds of 1000 Shares @	
			Rs.12 per share	12,000
To Shaym's Account:		5,200		
Office rent	800			
Legel charges	1,800			
Salary of clerical staff	2,900			
		5,500		
To Bank- payment for 1,000 shares		10,000		
To Profit - transferred to				
ShyamA/c. 2/5th	3,720			
Profit and Loss Account 3/5th	5,580			
		9,300		
		30,000		30,000

Dr. SHYAM'S ACCOUNT Cr

	Rs.		Rs.
To Joint Venture -		By Joint Venture A/c Rs.	
Sale proceeds of 1,000 shares	12,000	Office rent 800	
		Legal charges 1,800	
		Salary of clerical staff 2,900	
			5,500
		By Joint Venture a/c 2/5th share of profit	3,720
		By Bank Account settlement	2,780
	12,000		12,000

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Ledger Accounts in the Books of Shyam

Dr. JOINT VENTURE ACCOUNT Cr

		Rs.		Rs.
To Ram's Account:			By Ram's Account:	
Registration Fees	2,000		Sale proceeds of 1,500 shares @ Rs. 12 per share	18,000
Advertising	1,500			
Printing and distribution of Prospects	1,200		By Bank	
Other expenses	500		Sale proceeds of 1,000 shares @ Rs. 12 per share.	12,000
		5,200		
To Bank:				
Office rent	800			
Legal charges	1,800			
Salary of clerical staff	2,900			
		5,500		
To Ram's Account Payment for 1,000 shares		10,000		
To Profit transferred to				
Ram- 3/5th	5,580			
Profit - and Loss Account -2/5th	3,720			
		9,300		
		30,000		30,000

Dr. RAM'S ACCOUNT Cr

	Rs.		Rs.
To Joint Venture Account-Sale proceeds of 1,500 shares.	18,000	By Joint Venture A/c Rs.	
To Bank Account settlement	2,780	Registration Fees 2,000	
		Advertising 1,500	
		Printing etc. 1,200	
		Other expenses 500	
			5,200
		By Joint Venture Account-Payment for 1,000 shares	10,000
		By Joint Venture Account-3/5th share of profit	5,580
	20,780		20,780

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Check Your Progress – 1
Fill in the blanks selecting from the following alternatives.

i) Joint Venture Account is.....

a) Nominal Account
b) Personal Account
c) Real Account

ii) Which account is debited, when goods are purchased for the joint venture. .....
.....

a) Joint Venture Account
b) Purchases Account
c) Venturer' s Capital Account

iii) Which account is credited When a venturer, recording the transactions, brings goods to the joint venture from his own stock .....

a) Joint Venture Account
b) Purchases Account
c) Venturer's Capital Account

27.5.3 Memorandum Joint Venture Method

This method is an alternative to the method discussed above.

Under this method each venturer will open in his books one account called 'Joint Venture With..... (name of the co-venturer) Account'. This is a personal account and prepared on the basis of double entry method. It should be noted that it is not a nominal account and that it should not be confused with the 'Joint Venture Account' opened under earlier methods. This account will not disclose the profit or loss on the venture. It will disclose only the amount due to or from the other party.

In the 'Joint Venture with ... A/c' each venturer records only those transactions which are effected by him. He will not pass any entry for the transactions effected by the other party. The other venturer will also record only those transactions which are effected by him. For example, if goods are purchased on account of Joint Venture by A, then this transaction will be recorded only in the books of A, it will not be recorded in the books of B, the other venturer. Similarly, for the goods purchased and expenses incurred by B, the entry will be made only in the books of B and not in the books of A.

The profit or loss on the venture is ascertained by preparing the Memorandum Joint Venture Account. This account is not prepared on the basis of double entry method. Debits and credits are not shared between this account and any other account. It is prepared on a 'rough' basis to ascertain the profit or loss on the venture, that is why it is styled as 'Memorandum Joint Venture Account'. For the purpose of preparing 'Memorandum Joint Venture Account' each venturer sends to the other venturer a copy of the transactions effected by him. The expenses are shown on the debit side and income on the credit side. The balance of this account is the profit or loss on the venture. The profit or loss on the venture is divided among the co-venturers in the agreed ratio. After knowing the profit or loss on the venture, each venturer makes a journal entry in his books for his share of profit or loss. The Memorandum Joint Venture Account is same for both the parties. It is not necessary to prepare it separately in the books of each party.

If A and B have entered into Joint Venture, then the entries in the books of A will be as follows:

1. For goods supplied by A from his stock:
   Joint Venture with B Account ..... Dr.
   To Purchases Account.

2. For amount spent by A towards Joint venture:
   Joint Venture with B Account Dr.
   To Cash/Bank Account

3. For Bill drawn by A on B as advance:
   Bills Receivable Account Dr.
   To Joint Venture with B Account

4. For charging the discount of the Bill discounted by A:
   Joint Venture with B Account Dr.
   To Discount Account

5. For sales made or cash received by A:
   Cash/Bank Account Dr.
   To Joint Venture with B Account

6. For commission receivable by A:
   Joint Venture with B Account Dr.
   To Commission Account

7. a) For the share of profit of A:
   Joint Venture with B Account Dr.
   To Profit & Loss Account

b) For the loss:
   Profit & Loss Account Dr.
   To Joint Venture with B Account.

Similarly, B will also open an account in his books called "Joint Venture with A Account" and make entries for the transactions effected by him.

Illustration No. 6 is worked out according to Memorandum Joint Venture Method.

Solution

The Memorandum Joint Venture Account which will be the same for both Ram and Shyam is prepared here under.

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Dr. MEMORANDUM JOINT VENTURE ACCOUNT Cr

		Rs.		Rs.
To Ram:			By Ram:	
Registration Fees	2,000		Sale proceeds of 1,500 shares	18,000
Advertising	1,500		By Shyam:	
Printing etc.	1,200		Sale proceeds of 1,000 shares	12,000
Other expenses	500			
		5,200		
To Shyam:				
Rent	800			
Legal charges	1,800			
Salary	2,900			
		5,500		
To Ram - payment for 1,000 shares		10,000		
To Profit - transferred to				
Ram- 3/5th	5,580			
Shyam 2/5th	3,720			
		9,300		
		30,000		30,000

In the Books of Ram

Dr. JOINT VENTURE WITH SHYAM ACCOUNT Cr.

		Rs.		Rs.
To Bank Account:			By Bank	
Registration Fees	2,000		Sale proceeds of 1,500 shares @ Rs. 12 per share	18,000
Advertising	1,500		By Bank - settlement	2,780
Printing etc.	1,200			
Other expenses	500			
		5,200		
To Bank Account: Payment for 1,000 shares		10,000		
To Profit & Loss 3/5 share of profit		5,580		
		20,780		20,780

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In the Books of [illegible]

Dr. JOINT VENTURE WITH RAM ACCOUNT Cr

	Rs.		Rs.
To Bank Account:		By Bank	
Rent 800		Sale proceeds of	
Legal charges 1,800		1,000 shares @	
Salary 2,900		Rs. 12 per share	12,000
	5,500		
To Profit and Loss			
Account - 3/5th			
share of profit	3,720		
To Bank -settlement	2,780		
	12,000		12,000

Check Your Progress – 2

Write the correct answer selecting from the following alternatives.

i On what basis the Memorandum Joint Venture Account is prepared

a) On the basis of double entry method
b) Not on the basis of double-entry method
c) On the basis of single entry system

---

ii) In the case of memorandum Joint Venture method, how many accounts each co-venturer opens in his bookswhen there are three co-venturers.

a) One Account
b) Two Accounts
c) Three Accounts.

27.5.4 Where only One Party Maintains The Books

Under this method, only one of the co-venturers records all the transactions of the Joint Venture. such a method is followed when most of the buying and selling on account of Joint Venture is done by one co-venturer. Other co-venturers contribute only their share of investment in the joint venture. The co-venturer managing the business is usually allowed an extra remuneration for his services. The accounts maintained by him are:

(1) Joint Venture Account and
(2) Personal accounts of all other co-venturers.

The Joint Venture Account reveals the profit or loss on the venture and the personal account of the other co-venturers show the amount due to or from the other venturer or venturers.

The journal entries to be passed in the books of the co-venturer maintaining the records are as follows:

BRAOU

1. For receiving cash from other co-venturers as their share of investment:

Cash Account	Dr.	(with their respective
To Other co-venturers Personal Accounts		contributions)

2. For purchase of goods:

a) Cash Purchases :

Joint Venture Account	Dr.
To Cash Account	

b) Credit purchases:

Joint Venture Account	Dr.
To Supplier's Account	

3. For the supply of the goods by other co-venturer(s)

Joint venture Account	Dr.
To Other co-venturer's Personal Account	

4. For the supply of the goods by the venturer keeping the accounts:

Joint venture Account	Dr.
To Purchases Account	

5. For expenses paid on account of Joint Venture:

Joint Venture Account	Dr.
To Cash Account	

6. For payment of expenses by other co-venturer:

Joint Venture Account	Dr.
To Other Venturer's Personal Account	

7. For sale of goods:

a) Cash Sales:

Cash Account	Dr.
To Joint Venture Account	

b) Credit Sales:

Debtor's Account	Dr.
To Joint Venture Account	

8. For the unsold stock taken over by the venturer keeping the accounts

Purchases Account	Dr.
To Joint Venture Account	

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9. For the unsold stock taken over by the other co-venturer:

Other Co-venturer's Personal Account	Dr.	
To Joint Venture Account		

10. For Commission due to the Venturer keeping the accounts:

Joint Venture Account	Dr.	
To Commission Account		

11. For the profit on the venture:

Joint Venture Account	Dr.	
To Profit & Loss Account		(with the share of profit of venturer keeping accounts)
To Other Co-venturers Personal Accounts		(with their respective shares of profit)

NOTE: In case of loss, the above entry is reversed.

12. After completion of the venture, the amount due to other co-venturers is ascertained and payment is made to them. The entry is :

Other Co-venturer's Personal Accounts	Dr.	
To Cash Account		

Illustration - 7

X and Y enter into a Joint Venture for the purchase of certain goods in Hyderabad to consign them to Z of Bombay for sale by him on commission of 10% on sales. X invests Rs. 25,000 and receives a similar sum from Y as his investment. X purchases goods worth Rs. 50,000 and sends them to Z paying Rs. 5,000 towards freight and other expenses. Y also sends goods costing Rs. 10,000 to Z by incurring an expenditure of Rs. 1,500.

Z sells 3/4 th of the consignment for Rs. 80,000 and remits the amount due to X after deducting his commission. The remaining goods are returned to X who sells a part of them for Rs. 20,000. Y agreed to allow X commission @ 5% on sales effected by him. Y took over the unsold stock at a value of Rs. 6,000. Assuming the account was settled between the two, show the ledger accounts in the books of X.

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Solution

Ledger of X

Dr. JOINT VENTURE ACCOUNT Cr.

		Rs.		Rs.
To Bank Account:			By Bank Account:	
Purchase of Goods		50,000	Amount received from Z	
			Sales made by Z 80,000	
Freight, etc.	5,000		Less: Commission at 10% 8,000	
		55,000		72,000
" Y's Account:			By Bank Account	
Goods		10,000	Sale of part of the	
Expenses	1,500	11,500	goods returned by Z	20,000
			"Y's Account	
" Commission(5% on 20,000)		1,000	Unsold stock taken over	6,000
" Profit - transferred to				
Y 1/2 share		15,250		
Profit and Loss				
account 1/2 share	15,250	30,500		
		98,000		98,000

Dr. Y's ACCOUNT Cr.

To Joint Venture Account -			By Bank Account Advance	25,000
Stock taken over		6,000	By Joint Venture Account:	
" Bank Account -			Cost of goods 10,000	6.
Settlement		45,750	Expenses 1,500	
				11,500
			" Joint Venture Account:	
			1/2 share of profit	15,250
		51,750		51,750

27.6 SUMMING UP

Joint venture is a temporary partnership between two ro more persons who come together for a specific venture. As soon as the venture is completed the association comes to an end. The parties to a joint venture are called 'co-venturers'. Joint venture transactions can be recorded according to any one of the following methods: (a) where seperate books for the venture are kept; (b) where no separate books are kept and (c) where only one party maintains the books.

Under the first method, i.e., where separate books are kept the following accounts are maintained. i) Joint

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Venture Account, which is in the nature of nominal account, is prepared to know the profit or loss on the venture. ii) Joint bank account, is opened to record the amount received or paid during the conduct of the venture; iii) personal accounts of the co- venturers are opened to record the amount contributed by them and expenses incurred by them towards joint venture and their share of profit or loss on the venture. Final settlement is made through the Joint Bank Account.

Under the second method, where separate books are not maintained, the transactions are recorded in the books of each venturer as apart of his general business transactions. Each party prepares i) the joint venture account and (ii) the other co-venturer's account, under this system. There is an alternative method of recording joint venture transactions called the 'Memorandum Joint Venture Method'. Under this method, the profit or loss on the venture is ascertained by preparing the memoradum joint venture account, which is the same for both the parties. Each venturer will open in his books one account called 'Joint Venture with---(Name of the co-venturer) Account'. It is not a nominal account but a personal account. It is prepared only to know the amount due to or from the other party.

Under the third method, i.e., where only one co-venturer maintains the books, all records relating to the venture are maintained by one co-venturer. The accounts maintained by him are (i) Joint Venture Account; and (ii) Personal Accounts of all the other co-venturers.

27.7 ANSWERS TO CHECK YOUR PROGRESS

1. i) Nominal Account
   ii) Joint Venture Account
   iii) Purchases Account
2. i) b) Not on the basis of double entry method
   ii) a) One account.

27.8 MODEL EXAMINATION QUESTIONS

A. Short Answer Questions

1. What is joint venture?
2. What is the purpose of preparing the 'Joint Venture Account'?
3. What is Joint Bank Account and when is it prepared ?
4. What is meant by 'separate books maintained for joint venture' ?
5. What accounts are, generally opened when separate books are kept for recording the joint venture transaction s?
6. What is Memorandum Joint Venture Account ?
7. What kind of accounts are prepared in the books of each co-venturer when no separate books are kept for recording joint venture transactions?
8. What is 'Memorandum Joint Venture' Method ?
9. How is the profit on the venture and the amount due to or from the other co-venturer or ascertained when the 'Memorandum joint venture method is followed for recording joint venture transactions?
10. Ram and Ranga have entered into a joint venture agreement. Ram purchases goods worth Rs. 10,000 on account of Joint venture what journal entry is passed when:
    a) Separate set of books are kept for the joint venture.
    b) When Joint Venture records are maintained separately by Ram and Ranga.
    c) When records are maintained by Ram only.

B. Essay Answer Questions

11. Define Joint Venture and Distinguish it from consignment and partnership.
12. Explain the different methods of recording Joint Venture transactions.

Problems

1. Viswanath and Satyanarayana doing business separately as building contractors, undertake jointly to construct a building for a newly started joint stock company, for a contract price of Rs. 1,20,000 of which Rs. 90,000 is payable by instalments in cash and Rs. 30,000 in fully paid up shares of the company. A banking account is opened in their joint names, Viswanath paying in Rs. 30,000 and Satyanarayana Rs. 20,000. They are to share the profits and losses in the proportion of 2/3 and 1/3. Their transactions were as follows:

	Rs.
Paid wages	24,000
Bought materials	60,000
Materials, supplied by Viswanath	6,000
Materials supplied by Satyanarayana	3,000
Architect's fees paid by Viswanath	4,000

The contract was completed and the price (cash and shares) duly received. The joint venture is closed by Viswanath taking up all the shares of the company at an agreed valuation of Rs. 24,000 and Satyanarayana taking up the stock of materials at an agreed price of Rs. 7,000. Pass journal entries and prepare the necesary ledger accounts.

(Answer: Profit Rs.24,000, Final payment to Viswanath : Rs. 32,000 and to Satyanarayana Rs. 24,000)

2. Krishna Dutt and Satish undertook jointly to construct a building for ideal Engineering Company for a contract price of Rs. 9,00,000 of which Rs. 7,00,000 was payable by instalments in cash and Rs. 2,00,000 in debentures of the company. A joint bank account was opened in their names with Krishna Dutt paying in Rs. 2,50,000 and Satish Rs. 1,50,000. They were to share profits and losses equally. Their transactions were as follows:-

Bought materials	6,50,000
Paid wages	2,50,000
Materials supplied by Krishna Dutt	45,000
Architect's fees paid by Satish	20,000

The contract was completed and the price duly received. The joint venture was closed by Krishna Dutt taking up all the debentures of the company at an agreed valuation of Rs. 1,60,000 and Satish taking up the stock of materials at an agreed valuation of Rs. 25,000.

Prepare the Joint Venture Account, Joint Bank Account and accounts of Krishna Dutt and Satish, showing the final distribution of cash.

(Answer: Loss Rs. 80,000; Final payment to Krishna Dutt: Rs. 95,000; Satish: Rs. 1,05,000).

3. Guru Raj and Vasanth Kumar undertook the Construction [illegible] for Sudershan Nagar [illegible] Ltd., for a contract price of Rs. 3,00,000 of which Rs.2,00,000 [illegible] payable by instalments [illegible] 1,00,000 in advance. The company, General Engineering [illegible] Ramanath Kumar Rs. 60,000 as earnest [illegible] banking account opened for the purpose. They were to [illegible] and losses equally. The following amounts were spent from the joint bank account:

Wages [illegible] Rs. 1,60,000 and Plant [illegible] Guru Raj paid the contractor's fees [illegible] Rs. 2,000 and Vasanth Kumar supplied materials [illegible] Rs. 10,000.

[illegible] was effected by Guru Raj [illegible] was taken over by Vasanth Kumar [illegible] was sold for Rs. 20,000. [illegible] Kumar also took over the [illegible] at a mutually agreed price of Rs. 6,000. Vasanth Kumar [illegible] was to be paid Rs. 12,000 [illegible] towards [illegible] Rs. 5,000 was charged to the joint [illegible] account. The Contract [illegible] completed. Prepare the necessary [illegible].

(Answer : Profit [illegible] Guru Raj Rs. 38,700 and to Vasanth Kumar Rs. 38,700)

4. Ajay Sharma, Pragwal [illegible] entered into a joint [illegible] agreed to divide profits in the ratio of 6 : 3 : 1 respectively. They agreed to contribute the following [illegible] which were put in a joint banking account [illegible] Rs 14,000 ; Pragwal : Rs.10,000 [illegible] Rs.4,000.

[illegible] 30,000, the payment for [illegible] made from the joint bank account. [illegible] 200, a part of the [illegible] spoiled and were taken away by Ajay Sharma for Rs.[illegible] [illegible] losses were paid by [illegible] venturers : Ajay Sharma [illegible] Pragwal : Rs.200 and Naveen : Rs.100.

You are required to prepare ledger accounts which a separate [illegible] its main [illegible]

(Answer : [illegible] cheques to Ajay Sharma [illegible] Rs.10,700 ; Pragwal : Rs.4,700 and Naveen : Rs. [illegible]

5. Sanjay Varma, Subhash and Suresh entered into a [illegible] to divide profits equally. They bought goods from Dinesh for Rs.2,00,000 and from Sanjay Varma for Rs.50,000. Sanjay Varma contributed Rs. [illegible] Rs.80,000 and Suresh Rs.70,000, which [illegible] were banked in a joint account. They opened accounts with Dinesh by cheque and paid for carriage and other expenses amounting to Rs.10,000. Sanjay sold goods worth Rs.2,40,000 for cash and to Ramesh on credit for Rs.90,000, who accepted a bill [illegible] for the amount. The Bill was discounted with the bank for Rs.[illegible]. Sanjay [illegible] commission on sales and [illegible] the accounts [illegible] and [illegible] accounts showing the final settlement between parties [illegible] by cheque.

(Answer : Profit : Rs.23,100 ; Final Settlement : Sanjay Varma : Rs.1,76,300 ; Subhash : Rs.89,700 and Suresh : Rs.87,700)

6. [illegible] and Karan entered into a [illegible] in the ratio of 1/3rd and 2/3rd. [illegible] Rajubhai and [illegible] and [illegible] Kishore purchased [illegible] Karan received the [illegible] Kishore got it discounted for Rs.14,700. Karan settled [illegible] Rs.35,000. He had to spend Rs.700 towards fire insurance and Rs.300 towards rent. Under the agreement he was entitled to a commission of 5% on sales.

Give journal entries and ledger accounts in the books of Kishore and Karan.

(Answer : Profit : Rs.[illegible] ; Amount due from Karan : Rs.13,240).

7. Pradeep and Prakash [illegible] a joint venture for [illegible] other goods at a price of Rs.3,00,000 [illegible] Rs.1 each in Maruthi Ltd. They agreed to share profits and losses equally. The terms of agreement were that Pradeep and Prakash had to pay all expenses upto shipment in

consideration of Matrushi, Ltd., issuing to them 1,00,000 other shares of Re.1 each fully paid. Pradeep used cash to meet the following expenses :

Rent : Rs.3,000 ; Solicitors charges : Rs.5,000
Prakash incurred the following expenses :
Stamp charges : Rs.4,000 ; Advertising : Rs.2,500 ;
Printing charges of Memorandum of Association , etc., : Rs.6,000

The applications fell short of 5,00,000 shares by 20,000 shares. Pradeep used a further amount in cash on joint account for these shares. The amount was utilised to subscribe to these shares and paid to the company. The guarantee having been fulfilled, Matrushi, Ltd., handed over to Prakash and Pradeep 1,00,000 shares.

The partnership sold all the shares, Pradeep received the sale proceeds of 90,000 shares amounting to Rs.80,000 and Prakash of the remaining 30,000 shares amounting to Rs. 20,500.

Prepare the necessary ledger accounts in the books of Pradeep and Prakash.

(Answer : Profit : Rs.60,000 : Amount due to Prakash : Rs.22,000)

8. Ramakanth and Ravinder enter into a joint venture as dealers in land with effect from the 1st of January, 1989. On the same day, Ramakanth advanced Rs.2,20,000 and a plot of land measuring 12,000 sq. yards was purchased with this money. It was decided to sell the land divided into smaller plots and a [illegible] got prepared at a cost of Rs.5,200 paid by Ravinder. In the said plan [illegible] of the land was left over for public roads and the remaining land was divided into 5 plots of equal size. On the 1st of April, 1989 two of the plots were sold at Rs.45 per sq. yard, and the amount of Rs.2,000 per plot for stamp duty and registration expenses was agreed to be borne by the sellers. The remaining plots were sold at a net price of Rs.40 per sq. yard on the 30th of June, 1989. The sale proceeds of all the plots were received by Ramakanth. Ravinder was entitled to a commission of 5% on the net sale proceeds of plots. The net profit of the joint venture was to be shared in the proportion of 3/4 to Ramakanth and 1/4 to Ravinder.

Draw up the Memorandum Joint Venture account and personal accounts in the books of Ramakanth and Ravinder showing the amount payable by one to the other.

Assume that the joint venture was completed on the 30th of June, 1989.

(Answer : Profit : Rs.1,70,000 ; amount due to Ravinder : Rs.68,500)

9. Lalchand and Premchand agreed to enter into a joint venture for the purchase and sale of second hand motor cars and to share profits in the ratio of 3 : 2

On the 1st of January, 1989 Lalchand bought 3 cars for Rs.1,60,000 and on January 5th he paid tax and insurance amounting to Rs.8,000. On the 15th of March he sold these cars for Rs.2,10,000 of which he remitted Rs.30,000 to Premchand, paying the balance into his own bank account.

On January 20, 1989 Premchand bought 5 cars for Rs. 2,50,000 and on January 28th he paid tax and insurance amounting to Rs.10,000 and for repairs Rs.12,000. He sold three cars on March 2, 1989 for Rs.2,20,000 which he paid into his own bank account. It was agreed that Lalchand should take over the other cars at a valuation of Rs.80,000 and the venture was closed on March 31, 1989.

You are required to prepare :

i) The Memorandum Joint Venture account and
ii) The Account of Joint Venture with Premchand in the books of Lalchand.

(Answer : Profit: Rs.30,000 ; Amount paid to Premchand : Rs.50,000).

27.9 RECOMMENDED BOOKS

1. RL Gupta and VK Gupta : 'Principles and Practice of Accountancy' (Sultan Chand & Sons, New Delhi)

2. TS Grewal : 'Introduction to Accountancy' (Sultan Chand & Co, New Delhi)

3. VA Patil and JS Korlahalli : 'Principles and Practice of Accountancy'

4. SN Maheswari : 'Advanced Accountancy' Volume one, (Vani Educational Books, New Delhi).

27.10 GLOSSARY

1. **Co-venturers** : The parties to a Joint Venture are called "Co-Venturers".

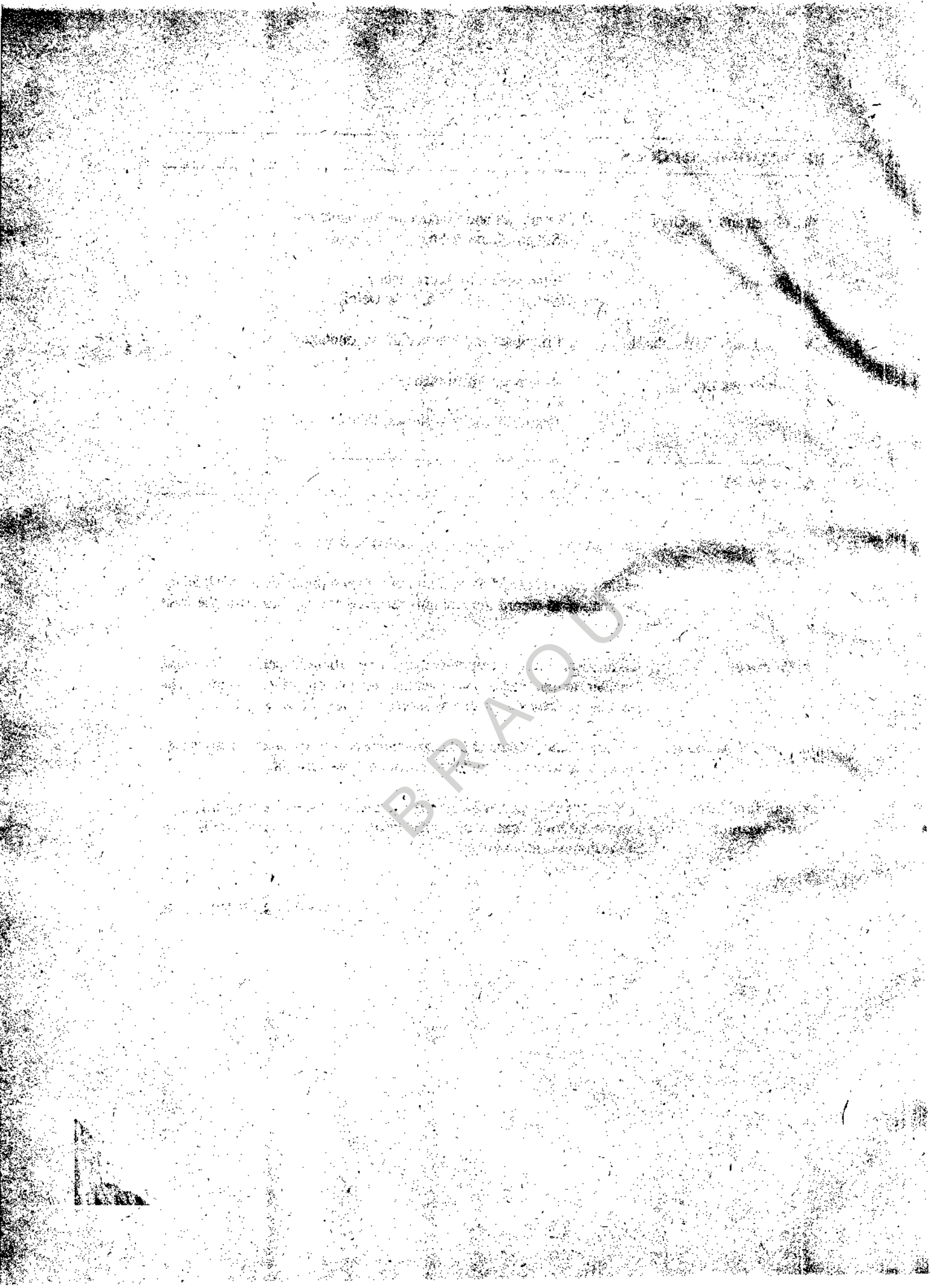
2. **Joint Bank Account** : It is an account opened by co-venturers when separate books are kept for the venture to record the amounts received and paid towards the joint venture.

3. **Joint Venture** : It is an association of temporary nature of two or more persons who come together to undertake some venture or job on joint account. The association comes to an end as soon as the venture is closed.

4. **Joint Venture Account** : It is an account prepared by the co-venturers to ascertain the profit or loss on the venture and is similar to profit and loss account.

5. **Memorandum Joint Venture Account** : It is an account opened by the Co-venturers to ascertain the profit or loss on the Joint Venture on 'rough' basis. It is not prepared on the basis of the double entry system.

Writer : Sri R.P. Trivedi.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Dr. B.R. AMBEDKAR OPEN UNIVERSITY
B.COM. II YEAR

GROUP -A : COURSE - 2 : ACCOUNTANCY
SYLLABUS

BLOCK - I : INTRODUCTION TO ACCOUNTANCY
Unit -1 : Accounting - An Overview
Unit - 2 : Journal
Unit - 3 : Ledger

BLOCK - II : SUBSIDIARY BOOKS
Unit - 4 : Sub-division of Journal
Unit - 5 : Cash Book - I
Unit - 6 : Cash Book - II
[illegible] : Bank Reconciliation Statement - I
[illegible] : Bank Reconciliation Statement - II
Unit - 9 : Bills of Exchange
Unit - 10 : Accommodation Bills
Unit - 11 : Trial Balance

[illegible] : FINAL ACCOUNTS
Unit - 12 : Capital and Revenue
Unit - 13 : Trading Account and Manufacturing Account
Unit - 14 : Profit and Loss Account
Unit - 15 : Balance Sheet
Unit - 16 : Adjustments - I
Unit - 17 : Adjustments - II
Unit - 18 : Comprehensive Problems
Unit - 19 : Errors and their Rectification
[illegible] : Suspense Account and Effect of Rectification on profit.

BLOCK - IV : OTHER ACCOUNTING TOPICS
Unit - 21 : Provisions and Reserves
Unit - 22 : Sinking Funds
Unit - 23 : Depreciation
Unit - 24 : Methods of Providing Depreciation
Unit - 25 : Consignment Accounts - I
Unit - 26 : Consignment Accounts - II
Unit - 27 : Joint Ventures

* * *

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Dr. B.R. AMBEDKAR OPEN UNIVERSITY
MODEL QUESTION PAPER
ACCOUNTANCY - B.COM. II YEAR
GROUP - A : PAPER - II

SECTION - A

Answer any four of the following :

Each Question carries 15 marks.

Answer these questions in about 20 lines.

1. **What are the principles to be kept in mind at the recording stage ?**

2. **What is a Trial Balance ? Why is it prepared ? Is the agreement of Trial Balance a conclusive proof of the accuracy of accounts ?**

3. **Bring out the distinction between provision, reserve and reserve fund, with suitable examples.**

4. **From the following Trial Balance and the additional information given below, prepare the final accounts of Sunder, relating to the year 1989.**

	Dr. Rs.	Cr. Rs.
Capital	—	50,000
Sales	—	3,50,000
Adjusted purchases	3,00,000	—
Salaries	12,000	—
Discounts	2,000	1,000
Expenses outstanding	—	2,000
Furniture	10,000	—
Prepaid insurance	200	—
Insurance	4,000	—
Debtors and creditors	25,000	10,000
Depreciation	1,000	—
Bank	—	2,000
Stock at 31.12.1988	60,000	—
Cash	800	—
	4,15,000	4,15,000

Additional information :

a) On December 25, 1989 a fire broke out and destroyed stock of the value of Rs.10,000. The Insurance Company admitted the claim for loss of stock of the value of Rs.8,000 only, and paid the amount on 2.1.1990.
b) Goods withdrawn for personal use Rs.1,000 for which no record was made.
c) The Manager is entitled to a commission of 5% on the net profits, after charging such commission.

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5. From the following particulars ascertain the bank balance in the pass book of X as on 31st December, 1989.

1) The Bank overdraft as per cash book on 31st December, 1989 was Rs. 6,000.
2) Interest on overdraft for six months ending 31st December 1989, Rs.200 is debited in the pass book
3) Bank Charges for the above period, also debited in the pass book amount to Rs.5
4) Cheques issued but not cashed, prior to 31st December 1989 amounted to Rs.15,0
5) Cheques paid into the bank, but not cleared and credited before 31st December, 1989 were for Rs.25,000.
6) Interest on investments collected by the bankers and credited in the Pass Book amounted toRs.3,000.
7) A customer has deposited directly in the bank account a sum of Rs.4,000 and this was not yet recorded in the cash book.

6. The following errors were detected in the accounts of Reddy & Sons for the year ended December 31, 1989 :

a) Goods worth Rs.300 returned by Ramprasad were put into the stock room, but no entry was made in the books ;
b) Repairs to plant and machinery amounting to Rs.875 has been charged to plant and machinery account ;
c) Wages paid to the firm's own workmen for certain additions to machinery amounting to Rs. 1,860 were posted to wages account :
d) A cheque for Rs.530 received from Ram Mohan was posted to the account of Ram Nivas and debited to cash instead of bank account :
e) A sum of Rs.850 drawn by the proprietors was debited to travelling expenses account.

Give necessary journal entries to correct the above errors and show the effect of correction on net profit.

7. Girish for the purpose of mutual accommodation of himself and Sirish drew upon the latter Bill for 3 months for Rs.8,000/- dated the 1st of January, 1989. The Bill was discounted by Girish @ 5% and half the proceeds was remitted to Sirish. Sirish at the same time drew a Bill at 3 months on Girish for Rs.4,000/-. After securing the acceptance, the Bill was discounted at 6% by Sirish who remitted half the proceeds to Girish. Sirish became bankrupt on March 31 and 25 paise in the rupee was received on the 15th May as the first and final dividend from his estate.

Write up journal entries in the books of Girish and open Sirish's A/c, and open Girish's A/c in the Books of Sirish.

8. A, B and C enter into a joint venture to divide profits equally. They bought goods from D & Co., for Rs.12,50,000 and from A for Rs.2,50,000. A contributed Rs. 3,00,000, B Rs.4,00,000 and C Rs. 9,00,000, which amounts were banked in a joint account. They settled their account with D & Co., by cheque and paid for carriage and other expenses Rs. 75,000. They sold goods for cash Rs.6,50,000 and to Q & Co., on credit for Rs.14,00,000 who accepted a Bill for the amount. The acceptance was encashed and realized Rs.13,70,000. A was allowed 5% commission on sales for effecting the transactions.

Open the necessary accounts, assuming that the final settlement between the parties was made by cheques.

SECTION - B

Answer any five of the following :

Each Question carries 8 marks.

Answer theory questions in about 5 lines.

1. Explain the need for accounting in a business.
2. Give the rules of debit and credit and explain them with examples.
3. Distinguish between debit note and credit note.
4. What is a Journal Proper ? Explain its uses in Accountancy.
5. Distinguish between provision and Reserve.
6. Ascertain the cost of goods sold from the following figures :

	Rs.
Opening Stock	20,000
Purchases	1,75,000
Carriage inward	5,000
Closing Stock	23,000
Sales	2,10,000

7. The following figures are given

		Rs.
1.1.1989	Provision for doubtful debts	3,600
	Bad Debts written off during the year	600
31.12.1989	Sundry Debtors	25,800
	Bad Debts to be written off for the year	1,800

The provision for doubtful debts is to be maintained at 5% on debtors.

Show the provision for doubtful debts account.

8. On 1.1.[illegible], a Machine was purchased for Rs.1,00,000. Rs.10,000 were spent towards erection charges. Its working life is 10 years. Estimated scrap value was Rs.12,000. It has been decided to depreciate it, at the rate of 10 per cent on diminishing balance method. Show the Machinery Account for the first three years.

9. The drawings of the proprietor of a business for theyear 1989 are Rs.15,000. Capital at the end of the year Rs.70,000. Profit for the year Rs.25,000. Calculate capital at the beginning of the year.

10. On 1st June 1989, "P" Sold goods to "Q" for Rs.3,000. 'Q' gave his acceptance for the Bill payable two months after date. Before maturity, Q requests P to renew it, which P does, adding Rs.300 towards interest. This renewed Bill was dishonoured on the due date.

Show the Ledger Accounts in the Books of Q.

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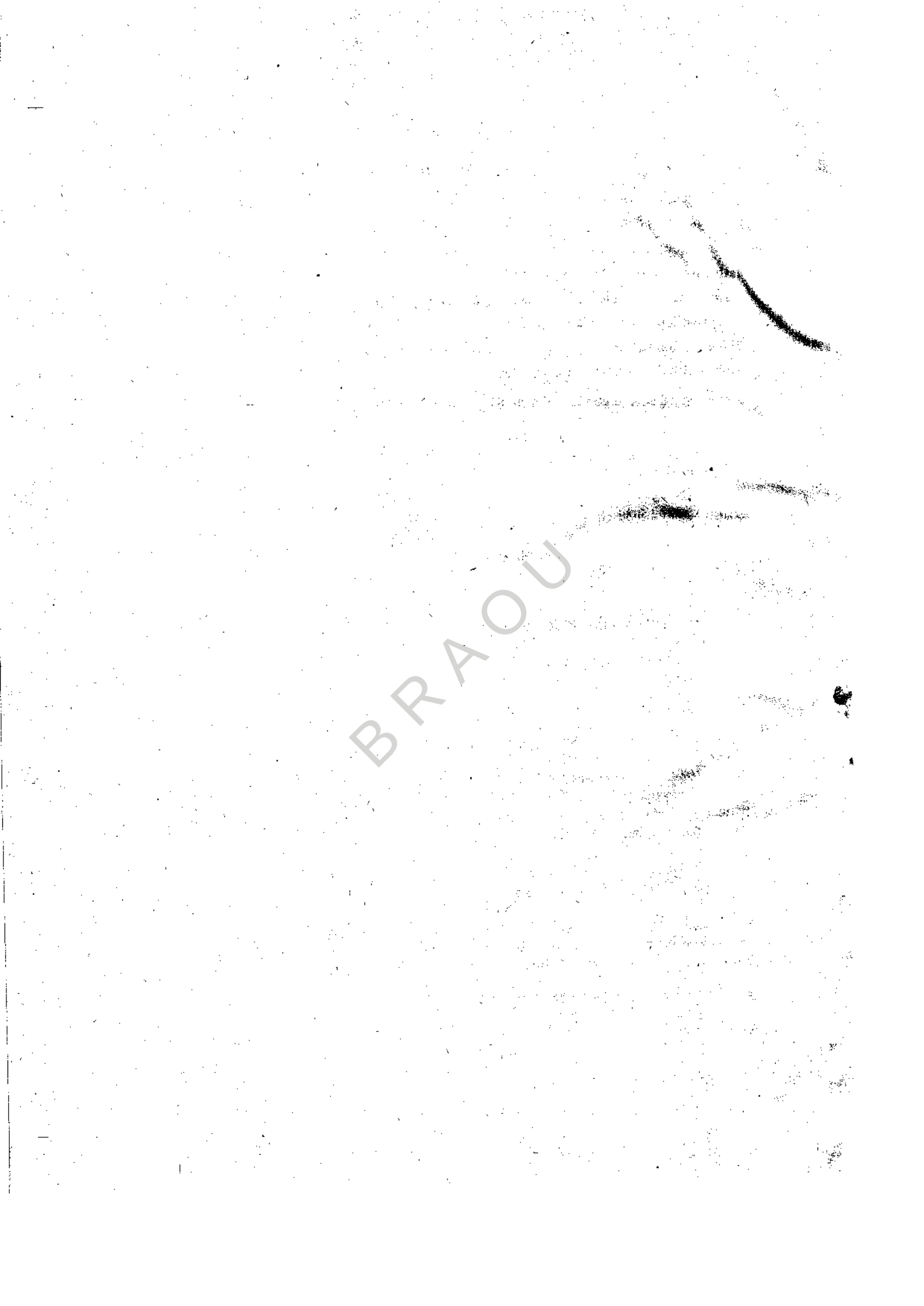
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Dr. B.R. AMBEDKAR OPEN UNIVERSITY
UNDER GRADUATE COURSE
B.Com. II Year

SUBJECT : COMMERCE
COURSE: ACCOUNTANCY

ASSIGNMENT - I

N.B.

1. Do not copy the answer directly from any of the books.
2. As far as possible try to answer the questions independently in your own words.
3. If it is necessary to quote from any source, give the correct reference.
4. Use your own foolscap pages for writing the assignment.
5. Leave sufficient margin for the comments of the evaluator.
6. Completion of this assignment normally should not take more than two hours time.

SECTION -A

Answer the theory question in about 30 lines.

1. What is a Trial Balance ? Is the agreement of Trial Balance a conclusive proof of the accuracy of accounts?

2. From the following information, supplied by Gopal prepare a bank reconciliation statement as on 31.12.1989.

	Rs.
i) Bank overdraft as per Pass Book	16,500
ii) Cheques issued but not presented for payment	8,750
iii) Cheques deposited with the bank but not collected	10,500
iv) Cheques recorded in the Cash Book but not sent to the bank for collection	2,000
v) A direct deposit by a customer of Rs. 3,500 does not appear in the Cash Book	
vi) Bank charges debited in Pass Book only	20
vii) Premium on life policy of Gopal paid by the bank on standing advice	180

2. Prepare the three column Cash Book from the following transactions and balance the accounts.

1990		Rs.
Jan.1	Cash in hand	3,500
Jan 1	Cash at Bank	10,000
Jan 3	Paid into Bank	1,000
Jan.6	Bought furniture and issued cheque	3,000
Jan.10	Purchases goods for cash	1,500
Jan.13	Received from Gavaskar	970
	Discount allowed	30
Jan.15	Cash sales	5,000
Jan.17	Paid to Srikanth by cheque	2,450
	Discount received	50
Jan.18	Paid into bank	900

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Jan.20	Withdrew from bank for private expenses.....	800
Jan.21	Received cheque from Pandit	1,480
	Discount Allowed	20
Jan.25	Deposited Pandit's Cheque into the Bank	
Jan.27	Withrew cash from Bank for office use	2,500
Jan.30	Paid rent by cheque	900

SECTION - B

Answer the theory question in about 15 lines.

1. Give the rules of debit and credit

2. Classify the following under personal, real and nominal accounts:

i) Stock	ii)Loan	iii) Bank Overdraft
iv) Capital	v) Bank	vi) Drawings.

3. Find out fault with the following entries and write the correct entry.

i) 'X' Account	Dr.	500	
To Cash Account			500
(Being Salary paid Rs.500 to 'X')			
ii) Purchases Account	Dr.	2,000	
To Cash Account			2,000
(Being Furniture purchased on cash for Rs.2,000 from Arun).			

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Dr. B.R. AMBEDKAR OPEN UNIVERSITY
UNDER GRADUATE COURSE
B.Com. II Year

SUBJECT : COMMERCE
COURSE: ACCOUNTANCY

ASSIGNMENT - II

N.B.

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SECTION -A

Answer the theory question in about 30 lines.

1. What is an error? What are the errors disclosed by and not disclosed by a Trial Balance?

2. A book-keeper prepared a Trial Balance on 31st December, 1989 which showed difference. The difference in books was carried to a Suspense Account. The undermentioned errors were subsequently discovered.

   i) An item of Rs.12.50 appearing in the credit side discount column of the cash book representing discount received from Mehta has been credited to mehta's account.

   ii) The total of purchases book of a page Rs.7,075 was carried forward as Rs.7,000.

   iii) Sales returns book has been undercast by Rs.600

   iv) A cash sale of Rs.185 to Sagar correctly entered in the cash book was posted to the debit of Sagar's personal account in the ledger.

   v) A sum of Rs.1,000 written off as depreciation on building was not posted to the depreciation account.

   vi) Repairs to buildings Rs.850 was posted to buildings account.

   Pass necessary journal entries to rectify the above errors. Also prepare suspense account.

3. From the following Trial Balance of Balakrishna prepare the Trading, Profit and LossAccount for the year ended 31st December, 1989 and Balance Sheet as at that date after making necessary adjustments.

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Trial Balance as on 31st December, 1989.

	Dr. Rs.	Cr. Rs.
Buildings	5,000	—
Capital	—	50,000
Plant and Machinery	10,000	—
General Expenses	5,000	—
Purchases	80,000	—
Cash at Bank	10,000	—
Sales	—	1,00,000
Returns	10,000	8,000
Stock(1.1.1989)	16,000	—
Salary	3,000	—
Rent	800	—
Taxes and Insurance	400	—
Debtors and Creditors	15,200	12,000
Bills Receivable and Payable	4,800	3,000
Commission	—	600
Interest	—	200
Investments	6,000	—
Carriage	2,000	—
Printing and Stationery	1,000	—
Advertisement	600	—
Cash in Hand	4,000	—
Total	1,73,800	1,73,800

Adjustments:

i) Closing stock was valued at Rs.25,000
ii) Depreciate plant at 5% and buildings at 2%
iii) Outstanding liabilities were: Salary Rs.400 and Rent Rs.200
iv) Insurance was prepaid to the extent of Rs.50
v) Make provision for doubtful debts at 5%
vi) Write off Rs.200 as bad debts.
vii) Interest accrued on investments amounts to Rs.100

SECTION - B

Answer the following theory question in about 15 lines.

1. Distinguish between capital and revenue expenditure

2. Ascertain the cost of goods sold from the following figures:

Opening stock	Rs. 18,000
Purchases	Rs. 22,000
Carriage Inward	Rs. 3,000
Sales	Rs. 26,000
Closing Stock	Rs. 25,000

3. Rectify the following errors:

i) A credit purchase of goods from Ravi Shastri amounting to Rs.1,000 has been wrongly entered in the sales book.
ii) A credit sale of Rs.500 to Arun was credited to his account.

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Dr. B.R. AMBEDKAR OPEN UNIVERSITY
UNDER GRADUATE COURSE
B.Com. II Year

SUBJECT : COMMERCE
COURSE: ACCOUNTANCY

ASSIGNMENT - III

N.B.

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5. Leave sufficient margin for the comments of the evaluator.
6. Completion of this assignment normally should not take more than two hours time.

SECTION -A

Answer the theory question in about 30 lines.

1. What is a Secret Reserve? How is it created? What are its advantages and limitations?

2. On 1st January, 1989, X for mutual and temporary accommodation of himself and Y draws upon the latter a Bill at 3 months for Rs.18,000. Y accepts the Bill and sends it to X. X discounts the Bill with his bankers at 12% and handsover half the proceeds to Y. Y for a similar purpose, and at the same time, draws a Bill at 3 months on X for Rs.9,000. X accepts the Bill. Y discounts the Bill at 12% and handsover half the proceeds to X. Y becomes insolvent on 31.3.1989, and as he fails to meet his acceptance on maturity. On 15th April, a first and final dividend of 50 paise in the rupee has been paid out of Y's estate.

   Show the journal entries and ledger accounts in the books of X and Y.

3. A and B, doing separate business as Engineers and Coptractors, undertook jointly to construct the factory building of XYZ Ltd., for a contract price of Rs. 6,00,000 payable 75 percent in cash and the balance in shares of the company. A banking account was opened in their joint names, A paying Rs. 2,00,000 and B, Rs.1,50,000. They agreed to share profits in the ratio of 3 : 2. Their transactions were as follows:

Cost of materials paid	.....	3,00,000
Wages paid	.....	1,50,000
Materials supplied by A	.....	20,000
Materials supplied by B	.....	30,000
Establishment expenses paid	.....	50,000

The contract was completed and price duly received, 50 percent of the shares received were sold at Rs.60,000 and the balance was taken by A and B equally, at an agreed valuation of Rs.50,000. The stock of materials was taken by A at Rs.30,000.

You are required to show necessary accounts in the joint books of the venture.

SECTION - B

Answer the theory question in about 5 lines.

1. Distinguish between provision and reserve.

2. On 1-1-1989, a Machine was purchased for Rs.40,000. The erection charges were Rs.4,000; The estimated life of the asset was 10 years. Depreciate the asset on diminishing balance method, at 10% per annum and show the Machinery account for the first three years.

3. Arun of Hyderabad consigned goods costing Rs. 40,000 to Babu of Bombay. Arun paid Rs. 2,000 towards freight and Rs. 1,200 towards insurance. One-fourth of the consignment was totally lost by fire in transit, and the insurance company agreed to settle the claim at Rs. 7,000. Calculate the abnormal loss and give entries to record the same.

* * *

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