ACCOUNTANCY
PAPER - II

BLOCKS : 1 — II

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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 the subject matter. Technical terms with which the student may not be familiar are explained 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-1: INTRODUCTION TO ACCOUNTANCY

UNIT-1 ACCOUNTING - AN OVERVIEW

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1.0 AIMS AND OBJECTIVES

This unit aims at discussing the need for accounting, its scope, advantages and limitations and the people to whom it is useful. Further it presents the systems of accounting and generally accepted accounting principles.

After the study of this unit, you will be able to :

- define accounting ;
- distinguish between book-keeping and accounting information ;
- explain the advantages and limitations of financial accounting ;
- recognise the systems and approaches to accounting;
- explain the accounting principles.

1.1 INTRODUCTION

Accounting is often called the 'Language of Business'. If you know accounting, you will understand how a business operates and how decisions are taken or made. Even if you do not take part in accounting

activities, you will find this knowledge helpful in order to know what accounting information means, how it is got and compiled, and how it can be used for practical purposes.

A business consists of a series of transactions. These business transactions are to be identified, measured, classified, recorded, summarised, analysed, interpreted and communicated to interested parties so as to serve as a basis for decision-making. The accounting information system is an important part of the total management information system. In fact, modern accounting serves as the "eyes and ears" of the management.

A business comes into existence generally with the commitment of the proprietor's funds, i.e. 'Capital'. The proprietor may further acquire, and generally does, additional resources in cash and kind from outsiders. Thus, a business will have certain resources, viz., its wealth, for which it is held accountable. In other words, the business is required to answer such questions as :

1. from what sources it has got the amount;
2. how it has used that amount ; and
3. whether the amount has increased, decreased or remained constant.

The accounting system is devised to answer these and such other questions.

1.2 NEED FOR ACCOUNTING

Consider yourself as a businessman. Will it be possible for you to remember hundreds, even thousands of transactions that have taken place in your business-that too, over a period of time, say in a year. It is not humanly possible to remember all the financial transactions which have taken place in a business during a considerable period of time. Even if some one does really remember all the transactions, he would find it impossible to calculate the net effect of all such transactions. Hence, the need for accounting.

As the business grows in size, it becomes necessary to employ outsiders to assist the businessman. Since outsiders are involved, it is necessary to maintain accounting records for the purpose of control.

Again if the business is a partnership firm having more than one owner, all of them might or might not be actively participating in the day-to-day management of the firm. Therefore it is necessary to record all the financial transactions in order to satisfy all the partners.

In the case of impersonal organisations like Joint Stock Companies and other Corporate bodies, there is a division between ownership and management. The owners, viz., the company shareholders, who have actually invested their money in the company and who may be living in different places, will find it convenient to entrust the management to their elected representatives and paid managers. Hence, the need for recording all financial transactions. However, whether you are an owner or manager of a business you would like to have information about;

1) the nature and amount of expenditure;
2) the nature, source and amount of earnings;
3) the amount and cause of losses, if any;
4) the size of capital and causes for its increase or decrease;
5) the nature and value of assets possessed ; and
6) the nature and value of liabilities.

Further, the business requires various types of information for both external and internal use. For example information is required for filing sales-tax, income-tax and other tax returns and for preparing statements for decisions to be taken by managers. The question is how to get this information. A systematic accounting record is the only answer. Thus, the need for accounting arises on account of practical needs, and sometimes, legal requirements.

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Accounting is absolutely necessary for commercially run (i.e., profit objective) organisations. Even in the case of non-profit organisations like co-operative societies, educational institutions, etc., and governments and quasi-governmental institutions such as Municipalities, Zilla Parishads, it is necessary to maintain accounting records of funds received from various sources and expenditure on various activities, as they are accountable.

1.3 DEFINITION OF ACCOUNTING

Accounting has been defined in different ways by different authorities on the subject. Accounting is a comprehensive discipline which cannot be satisfactorily explained through any single definition. Indeed, there is, no precise and universally acceptable definition of accounting.

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

According to the Committee on Terminology of the American Institute of Certified Public Accountants :

"Accounting is the art of recording, classifying and summarising in a significant manner and in terms of money, transactions and events which are, in part at least, of a financial character and interpreting the results thereof".

1.4 SCOPE OF ACCOUNTING

1. Accounting is concerned with financial transactions and events which bring about a change in the financial position of an accounting concern or entity. Such transactions and events must be in terms of money or must be capable of being expressed in terms of money. If the transactions or events cannot be expressed in terms of money they are of no concern to accounting.
2. Such financial transactions or events are identified as and when they occur, their money value measured and classified according to their nature and recorded in appropriate books of accounts.
3. The record of many transactions will result in a large body of financial data. It is, therefore, necessary to summarize such data, at least periodically, into a significant form.
4. The classifying, recording and summarising are all done in monetary terms only, which means that the financial transactions must be measured in terms of the standard money of the country as for example, in terms of Rupees in the case of India.
5. The summarised financial statements - profit and loss account, balance sheet, statement of changes - are analysed with the help of statistical tools such as averages, percentages, ratios, rates etc., and are interpreted in terms of set standards and conventions.
6. Interpreting the results of accounting information involves communicating and explaining the information to interested parties and decision makers like owners, creditors, investors, Government and management. In other words the summarised accounting information, along with analysis and interpretation, if any, must be in the form of suitable reports which will help in specific decision - making.

1.5 BOOK-KEEPING AND ACCOUNTING

It is necessary to distinguish between book-keeping and accounting. Actually, the two are very closely related and there is no universally accepted line of demarcation. Generally, book-keeping involves the

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chronological recording of financial transactions in a systematic manner. According to Northcott, "book-keeping is an art of recording in books of account the monetary aspect of commerical or financial transactions". According to G.A. Lee, the accounting system has two branches :

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

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

Branch (1) is called book-keeping or more generally, data processing, and branch (2) is accounting.

As explained above, book-keeping is the record-making phase of accounting. The recording of transactions tends to be routine, repetitive and mechanical (as a matter of fact it is being increasingly mechanised). It is a part of accounting. Accounting includes, besides book-keeping, the design of accounting system, preparation of financial statements, audits, cost studies, preparation of forecasts (budgeting), income-tax and other taxation work, analysis and interpretation of accounting information as an aid to decision-making. Even though the work of a book-keeper is routine and simple, and that of the accountant complex and complicated, it is difficult to draw a line to show where the book-keeper's work ends and where the accountant's work begins.

Check Your Progress - 1

Distinguish between book-keeping and accounting

1.6 BRANCHES OF ACCOUNTING

Changes in economic environment and technological improvements have resulted in an enormous increase in the scale of operations. Further, the management function is becoming more and more complex. These have increased the importance of accounting and have given rise to specialised fields of accounting. The important branches are as follows:

1. **Financial Accounting** : The purpose of this branch of accounting is to ascertain the financial result, i.e., profit or loss in the operations during a period, and financial position, i.e., assets, liabilities and equity position at the end of the period, and provide othe relevant information to the management for decision-making, planning and controlling the operations of the business and to satisfy the statutory requirements.

2. **Cost Accounting** : The purpose of this branch of accounting is to ascertain the cost of a product/ operation/venture/project and the costs incurred for carrying out various activities, and also assist the management in controlling the costs. The necessary data and information are gathered from financial accounts and other sources.

3. **Management Accounting** : Its aim is to assist the management in taking correct policy decisions and to evaluate the impact of its decisions and actions. The data required for this purpose are drawn, generally, from the above mentioned two branches, viz., financial accounting and cost-accounting.

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In this course, we are concerned with financial accounting only.

Check Your Progress - 2
List out the branches of Accounting.

1.7 PARTIES INTERESTED IN ACCOUNTING INFORMATION

Accounting information is useful to various parties. They are :

1. **Owners** : Owners asssume the primary risk of business by investing their funds in it. Naturally, they are interested in obtaining information about the operations of their business, how much it has earned and the position regarding their capital. They also use the accounting information to evaluate the management's performance and to compare their enterprise with others.

2. **Managers** : Accounting reports are important to managers for basing their decisions, or for evaluating the results of their decisions, or for controlling the activities of the business. In addition to external financial statements, managers need detailed internal reports either branch-wise, division or department-wise or product-wise. Accounting reports for managers are prepared much more frequently than external reports and are usually available only for internal purposes.

3. **Creditors and Bankers** : Creditors (i.e. either the suppliers of goods and services on credit or bankers or other lenders of money) want to know the solvency of the concern so as to satisfy themselves that their money will be safe and that they can expect repayment in time.

4. **Prospective Investors** : Prospective investors, prior to committing their money to a business either in the form of ownership capital or loan capital, need to make a careful analysis of the financial statements of that business so as to know how safe and rewarding the proposed investment will be.

5. **Employees** : The employees of large organisation are interested in the results of their organisation's operations. They use the accounting data to know whether they are getting a fair share of the resources distributed by the organisation.

6. **Governments** : Numerous governmental agencies, both State and Central, are interested in the accounts of concerns for the purposes of collecting taxes, for exercising control and regulation such as directing the flow of capital, for granting licences or loans, for determining whether welfare measures and social security benefits to their employees are observed or not, etc. Further, as a central statistical agency, the government collects various types of information from business entities and publishers statistical data about different aspects of business.

7. **Financial Analysts** : Many investment decisions are made on the advice of financial analysts who are experts in analysing accounting reports. Security analysis employed by Stock Exchange dealers advise their clients on the buying and selling of shares of companies. Many institutions like banks, companies, trusts, pension or provident fund trusts maintain their own staff who can analyse financial statements.

8. **Researchers** : Financial statements are of immense use to research scholars who want to make a study of financial operations.

9. **Consumers** : Consumers, too, are interested in knowing about the concern's pricing policy, quality of goods, etc.

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The users of accounting information are therefore many and diverse, and hence it is impossible to provide information suited to the requirements of each one of them. While internal management can have access to all the detailed information contained in the entity's records, the external users have to rely heavily on the abridged, periodically published financial statements prepared on the basis of generally accepted accounting principles and practices. Accounting reports are, therefore, general purpose statements intended to serve the various needs of the above mentioned groups. However, these reports should possess relevant, timely, accurate and adequate information as far as possible.

Check Your Progress - 3

List out the users of Accounting Information

1.8 ADVANTAGES OF ACCOUNTING

The following are the advantages of a properly maintained accounting system.

1. The results of the operations, i.e., profit or loss, and the financial state of affairs of an organisation can be known.
2. Since all the past financial events and transactions are recorded in the books of accounts, they serve as historical records. Any information required at any time can readily be had from the books of account.
3. With the help of financial statements an organisation can evaluate its present performance with that in the past, and/or compare it with that of other organisations.
4. Accounts form the basis for the settlement of tax liabilities such as income tax, sales tax, etc.
5. In the event of the business being sold, the accounts are helpful in ascertaining the value of the business.
6. It is difficult to conceal fraud or theft, particularly where the book-keeping work is divided among many clerks, as there is automatic checking in the form of periodic balancing of the books of accounts.
7. Accounting is an aid to the management. It is possible to find out exact reasons for the loss incurred or profit earned. The identification of reasons help the management in taking necessary steps to avoid losses or to further increase profits.
8. A business organisation in order to justify its existence should operate profitably and maintain solvency. Maximum operational efficiency calls for some kind of future planning. The financial information provided by the accounting system is needed to help the management in planning and controlling the activities with the help of budgets.

1.9 LIMITATIONS OF FINANCIAL ACCOUNTING

Financial accounting information is communicated through figures. The nature of figures and the way in which they are reported may give the impression that the financial accounts are precise, exact and final. But this is not so. These accounts have the following limitations :

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1. **Scope for alternative treatment** : Recording of transaction is based on certain 'generally accepted accounting principles', but there exists more than one principle for the treatment of certain items. For example, the closing stock of a business can be valued in any one of the following ways :

a) First-in-First-out (FIFO)
b) Last-in-First-out (LIFO)
c) Average Price
d) Standard Price, etc.,

Application of different principles will yield different values for the closing stocks and consequently, determination of profit will also be affected. Thus the possibility of alternative treatments makes the results different and incomparable.

2. **Scope for subjectivity** : Certain estimates have to be made regarding items like expected useful life of an asset and its salvage value at the end of its useful life. As these estimates require personal judgements, subjectivity creeps in, i.e., different persons are likely to estimate differently and hence, there is no objective estimate. Further, the income so determined is at best an approximation and should not be regarded as an exact figure.

3. **Ignoring certain important, Non-monetary information** : Financial Accounting records only those transactions which can be expressed in terms of money. Transactions which are non-monetary, however important they might be are left out. Examples of such non-monetary items of importance are :

a) Value of Research and Development effort possessed by the organisation.
b) High morale of the employees
c) Market position of the organisation, etc.,

Matters of this type are of crucial importance to the organisation, but there is no system of recording these aspects in the books of accounts. Users of accounting information will not be in a position to understand the internal strengths and weaknesses. Further, accounting information alone cannot form the exclusive basis for evaluating managerial performance as other relevant information is required.

4. **Discloses only the 'Going concern' values** : Recording of transactions is based on the 'cost concept' and it is assumed that the purchasing power of money is stable. Further, it is assumed that the entity will exist continuously and hence, the values state in the books are 'going concern' values and not 'realizable values'. Thus, the present value, i.e., what the business will fetch when sold, is not readily revealed.

Check Your Progress - 4

List out the limitations of financial accounting

1.10 THE ACCOUNTING PROCESS

The business activity may be boradly divided into two categories, viz., manufacturing and non-manufacturing. In the case of manufacturing activity the business has to pruchase either on cash or credit basis the various inputs required for production and produce the output. The produced output may be sold on cash or credit basis. All credit transactions are finally converted into cash transactions. In the case of non-manufacturing activity goods are purchased and sold at a price either on cash basis or on credit basis. In the case of service organisations services are offered for sale.

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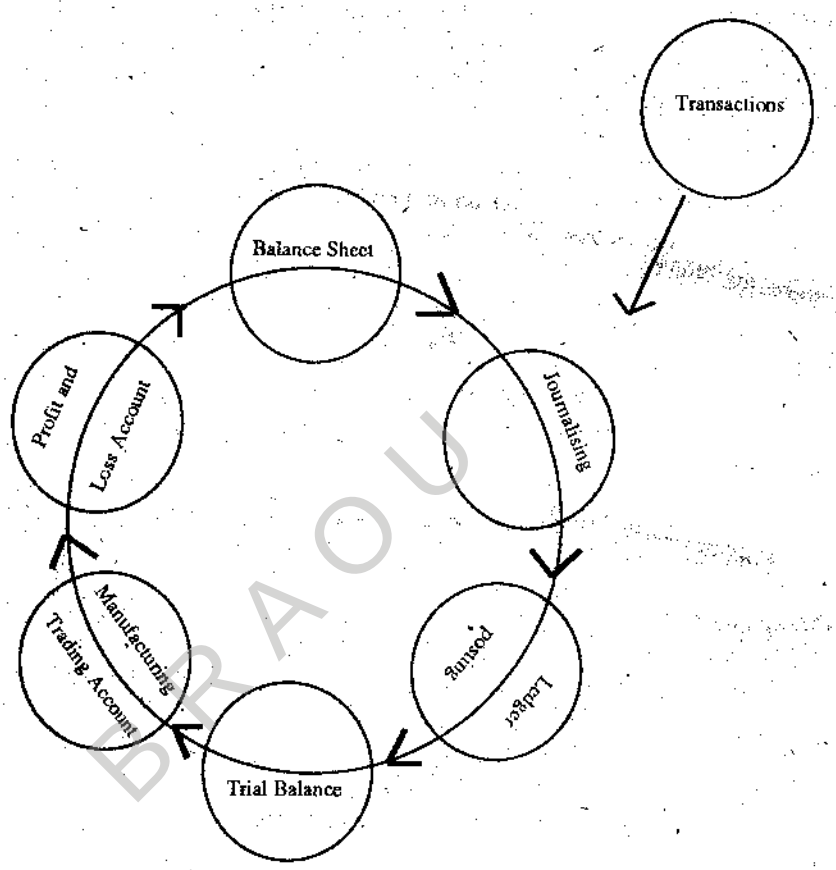
The accounting process, therefore, begins when a financial transaction takes place. In proof of the transaction, a business document - receipt, voucher, bill or invoice - is obtained. Based on this evidence, the transaction is rcorded first in a book called 'Journal' and later posted in seperate accounts maintained for the prupose in a 'ledger'. After some time, generally at the end of the accounting year, whether the actual figures are entered accurately or not in the accounts is tested by preparing a 'trial balancc' . With the hlep of this 'trial balance' and other information 'final accounts' are prepared to find out the financial result of the operations (Profit and Loss Account) and the financial position (Balance Sheet) of the accounting entity. In the subsequent year the accounting books are opened with the previous year's closing balances to start with, and then only the current year's transactions are recorded. The process, thus, repeats itself like a cycle. The accounting cylcle may, therefore, be presented in the form of a diagram as given below

ACCOUNTING CYCLE



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1.11 FUNCTIONS OF ACCOUNTING

The purpose of accounting is to provide financial information about an economic entity which enters into transactions with others. The financial information provided by an accounting system is needed by managerial decision makers to help them plan, control and evaluate the activities of the economic entity. The main functions of accounting are:

1. **Managerial Function:** Providing information to the management for planning, controlling and evaluating the operations.
2. **Historical Function:** Collecting, organising and summarising information in a systematic manner and reporting it through financial statements and other reports to the interested parties.

Check Your Progress - 5

List out the functions of accounting

1.12 SYSTEMS OF ACCOUNTING

Broadly, there are two systems of accounting, viz., the 'double entry' system and the 'single entry' system.

Double entry system : Every transaction has two aspects, giving and receiving. For example, when you pay money there is somebody to receive it. Thus, for every transaction two accounts are realized at the same time and with the same amount- one account about giving the benefit and the other about receiving the benefit. 'Double entry' is a system which recognises and records both the aspects of a transaction. This system has many advantages ; for example (1) the accuracy of the accounts can be verified (2) final accounts can be prepared with ease. Since there is check and counter check in the form of double entry, it is difficult to commit fraud or misappropriation.

Single Entry system : It is a combination of double entry, single entry and no entry. The accounts maintained under this system are incomplete and unsystematic. This style of account keeping is often called 'accounts from incomplete records'. Generally what is not double entry accounting is termed 'single entry' accounting thereby implying that the accounts are incomplete.

Big organisations or many of the enterprises in the organised sector maintain accounts based on double entry system. In spite of many defects in single entry system small business adopts this system. We shall know more about 'single entry' at a later stage.

Check Your Progress - 6

What is double entry system ?

1.13 APPROACHES TO ACCOUNTING

Generally, there are two approaches to accounting, viz., accrual basis and cash basis of accounting. All the revenues earned in a year may or may not be received in cash in that year. Similarly, all expenses incurred in a year may or may not have been paid in that very year. The question, therefore, is whether the revenues should be booked in the year in which it is earned or in the year in which it is actually received? The same applies to expenses also.

If the revenue (income) is taken into account in the year in which it is earned irrespective of whether it is received in cash or not, and if similarly, the expenses are taken into account for the year in which they are

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incurred whether actually paid in cash or not it is called, ' Accrual basis of Accounting'. It is also called 'mercantile system'. On the other hand, if the revenues and expenses are taken into account in the year of actual receipt or payment, it is called 'cash basis of accounting'. It is also called 'realisation basis of accounting'. Financial Accounting, it should be noted, is generally on accrual basis.

Sometimes a businessman adopts a combination of both methods as explained above, in which case it is called 'mixed or hybrid method'. For example purchases and sales may be recorded on accrual basis and incomes and expenses on cash basis.

Check Your Progress - 7

What do you mean by accrual basis of accounting ?

1.14 ACCOUNTING DEVICES

There are a variety of accounting recording systems. They are also called' data processing methods'. The adoption of a particular system depends on the size and complexity of the business, the degree of sophistication desired, the philosophy of the management, the speed and the frequency with which information is required, etc. Four main systems of 'data processing' are listed below :

1. **Manual Method** : This is also called 'handwritten system'. The whole accounting process is carried on manually. Of course calculators may be used for calculations such as additions and subtractions. This is the conventional system of account-keeping.

2. **Key-board Machine Methods** : It is a semi-manual or quasi-mechanical system. Here, generally, the mechanisation begins with the ledgers. In this system accounts are kept on cards or thick papers which are filled in trays. Entries are made from original documents by means of a key-board machine. It is like an expanded typewriter, which has adding devices, provides periodic totals of similar items, and also calculates and prints out a revised balance after each entry.

3. **Punch-card method** : This is the oldest form of total mechanisation of the 'data processing system'. It involves the use of electro-mechanical devices actuated by holes punched in small cards.

4. **Electronic Data Processing Method or Computerised Method** : In the Electronic Data Processing (EDP) system digital computers are used. The computer can be programmed not only to keep the records but also to perform many routine and decision - making functions. The computer can store vast quantities of numerical information and can do calculations much more swiftly than any other device. It has also the ability to print as per form and simultaneously any other documents required. In the above mentioned three methods the accounting information is stored on paper, but in EDP information it is stored in its memory.

1.15 GENERALLY ACCEPTED ACCOUNTING PRINCIPLES

What are 'generally accepted accounting principles'? To a large extent what is generally accepted is what has been done over a large number of years. Hence, tradition and widespread use by practising accountancy are the major determinants of what is generally accepted.

In an effort to make accounting practices more uniform than it would be otherwise, the accounting profession, industry and government have created specific organisations, to set forth accounting principles or standards. They are, for example, the 'Financial Accounting Standards Board' of America, the 'Accounting Standards Steering Committee' of Britain, the 'Accounting Standard Board' of India, and the 'International Accounting Standards Committee'.

The principles which constitute the 'ground rules' or guidelines for financial record-keeping and reporting are usually called 'generally accepted accounting principles'. Accounting principles * are also referred to as standards, assumptions, concepts, conventions, doctrines, axioms, etc.**. The various terms which have come to be used to describe accounting principles indicate the prevailing confusion and lack of clarity in accounting theory. However, serious efforts to construct a satisfactory body of accounting theory are still being made, the results of which may be available in the near future.

It is important for financial statements to be prepared in a manner that permits them to be compared fairly with the 'statements of earlier years' and with that of other organisations. We, therefore, need a well defined body of accounting principles or standards to guide managers and accountants in preparing financial statements which will achieve the objectives of understandability, reliability, and comparability in addition to being informative.

At the present juncture, it is difficult to codify the accounting principles as there is no authoritative list. Further, they are subject to change with the passage of time. However, the principles/standards/concepts/ conventions which are generally found in accountancy books are classified into two broad groups and presented below. It must, however, be remembered that some of them are overlapping and even contradictory. In fact, there are very few accounting principles which are not subject to challenge.

I. Principles to be kept in Mind while Recording the Transactions :

1. The Business Entity Concept : Any legal or economic unit which controls economic resources and which is accountbale for those resources is an accounting entity. Accounts are maintained and accounting reports are prepared for a specific accounting entity whose financial affairs can be considered distinctly without reference to other such units. For example, sole proprietorship concern, partnership firm, joint stock company, co-operative society, government, bank, school, university, club, are all accounting entities.

The concept of business entity assumes that a business is separate and distinct from its proprietors/owners. Accounting system gives the information about business only. The focus of accounting, thus, is business enterprise for which the accounting is done and not its owners. The entity concept regards the proprietor of the business as just a creditor having a claim over the assets of the business. Because of the distinction between the business and proprietor and because of treating him as a creditor, capital, i.e, proprietor's claim, also becomes a liability to the business. When capital or owners' claim is considered a liability to the business, its assets are always equal to its liabilities. which gives the balance sheet equation, i.e., total assets (ΣA) = total equities (ΣE)

An accounting enuty may have one or more sub-accounting entities so as to facilitate responsibility accounting. Accounts can be maintained department-wise, branch-wise, consignment-wise or venture-wise, or even product-wise. For example, StateBank of Hyderabad is an accounting entity and its branches are sub-accounting entitites.

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* The recent trend is to term them as 'accounting standards'.

** Here 'Standard' means something established as a rule or basis, a usage or practice that is generally accepted or followed. 'Assumption' means a supposition or presumption. 'Concept' means an idea or thought. 'Convention' means a usage which is generally accepted and customarily used. 'Doctrine' means belief. 'Axiom means a statement widely accepted as true. 'Principle' means a fundamental truth upon which others are based. The accounting concepts or whatever the other terms used, are such ideas as by common agreement or acceptance are used in the theory and practice of accounting.

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The accountant must carefully define the limits of an accounting entity and sub-entity, if any, and should keep its financial affairs separate from those of other entities in order that the users of accounting information may know precisely whose affairs are described in the financial reports. The student/book-keeper should know in whose books the transactions are to be recorded and should record from that entity's point of view. For example. Rama & Co. sells goods to Sanjeeva & Co. For Rama & Co., this transaction is sales but to Sanjeeva & Co., it is purchases. In Rama & Co., books, it should be recorded as 'sales' and in the books of Sanjeeva & Co. , as 'purchases'.

2. **Money Measurement Concept**: A business usually deals in heterogeneous items, which are expressed in different physical units (e.g., kilograms, litres, bales, bags, meters, etc.). If different items are expressed in different units, adding them together will not produce any meaningful total. But if these are reduced to a common denomination then their addition becomes homogenous and meaningful. Money does this function.

Money is the common denominator or measuring unit in which all accounting measurements are made, recorded, and summarised. The use of money as a measuring unit means that money unit is considered to be of stable value. Further, only such transactions or events which are expressed in terms of money are to be recorded in the books of account. Other facts and happenings (non-monetary), however, important they may be, cannot be recorded if they do not have money value.

3. **Objective Evidence Concept** : The term 'Objectivity' refers to measurements which are unbiased and subject to verification by independent experts. All accounting transactions should be evidenced and supported by documents such as receipts, vouchers, invoices. These supporting documents are the basis for making entries in the accounting records and for later verification by auditors.

However, for internal apportionment of costs over the accounting periods, provision for depreciation, for doubtful debts and such other imputed tranactions, evidence is not available as they have not taken place between two entities.

Despite the goal of objectivity, it may not be possible to rule out subjectivity completely (for example, estimating the useful life of an asset). However, to the extent possible accounting records should be factual, objective and based on evidence.

4. **Historical Record Concept**: According to this concept, the transactions which have actually happened should be recorded in the accounting books in the chronological sequence in which they have taken place. Accounting record presupposes identification and measurement of a transaction. Future events can hardly be ascertained with certainty and measured accurately. But past events are known with factual data. Further, evidenee of past transactions is objective and not subjective. Transactions are, therefore, recorded in the books on the basis of actual happening of events and not on the basis of future probabilities. If this principle is not followed the financial statements would then show only the wishes and hopes rather than actual performance. Further show only the wishes and hopes rather than actual performance. Further, the transactions are to be recorded in the chronological order of their occurence, i.e., date-wise.

Sometimes contrary to what is stated above, an estimate of probable loss is taken into account (e.g provision for doubtful debts.). This is in accordance with the principle of conservatism.

5. **Historical Cost Concept** : Business activity is essentially exchange of goods and services through the medium of money. The price paid at the time of exchange (i.e, at the time of purchase) is called 'cost'. The cost of an asset to a business is, thus, the price paid to acquire that asset.

Business transactions are to be recorded in the books on the basis of their cost, i.e., price paid or received, irrespective of the value attached to it by the business. For example, a business purchases a machine for Rs.1,00,000. The cost of the machine should be recorded at that price only even though the value of the machine to the business may be something more or less than that price.

The cost principle is derived from the principle of objectivity. Objective evidence is generally available to support cost, but fair value or market value is less objective as evidence is not usually available to support it. The cost concept makes the accounting record more objective as it does not allow transactions to be recorded at some arbitrary value. Since the records are maintained at historical costs, this accounting is also called historical cost accounting.

6. **Dual Aspect Concept** : This principle is the core of double-entry accounting. all transactions are recorded as having a dual (double) aspect.

It is a famous dictum that every receiver is a giver and that every giver is a receiver. Based on this principle the double-entry theory considers every transaction as having two accounts effected by the same amount but in opposite directions. It is similar to Newton's Third Law of Motion which states that 'for every action there must be an equal opposing reaction, . The duality or dual aspects (viz., the two-fold effect of a transaction), too, implies that if there is a change in one item, there must be an equal and opposite change in some other item. For example, if you purchase a table for Rs.500, you are receiving a table and at the same time you are giving Rs.500. Similarly, if you are selling goods for Rs.200 you are receiving Rs. 200 and giving goods worth Rs.200. Therefore, every transaction is considered as involving some benefit being received by one account and the equivalent benefit being given by another account and thus giving the equality (equation) of benefits received and benefits given in other words, debits equal credits.

The funds required by the business are contributed by the owner to start with (i.e., capital) and later by the outsiders also (i.e, creditors). Cash or assets received by the business become its resources (as per the business entity concept). But at the same time these create corresponding obligations for the business as regards their repayment (as per the dual aspect concept). Thus, a contribution to the business either in cash or kind not only increased its resources (assets) but also increses its obligations (liabilities) simultaneouly and correspondingly. Hence, total sources (claims or equities = $\sum$E) and total resources (assets represented by claims = $\sum$A) must agree $\sum$ A = $\sum$ E. This is called the accounting equation or balance sheet equation which can be stated as :

Assests = Equities

or Assets = Outside Liabilities + Proprietor's Equity

or Proprietor's Equity = Assets — Outside Liabilities.

Because of the equality of debits and credits, any change in the financial set-up or transaction cannot distturb the identity or equality A = E, as opening assets plus debits during the period are equal to opening equities plus credits during the period.

In order to bring about this equality, the account receiving the benefit should be debited and the account giving the benefit should be credited in the case of all transactions without exception.

II. Principles to be kept in mind while preparing the Final Accounts :

1. **Going Concern Concept**: If one undertakes the execution of a contract or a particular venture it is a short-lived affair. But in the case of a business it is not so. Then business is intended to continue indefinitely or for a long period. Accordingly, continuity (Permanancy) of activity is assumed and the annual financial statements are prepared on a going concern basis as against liquidation basis. Under liquidation (or forced sale) accounting measurements are made on the basis of disposable values, i.e. what the business is currently worth to a buyer.

   Since it is assumed that the business entity will go on for ever, it is implied that a certain expenditure will give rise to benefits accruing over a long period and that they should be spread over the period benefited by that expenditure. Further, such expenditure should be distinguished from the expenditure whose benefits will be exhausted within the year.

For example, when a machine or any other asset is purchased, there are two options available to the account.

i) He knows that the machine or asset is going to last long (for a number of years) and that the business itself will continue for long, permitting the business to make use of that machine for a long period. He, therefore, estimates the life of the machine and for the purpose of accounting, spreads the cost of the machine over its useful life (i.e. , in the form of depreciation) He, thus, writes off a part of the cost every year.

ii) If the going concern assumption is not made, then assuming that the business will be closed, the accountant will have to write off the entire cost of the machine in the year in which the machine is purchased.

Thus, the distinction between the capital and revenue expenditure is to be found in the going concern concept.

2. **Accounting Period Concept** : Even though it is assumed that the business will continue for a long period, almost indefinitely, the businessman cannot postpone the ascertainment of its profit and financial position indefinitely. Moreover, it is necessary to prepare financial statements at periodical intervals in order that interested parties may be able to make an assessment of its progress. It is a convention (in most cases) to divide the life of the business into what are called 'accounting periods' and assess the profit of each such period and the financial position at the end of such a period. Generally, the accounting period adopted is a period of twelve months' duration i.e, a year. However, for internal purposes accounts can be prepared even for shorter periods. The accounting period convention necessitates the adjustment (for accounting) of the expenditure and income for the accounting period concerned.

3. **Matching Concept**: Although business is a continuous process its continuity is broken into several accounting years for determining its periodic operational result, i.e, profit or loss. As profit is an excess of income over expenditure, it becomes necessary to bring together all incomes and expenses pertaining to a particular accounting year. It means that expenditure incurred in an accounting year should be matched with the incomes earned in that year. In other words, if a certain income is entered (credited) in profit and loss account, the expenses relating to it, whether paid or payable, should also be entered (debited) in that profit and loss account. Similarly, if certain expendiutre is entered in the porfit and loss account, the corresponding incomes derived by that expenditure, whether received or receivable, should also be entered in that profit and loss account.

Because of this principle, the closing stock has to be valued and taken into account, and other costs and revenues received in advance or outstanding have to be adjusted over the accounting years and brought into the books.

4. **Realisation Concept**: Proper recognition of revenues is essential, since it determines the particular period to which the revenue is to be attributed. Revenues represent the inflow of amounts received or receivable by the business in exchange for the goods and services supplied by it in the course of its normal business operations (e.g.sales revenue).

Revenue-realisation or recognition does not necessarily mean that revenue must be realised in cash. Both cash and credit sales result in the realisation of revenue either immediately or at a later date.

The process of revenue earning involves a series of activities. In the case of manufacturing enterprises, it involves purchase of raw materials, processing and turning them into finished products, selling them either on cash or on credit basis and collecting cash later. There will always be some raw materials, some semi-finished goods and stock of finished goods. Now the question is at what point revenue should be recognised and what amount should be regarded as revenue. At

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an intermediary stage it is not possible to estimate exactly the amount of revenue. It is a rule in accounting that no revenue is considered to have been earned till it is either realised in cash or some other party is legally liable to pay the amount for the goods or services obtained. This is possible only when the sale is effected. Therefore, for majority of commericial undertakings the appropriate time of revenue recognition is the point of sale. In whichever year the sale might take place, the revenue is considered to have been earned or realised in that accounting year only, even though the amount is not actually received in that year.

Even though revenue is recognised at the point of sale and taken into account, there may still be uncertainties like return of goods by the customer, giving cash discount for prompt payment, loss due to bad debts, etc., which has the effect of reducing the amount of revenue taken as realised earlier. Such events should also be duly provided for and accounted for in the books.

Although 'sale' is the most common point of revenue recognition, in some cases revenue is also recognised at other points. For example, in the case of long-term construction of engineering contracts it is an accepted practice to recognise revenue prior to completion. In the case of gold-mining, and agricultural commodities to which government controlled prices apply, revenue is recognised at the point of the completion of production. In certain other cases, if the revenue is regular and of recurring nature (e.g. rent, subscription) it is treated as realized on the basis of the period to which it is related irrespective of whether it is received or not.

5. **Account Concept**: According to this, profit is considered to have accrued or have been earned only when there is an increase in the capital of the proprietor without considering the additional capital introduced and drawings. In other words, profit should be recognised only when the capital is kept intact.

Revenues lead to an increase in owners' equity and expenses lead to a decrease in owners' equity. Since the difference between revenues and expenses represent profit or loss, the owners equity increases if profits are earned and decreases if losses are incurred.

6. **Conservatism Concept**: According to the concept of conservatism. When alternative treatments are available, and /or in case of doubt, the treatment which minimizes the reported profit or asset valuation or maximizes the reported figure of loss or liability, valuation shall be adopted. In other words, all kinds of losses whether actually incurred or likely to be incurred,(in that case its probable estimate) should be taken into account. But anticipated probable profits should not be taken into account unless realised. This will prevent the practitioners of accounting from doing window dressing or painting a rosy picture. Valuation of closing stock at cost or market price, whichever is less, provision for doubtful debt, etc., are made according to this concept.

7. **Consistency Concept:** The principle of consistency implies that a particular accounting system or basis or method or procedure or treatment adopted will not be changed from year to year in order that it may give consistent results. If the measurements are not consistent, then inter-period comparison of its own performance or inter-firm comparison becomes difficult and unreliable. On the other hand, if the measurements are consistent, it enables the users of financial statements to interpret intelligently the changes in the financial results and the position of the business enterprise and draw meaningful conclusions.

Consistency does not mean prohibition of change. Desirable changes are always welcome. But when the change is introduced, that fact and its effect should be fully disclosed.

8. **Full Disclosure Concept:** Full disclosure means all material and relevant facts pertaining to the financial position and the results of the operations of the business should be communicated to the users of the accounting information. This can be done through the financial statements so as to make those statements all the more useful. This does not mean that all information should be disclosed. It only means that no important fact should be witheld inorder that the users of the information may not be misled.

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9. **Materiality Concept:** It means that where calculation of accurate figures involves troubles, expenses or delay disproportionate to any advantage, a reasonable approximation in figures shall be considered acceptable.

It also refers to the relative importance of the information to be disclosed in the financial statements. While disclosing information a distinction must be made between material and immaterial matters. An item is material if there is a reasonable expectation that the knowledge of it would influence the decisions of prudent users of financial statements. All such material information should be disclosed throught the financial statements.

In this study-unit, various aspects pertaining to accounting theory have been presented. It may be difficult to fully appreciate or understand them at once, especially for a beginner. The student, is therefore, advised to study this unit once again after completing the study of the final accounts.

10. **Legal Aspect Concept:** This concept refers to the need for recording the transactions in manner which reflects the legal position. A businessman cannot treat a person as his debtor, unless the other person is legally liable to pay him the amount.

Check Your Progress -8

How does 'Historical Record Concept' differ from 'Historical cost Concept'?

1.16 SUMMING UP

Accounting is often called the language of business, because the terms and concepts of accounting are used in record keeping and in the preparation of reports. Business is a bundle or a series of transactions. The effects of these transactions must be brought into books of accounts and summarised so as to find out the net result of the operations and the financial state of affairs of the business. It also provides useful information to the management for decision making.

Accounting involves different types of work. Transactions or events as and when they occur are to be identified, measured in terms of money, classified according to their nature, and recorded in the books of accounts. These recorded transctions are to be summarised periodically in the form of fincial statements (Profit and Loss Account, Balance Sheet, etc), analysed with the help of statistical tools, interpreted according to conventions or law, if any, and communicated in the form of reports to the interested parties.

Book-keeping is the record making part of accounting. Accountancy is systamatic knowledge while accounting is the practice of the knowledge. The job of accountant/accounting department involves various types of work, viz., designing, recording, summarising, analysing, reporting, forecasting, taxation, and critical evaluation work.

Accounting information is useful to various parties such as owners, managers, creditors, investors, governments, employees and researchers. There are many advantages with a properly maintained accounting system. The accounting information is useful to the management in planning, controlling and evaluating its activities, and in finding out the operating results and the financial position of the business.

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Financial accounting has certain limitations too, as there is scope for alternative treatments and subjective judgement. Further, it only records monetary information and discloses the going concern values.

The accounting process runs like a cycle, starting with the identification of the transations, journalising and posting them into ledger accounts, preparation of trial balance and finally culminating in the preparation of trading and profit and loss account, and balance sheet. Accounting has mainly two functions to perform viz., managerial function and historical function.

Broadly speaking, there are two systems of book-keeping: (a) double entry system and(b) single entry system. Double entry system recognises and records both the aspects of a transaction whereas single entry system records only one aspect of the transaction. Generally, there are two approaches to accounting viz., the accrual basis and the cash basis of accounting. Sometimes a third method, which is a mixure of these two is also followed. The recording and summarisation of accounting information may be carried out through mannual process or machanical process. The primary objective of accounting is measurement of wealth in both the dynamic and static sense. Measurement assumes some unit of measurement and some procedure of valuation.

The principles which constitute the ground rules for recording and reporting the accounting information are usually termed 'generally accepted accounting principles'. In order to make accounting information uniform in the interests of understandability, reliability and comparability in addition to be informative, accounting principles/standards are being divised from time to time by professional organisations. The principles which are generally followed can be found expressed through the following concepts which are broadly devided into two groups:

I. Principles to be kept in mind while recording the transactions:

i) Business entity; ii) Money measurement, iii)Objective evidence;

iv) Historical record; v) Historical cost; and vi) Dual aspect.

II. Principles to be kept in mind at the time of preparation of final accounts.

i) Going concern; ii)Accounting period; iii)Matching of revenues and expenses;

iv)Realization or timing of revenue v) Accrual or profit recognition;

vi) Conservatism; vii)Consistency; viii) Full disclosure; and ix) Materiality.

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1.17 ANSWERS TO CHECK YOUR PROGRESS

1) Book-keeping involves the chronological recording of financial transactions in a systematic manner. Book-keeping is the record-making phase of accounting. Accounting includes besides book-keeping work, the design of accounting system, preparation of financial statements, forecasts (bedgeting), taxation work, and analysis and interpretation of accounting information.

2) The important branches of accounting are : a) Financial Accounting; b) Cost Accounting, and c) Management Accounting.

3) Accounting information is useful to the following parties.
Owners, Managers, Creditors, Prospective investors, Employees, Governments, Researchers, Financial analysts, Consumers.

The limitations of financial accounting are :

a) Scope for alternative treatment.
b) Scope for subjectivity
c) Ignoring certain important, non-monetary information
d) Discloses only the 'Going Concern' values.

5) a) Managerial function
b) Historical function

6) Every transaction has a dual aspect, i.e., the receiving aspect and the giving aspect of the benefit involved. Thus for every transaction two accounts are involved at the same time and with the same amount. Double entry is a system which recognises and records both the aspects of a transaction.

7) If the revenue (income) is taken into account in the year in which it is earned irrespective of whether it is received in cash or not, and if similarly, the expenses are taken into account for the year in which they are incurred whether actually paid in cash or not, it is called 'accrual basis of accounting'.

8) According to 'Historical Record Concept' the transactions which have actually happened should be recorded in the accounting books in the chronological order in which they have taken place. According to 'Historical cost concept', the transactions are to be recorded in the books on the basis of their cost, i.e., price paid or received, irrespective of the value attached to it by the business.

1.18 MODEL EXAMINATION QUESTIONS

A. Short Questions

1. What is Book-keeping ?
2. Define Accounting ?
3. List out the users of accounting information.
4. What are the limitations of accounting ?
5. Distinguish between book-keeping and accounting ?
6. What are the branches of accounting ?
7. What are the advantages of accounting ?
8. What are the systems of accounting ?
9. What are the functions of accounting ?
10. What do you understand by double entry system ?
11. What do you understand by dual aspect concept ?
12. What is called accounting equation ?
13. What is 'going concern concept' ?
14. What is matching concept ?
15. How does 'historical record concept' differ from 'historical cost concept' ?
16. What is 'business entity' ? describe some entities.
17. Explain money measurement concept in accounting.

B. Essay Answer Questions

1. Explain the need for accounting in a business.
2. What is accounting ? Explain its advantages and limitations.
3. Who are the parties interested in accounting information ? Why do they need the information?
4. What are the different systems of book-keeping ? Explain with examples.
5. Explain the accounting process.
6. Explain the accounting devices.
7. Write short note on :
i) Matching concept ; ii) Realisation concept ; iii) The concept of conservatism

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8. What are the generally accepted accounting principles ?
9. What are the principles to be kept in mind at the recording stage ?
10. What are the principles to be kept in mind while preparing the final accounts ?
11. 'Each transaction has a double aspect' - Explain this statement with examples.
12. Explain the need for accounting principles.

1.19 . RECOMMENDED BOOKS

1. RL Gupta and VK Gupta — 'Principles and Practice of Accountancy' (Sultan chand & sons, New Delhi - 110002)
2. T.S.Grewal — 'Introduction to Accountancy' (Sultan Chand & Co, New Delhi)
3. V.A. Patil and J.SKorlahalli — "Principles and Practice of Accountancy" (S.Chand & Co. New Delhi)
4. S.N.Maheswari — 'Advanced Accountancy' Volume One, (Vani Educational Books New Delhi)

1.20. GLOSSARY

1. Accountancy	:	Accountancy is the science of measurement of wealth. It is the systematised knowledge of accounting.
2. Accounting	:	Accounting is the process of identifying, classifying, recording, summarising and intrepreting business transactions in terms of money.
3. Accounting System	:	An accounting system is an orderly combination of accounts and other financial records arranged according to some rational principles, capable of generating accounting information.
4. Asset	:	Anything which has economic value is an asset.
5. Balance Sheet	:	Balance Sheet is a statement showing the financial position of a business organisation at a given point of time.
6. Book - Keeping	:	Book-keeping is the systematic recording of business transactions in financial terms.
7. Books of Account	:	The double-entry accounting system consists of two types of records called the 'Journal' and the 'Ledger', including their sub-divisions. Together they are called 'books of account', in which all aspects of business transactions are recorded.
8. Business Enterprise	:	A business unit formed for the purpose of carrying on some kind of economic activity with a profit motive.
9. Capital	:	The owners' investment or equity in an enterprise.
10. Cost Accounting	:	It involves the measurement of costs incurred in manufacturing products or providing services.
11. Double-Entry System	:	Every transaction has a dual aspect, i.e., the receiving aspect and the giving aspect of the benefit involved. In the double-entry system, the amount invovled in any transaction recorded twice, once as a debit and again as a credit.
12. Entity	:	Entity means anything that has a definite individual existence. A business entity is assumed to be separate and distinct from its proprietor for accounting purposes.

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13. Equity	:	The value of a claim or financial interest in an asset or a group of assets of a business.
14. Expenditure	:	Expenditure refers to spending, either by paying cash now or by promising to pay at a later date for the purchase or mainteriance of assets, the benifit of which will be available beyond the accounting year.
15. Expenses	:	Expenses refer to cost of services orgoods acquird which have been used up or consumed within the same accounting year.
16. Financial Accounting	:	It is primarily concerned with record-keeping, directed towards the preparation of final accounts and other accounting reports.
17. Final Accounts	:	'Final Accounts' refer to summary statements of accounting information prepared generally at the end of each accounting year such as'Profit & Loss Account', and 'Balance Sheet'.
18. Goods	:	The term 'Goods' is used to denote those things or articles in which the business deals.
19. Income	:	Income is what wealth yields or any amount received or receivable for services rendered or from any investment.
20. Information	:	Information is the aggregate of facts of data organised into knowledge.
21. Loss	:	Amount lost without any benefit or the excess of expenses over revenue.
22. Management	:	The person or persons who manage the day-to-day affairs of the business.
23. Management Accounting	:	It is that branch of accounting which provides information to support the operations, management and decision-making functions in an organisation.
24. Organisation	:	As a physical unit it means any unit of activity. In another sense, it means a group of people joined together in seeking common goals.
25. Partnership	:	It is a business which has two or more owners who have agreed to carry on the business and share profits or losses in an agreed ratio.
26. Profit	:	It is the excess of revenue over expenses.
27 Profit and Loss Account	:	It is a statement showing the result of business transactions over a period of time.
28. Proprietor	:	He is the owner of the business, who assumes the primary risk of the business by investing his funds in it as capital.
29. Revenue	:	Revenue is the total price realised for the goods sold or for the services rendered during a period of time.
30. Service	:	It means the work rendered for some return.
31. Single-Entry System	:	What is not double entry System is Single entry System.
32. Sole Proprietorship	:	It is a business unit which is owned by one individual.
33. Transaction	:	any event affecting an economic entity which can be expressed in terms of money, and which involves transfer of money or money's worth.
34. Wealth	:	It refers to economic resources or properties possessed by an entity.

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UNIT 2 : JOURNAL

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2.1 Introduction
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2.0 AIMS AND OBJECTIVES

This unit will explain the classification of accounts, principles of 'double entry', the rules of debit and credit and the application of rules of debit and credit for recording the transactions, in the form of 'journal entries', in the books of account.

Having gone through this unit you would be able to :
- classify the accounts and indentify the principles of double entry;
- state the rules of debit and credit ;
- apply the rules of debit and credit for recording the transactions in the books of account.

2.1 INTRODUCTION

In the previous unit various concepts of accounting were discussed. In this unit the classification of accounts and rules ofdebit and credit and their application are explained which will help you for recording the business transactions in the books of account. Business transactions are recorded in two stages. First, they are written in a book called the 'JOURNAL' and later they are entered in another book called the 'LEDGER'. In this unit we will discuss the first stage of recording.

2.2 MEANING OF AN ACCOUNT

An account is a summarised record of transaction relating to a particular person or thing. An account is vertically divided into two halves. It resembles in shape the English alphabet 'T' as here under :

Dr.	Name of Account	Cr.

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The left-hand side is called the "Debit" side and the right-hand is called the "Credit" side. The word 'Dr.' (abbreviation for 'debit') is written on the left-hand top corner of the account and the 'Cr'. (abbreviation for 'Credit') is written on the right-hand top corner of the account to indicate the debit side and credit side respectively. The name of the account is written at the top in the centre. The word, 'Account', or its abbreviation A/c . is added to the name of the account.

2.3 CLASSIFICATION OF ACCOUNTS

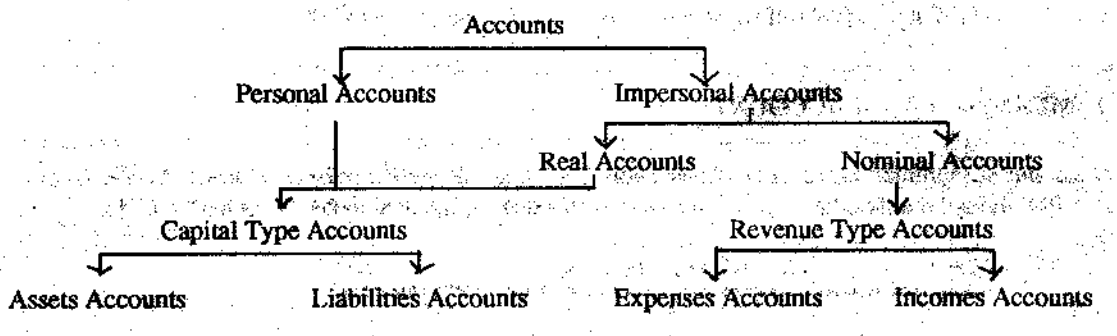
Accounts are classified as Personal Accounts and Impersonal Accounts. Impersonal Accounts are further classified as Real Accounts and Nominal Accounts.

1. **Personal Accounts :** Accounts which relate to persons, both natural and artificial, are called 'Personal Accounts'. They show dealings with persons. A separate account is maintained for each person. Some examples are Sri Ganesh's Account, Mohan's Account, Ramlal's Account, Central Bank Account, Delhi Cloth and General Mills Ltd. Account, etc.
2. **Real Accounts :** Accounts which show dealings in assets or properties are called 'Real Accounts'. A separate account is kept for each property. Some examples are Machinery Account, Furniture Account, Cash Account, etc. They are called 'real' accounts as they represent things of value owned by the business.
3. **Nominal Accounts :** Nominal Accounts record expenses, losses and incomes. Separate accounts are maintained for each item of expenses or incomes. Some examples are Salaries Account, Wages Account, Commission Received Account, etc. They are called 'nominal' accounts because they are accounts only for name's sake.

Accounts may be classified in another manner as here under.

1. **Capital Type Accounts :** Accounts which represent receipts and payments, the effect (benefit) of which is felt not only in the same accounting period but also in the subsequent periods, are called 'Capital Type Accounts'. Some examples are Machinery Account, Furniture Account, Capital Account, Loan Account, etc. Personal Accounts and Real Accounts discussed above belong to this category. 'Capital Type Accounts' may further be classified as 'Assets Accounts' and 'Liabilities Accounts'.
2. **Revenue Type Accounts :** When the effect of receipts and payments is felt in the same accounting period, the accounts representing them are called 'Revenue Type Accounts'. Some examples are Commission Received Account, Wages Account, etc.

Nominal Accounts discussed above are all Revenue Type Accounts. They may be divided into two groups. viz., 'Incomes Accounts' and Expenses Accounts'.
The following diagram shows the integration of both classification of accounts given above :



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More Examples of Accounts :

Personal Accounts	Real Accounts	Nominal Accounts
Arun's Account	Land Account	Carriage Account
Andhra Bank Account	Building Account	Rent Account
United India Insurance Company Limited Account	Motor Lorries Account	Interest Account
	Office Equipment Account	Insurance Account
Vazir Sultan Tobacco Company Limited Account	Investment Account	Travelling Expenses Account
* Outstanding Salaries Account	Loose Tools Account	Postage-Telegram Account
* Outstanding Commission Account	Patent Account	Advertising Account
* Insurance Prepaid Account	Goodwill Account	Miscellaneous Income Account
* Rent Received in Advance Account	Typewriter Account	Repairs Account

*NOTE : These four accounts are treated as personal accounts even though they do not have any person's name as a part of their title. They represent amounts payable to or to be received from many individuals.

Check Your Progress - 1

1.i) Classify the following under personal, real, and nominal accounts :
a) Bank ; b) Loan ; c) Cash ; d) Goodwill ; e) Carriage ; f) Postage and Telegram ; g) Drawings; h) Bank Overdraft ; i) Stock.

ii) Under what heading (Personal, real or nominal) would you classify the following accounts.
a) Interest ; b) Outstanding interest ;
c) Rent ; d) Rent outstanding ;
e) Salary ; f) Salary outstanding ;
g) Insurance ; h) Insurance prepaid.

PRINCIPLES OF DOUBLE ENTRY

A transaction, as you already know, results in the transfer of money or money's worth, i.e., goods or services. As every transaction involves a transfer it consists of two aspects, viz., (i) the giving aspect and (ii) the receiving aspect. These two aspects are inseparable and it is necessary to note that it is impossible to think of one without the other ; giving necessarily implies receiving and vice versa. For example, let us consider a transaction where goods are sold for cash. In this case, the receiving aspect is 'cash' (as cash comes into the hands of the seller) and the giving aspect is 'goods' (since goods are handed over to the buyer). Similarly, in a transaction in which purchase furniture is made for cash, the receiving aspect is furniture (as furniture comes in) and the giving aspect is cash (as cash goes out).

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Usually two parties are involved in a transaction and the benefit of the transaction is exchanged between them. When 'A' sells goods for cash : from the point of view of the 'A' 'goods account' and 'cash account' are involved in the exchange of benefits. However, if the sale is on credit basis, no cash would come in, since 'B' is obliged to pay the amount only later, and so it is 'B's account which is considered as receiving the benefit. Thus, 'B' is represented by (i) in the case of a credit transaction by his 'personal account' and (ii) in the case of cash sales transaction by cash account ;

The terms, DEBIT and CREDIT, are used in Accountancy to represent the receiving and giving aspects. The debit denotes the 'receiving aspect' and the credit the 'giving aspect'. It would be necessary to record both these aspects to get complete record of any business transaction. This system of recording the two-fold effect of each transaction is called the "Double-Entry" system.

For recording the two aspects of each transaction, two separate accounts are opened in the books and the entry will have to be made in both of them, i.e., on the debit side in one of them and on the credit side in the other. In other words, for every debit there must be a corresponding credit involving an equal amount. This is called the principle of double entry.

Some more examples of the dual aspect of business transactions:

	Transaction	Two Aspects			
		Receiving/ Receiver	Account Affected	Giving/ Giver	Account Affected
1.	Purchased goods for cash : Rs.4,000/-	Goods Rs.4,000	Goods A/c	Cash Rs.4,000	Cash A/c
2.	Sold goods to Murali on credit : Rs.2,500/-	Murali Rs.2,500	Murali A/c	Goods Rs.2,500	Goods A/c
3.	Purchased machinery for cash : Rs.20,000	Machinery Rs.20,000	Machinery A/c	Cash Rs.20,000	Cash A/c
4.	Sold old typewriter for cash Rs.300/-	Cash Rs.300	Cash A/c	Typewriter Rs.300	Typewriter A/c
5.	Paid wages Rs.2,000/-	Services of workers Rs.2,000	Wages A/c	Cash Rs.2,000	Cash A/c
6.	Received cash from Murali Rs.1,500/-	Cash Rs.1,500	Cash A/c	Murali Rs.1,500	Murali A/c
7.	Paid cash to Ganesh Rs.2,500	Ganesh Rs.2,500	Ganesh A/c	Cash Rs.2,500	Cash A/c
8.	Additional capital brought in Rs.5,000/-	Cash Rs.5,000	Cash A/c	Proprietor Rs.5,000	Capital A/c (Proprietor's personal A/c)
9.	Received Cash Rs.500 as Commission	Cash Rs.500	Cash A/c	Services rendered Rs.500	Commission A/c
10.	Returned goods to Raju Rs.200/-	Raju Rs.200	Raju A/c	Goods Rs.200	Goods A/c

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2.5 RULES OF DEBIT AND CREDIT

It is shown that every business transaction affects two accounts, and for a complete record of each such transaction, it would be necessary to debit one account and credit another account. In order to decide which of the two accounts is to be debited and which to be credited, the first thing is to find out which type of accounts - Personal, Real or Nominal - are affected by the transaction. Then, the following rules of debit and credit will have to be applied.

1. **For Personal Accounts**

Debit the RECEIVER
and
Credit the GIVER.

According to this rule, the account of the person receiving the benefit (from the business) of the transaction will have to be debited and the account of the person giving the benefit (to the business) of the transaction will have to be credited.

2. **For Real Accounts**

Debit what comes IN
and
Credit what goes OUT

As per this rule, when any property comes into the business, the account of that property is debited and when any peroperty goes out of the business, the account of that property is credited.

Example : Purchased machinery for cash : Rs.20,000.
In this case, Machinery Account and Cash Account are affected. Both are 'Real Accounts'. As machinery has come in and cash has gone out, Machinery Account will be debited (debit what comes in) and Cash Account credited (Credit what goes out) to record this transaction.

Take for example, a transaction : Paid cash to Ganesh : Rs.2,500.
In this case, Ganesh Account (a personal account) and cash account (a real account) are affected. Ganesh has received the benefit (Cash Rs.2,500) from the business. Therefore, his account will be debited as per the rule "Debit the receiver". Cash Account will be credited according to Rule 2.

Consider another transaction in which cash is received from Murali amounting to Rs. 1,500. The two accounts affected by this transaction are Cash Account (a real account) and a Murali account (a personal account). Murali has given the benefit (cash Rs. 1,500) to the business and, therefore, his account will be credited as per the rule, "Credit the giver". Cash Account will be debited according to rule 2.

3. **For Nominal Accounts**

Debit EXPENSES AND LOSSES
and
Credit INCOMES AND GAINS

In other words, when an expense is incurred or loss suffered, debit the account of the expense or the loss, and when any income is earned or gain made, credit the account of the income or the gain.
Examples : (a) Paid salaries : Rs.3,000.
As a result of this transaction, the accounts affected are Salaries Account (a nominal account) and Cash Account (a real account). As salaries represent an expense, Salaries Account will be debited (debit expenses and losses). Cash Account will be credited as cash has gone out (credit what goes out.)
(b) Received Cash Rs.500 as Commission.

The two accounts affected in this case are 'Cash Account' (a real account) and 'Commission Account' (a nominal account). 'Commission Account' will be credited as Commission represents an income (credit incomes and gains). Cash Account will be debited as cash has come in (debit what comes in).

Some more transactions :

Transaction	Accounts affected	Type of Account	Rule	Account to be debited	Account to be credited	Reasons
(1)	(2)	(3)	(4)	(5)	(6)	(7)
1. Bought Goods from Ram on Credit Rs. 5,000	i. Goods A/c ii. Ram's A/c	Real Personal	Debit what comes in Credit the giver	Goods A/c –	Ram's A/c	Goods come in. Ram gives the benefit.
2. Bought goods for Cash Rs. 3,000	i. Goods A/c ii. Cash A/c	Real Real	Debit what comes in Credit what goes out	Goods A/c -	– Cash A/c	Goods come in. Cash goes out.
3. Sold goods to Gopal on credit Rs. 2,500	i. Gopal's A/c ii. Goods A/c	Personal Real	Debit the receiver Credit what goes out	Gopal'sA/c –	– Goods A/c	Gopal receives the benefit. Goods go out.
4. Sold goods for cash Rs. 1,000	i. Cash A/c ii. Goods A/c	Real Real	Debit what comes in Credit what goes out	Cash A/c –	– Goods A/c	Cash comes in. Goods go out.
5. Purchased Machinery from A & Co. on Credit Rs. 50,000	i. Machinery A/c ii. A Co.'s A/c	Real Personal	Debit what comes in Credit the giver	Machinery A/c –	– A&Co.'s A/c	Machinery comes in. A&Co., gives the benefit.
6. Returned goods to Ram Rs. 300	i. Ram's A/c ii. Goods A/c	Personal Real	Debit the receiver Credit what goes out	Ram's A/c –	– Goods A/c	Ram receives the benefit. Goods go out.
7. Gopal returns goods Rs. 100	i. Goods A/c ii. Gopal's A/c	Real Personal	Debit what comes in Credit the giver	Goods A/c –	– Gopal's A/c	Goods come in Gopal gives the benefit.
8. Bought Stationery Rs. 150	i. StationeryA/c ii. Cash A/c	Nominal Real	Debit expenses Credit what goes out	StationeryA/c –	– Cash A/c	Stationery is an Expense. Cash goes out.
9. Paid rent Rs. 600	i. Rent A/c ii. Cash A/c	Nominal Real	Debit expenses Credit what goes out	Rent A/c –	– Cash A/c	Rent is an expense Cash goes out.
10.Received interest on investments Rs. 500	i. Cash A/c ii. Interest A/c	Real Nominal	Debit what comes in Credit incomes	Cash A/c –	– Interest A/c	Cash comes in. Interest is an income.

2.6 MODERN APPROACH TO THE DOUBLE ENTRY PRINCIPLE

All business transactions, as is shown are recorded in such a way that they are shown as having a dual aspect. Suppose 'A' starts his business with Rs.25,000 as his capital. We record this transaction from the business point of view. It produces the following two effects :

i) an asset. viz. Cash Rs.25,000. comes into the business, and
ii) a claim of the proprietor (Known as owner's equity or capital) on the assets of the business arises.

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Thus, when a person comes into the business, claim for an equal amount arises. This fact can be expressed in the form of an equation called Accounting or Balance Sheet Equation, which is as follows :

Assets = Equities

It implies that any change (increase or decrease) in assets must produce a corresponding change in the equities. Generally, outsiders also contribute funds for running the business. The claim of the outsiders are called 'creditors equity' (or liabilities). Thus, the total equities consist of owner's equity and creditor's equity. Accordingly, the above equation can also be written as :

Assets — Capital + Liabilities

The equation can be used to determine the owner's equity by rewriting it as under :

Assets— Liabilities = Capital

The accounting equation can also be shown in the form of a statement known as 'the Balance Sheet'.

BALANCE SHEET AS ON (DATE)

Capital and Liabilities	Rs.	Assests	Rs.

In this connection, it is necessary to note that income (or profits) increases the owner's equity and expenses or losses decrease the owner's equity.

We shall discuss the accounting equation with the help of the following examples of transactions:

1. A starts his business with Rs.25,000 as his capital :

As a result of this transaction the business has acquired an asset worth Rs.25,000 in the form of cash and its proprietor has a corresponding claim in the form of capital. The accounting equation now reads as under :

Assets = Captial + Liabilities
Rs.25,000 = Rs.25,000 + 0

2. Purchased machinery for cash Rs.10,000 :

The effect of this transaction is that cash decreases by Rs.10,000 and another asset (machinery) worth the same amount has come into existence. But capital remains unchanged.

The accounting equation will now appear as under :

	Assets		= Capital +	Liabilities
	Cash+	Machinery		
Old Equation	25,000 +	0	= 25,000+	0
New Equation (—)	10,000+	10,000	= —	—
New Equation	15,000 +	10,000	= 25,000 +	0

3. Purchased goods from Suresh on Credit : Rs.7,000

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It means that the business has acquired an asset (goods) worth Rs.7,000 which amount is payable by the business to Suresh, the supplier of the goods. The position now will be as follows :

	Assets			= Capital +	Liabilities
	Cash +	Machinery	+Goods		
	Rs.	Rs.	Rs.	Rs.	Rs.
Old Equation	15,000 +	10,000 +	0	= 25,0000 +	0
New Transaction	0 +	0 +	7,000	= 0 +	7,000
New Equation	15,000 +	10,000 +	7,000	= 25,000 +	7,000

4. Paid Salaries : Rs.2,000

The result of this transaction is that the cash balance is reduced by Rs.2,000. Since no asset has come into existence, the capital will be reduced by Rs.2,000. The accounting equation will be as under :

	Assets			= Capital +	Liabilities
	Cash +	Machinery	+Goods		
	Rs.	Rs.	Rs.	Rs.	Rs.
Old Equation	15,000 +	10,000+	7,000	= 25,000 +	7,000
New Transaction	(—) 2,000	+ 0 +	0	=(—)2,000	0
New Equation	13,000 +	10,000 +	7,000	= 23,000 +	7,000

Thus, at any time, any change in any variable must simultaneously produce a corresponding change in another variable to the same extent. In other words, every transaction has a double effect and the accounting equation, Assets = Capital + Liabilities is always true. The last equation will appear as follows when it is shown in the Balance Sheet form :

BALANCE SHEET AS ON (DATE)

Capital & Liabilities	Rs.	Assest	Rs.
Capital	23,000	Cash	13,000
Creditor (Suresh)	7,000	Machinery	10,000
		Goods	7,000
	30,000		30,000

Illustration 1

Show the accounting equations on the basis of the following transactions and present the last equation in the form of a Balance Sheet :

		Rs.
1.	Aditya commenced business with cash	60,000
2.	Bought goods on credit	10,000
3.	Sold goods for cash (Cost Rs.1,600)	2,000
4.	Paid rent	500
5.	Purchased furniture on credit	5,000
6.	Bought goods for cash	3,000
7.	Sold goods on credit (cost Rs.4,000)	5,000
8.	Salaries payable	2,000
9.	Interest receivable	500

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Solution

Accounting Equation: Assets = Capital + Liabilities

No.	Transactions	Assets =	Capital +	Liabilities
		Rs.	Rs.	Rs.
1.	Aditya commenced business with cash Rs.60,000	60,000 =	60,000 +	0
2.	Bought goods on credit Rs.10,000	10,000 =	0 +	10,000
	New Equation	70,000 =	60,000 +	10,000
3.	Sold goods costing Rs.1,600 for Rs.2,000 in cash	(—)1,600 (+)2,000 =	(+) 400 +	0
	New Equation	70,400 =	60,400 +	10,000
4.	Paid rent Rs.500	(—) 500 =	(—) 500 +	0
	New Equation	69,900 =	59,900 +	10,000
5.	Purchased furniture on credit Rs.5000	(+) 5,000 =	0 +	5,000
	New Equation	74,900 =	59,900 +	15,000
6.	Bought goods for Cash Rs.3,000	(+) 3,000 = (—) 3,000 =	0 +	0
	New Equation	74,900 =	59,900 +	15,000
7.	Sold goods costing Rs. 4,000 for Rs.5,000 on Credit	(—) 4,000 = (+) 5,000 =	(+)1,000 +	0
	New Equation	75,900 =	60,900 +	15,000
8.	Salaries payable Rs.2,000	0 =	(—)2,000 +	(+)2,000
	New Equation	75,900 =	58,900 +	17,000
9.	Interest receivable Rs.500	(+)500 =	(+)500 +	0
	New Equation	76,400 =	59,400 +	17,000

BALANCE SHEET AS ON (DATE)

Capital + Liabilities	Rs.	Assets	Rs.
Capital	59,400	Furniture	5,000
Creditors	17,000	Goods	7,400
		Debtors	5,500
		Cash	58,500
	76,400		76,400

Check You Progress - 2

i) Fill in the blanks by putting 'debit' or 'credit'

a) The increase in machinery account will be _____

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b) The decrease in machinery account will be _____

c) The increase in salary paid account will be _____

ii) Fill in the blanks by selecting appropriate word given in brackets.

a) Capital account is _____ by the Expense
(increased/decreased)

b) Capital account is _____ by the revenue
(increased/decresed)

iii) Both assets and owner's equity (i.e., capital) would be increased by :

a) Purchasing a machine on credit

b) Proprietor's withdrawals

c) Retained earnings.

---

iv) What is the effect of purchase of Machine for cash

a) decreases total assets

b) increases total assets

c) keeps total assets unchanged.

2.7 ADVANTAGES OF DOUBLE-ENTRY SYSTEM

The following are the advantages of 'Double Entry System' of Accounting

1. It provides a proper, complete and reliable record of all business transactions.
2. It supplies full information regarding expenses, losses, incomes, assets and liabilities of the business.
3. The arithmetical accuracy of the Books of Account can be known through the Trial Balance.
4. The trading result, i.e, profit made or loss suffered, for any given period can be found out.
5. The financial state of affairs of the business can be known.
6. It helps the management in taking suitable decisions.
7. It is helpful for the comparing of the business performance in the current year with that in the preceding years so as to know the progress of the business.

2.8 JOURNAL

The word 'Journal' means a daily record. Business transactions are entered in the Journal in chronological order as they occur. It is called a 'Book of prime or original entry' as transactions are recorded for the first time in this book before further entries are made in other books of account. The process of recording in the 'Journal' is called 'Journalising' and the various entries made in the journal are called 'Journal Entries'.

2.9 FORM OF THE JOURNAL

The following is the form of the journal.

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JOURNAL

Date (1)	Particulars (2)	L.F (3)	Dr. Amount (4)		Cr. Amount (5)	
			Rs.	Ps.	Rs.	Ps.

The columns of the jounal are explained below :

Column (1) : The date of the transaction is written in this column. The year is written at the top, the month is written below the year and the day (the particular date) is entered after the month.

Example :1989 Year
July, 1 Month, Date

Column (2) : It is meant for recording the names of the two accounts which are affected by the transaction. The name of the account to be debited is written close to the left-hand margin line (i.e. near the date line). The word 'Dr' is written on the same line against the name of the account towards the end of the columa (i.e. closer to the third column). The name of the account to be credited, preceded by the word 'To' is written on the next line, after leaving a little space. (Please note that the words, 'Dr' and 'To', are being gradually dropped in modern practice). Then in the next line, a brief description of the nature of the transaction is given. This is called 'narration'. It is customary to prefix the word 'Being, or 'For' to the narration. Narration should be written in the particulars column only. it should not extend to other columns. After writing the narration, a line (called 'dividing line) should be drawn across the second column in order to separate the transactions from one another.

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Example

1	2	3	4		5	
Account to be debited Account to be credited Narration	Furniture Account Dr. To Cash Account (Being furniture purchased)					

Column (3) : This column is meant for writing the page number in the ledger on which the account appears ('L.F'. stands for 'Ledger Folio')

Columns (4) & (5) : The amount or amounts to be debited and credited to the accounts concerned are entered in columns (4) and (5) respectively.

2.10 STEPS IN JOURNALISING

1. Read the transaction carefully from the business entity point of view and determine the two accounts that are affected by the transaction.
2. Find out the class to which each account relates, i.e., whether it is a personal account or a real account or a nominal account.
3. Now recollect the rules of debit and credit and apply the concerned rule to decide which account is to be debited and which is to be credited.

Illustration 2 : Transactions relating to purchase and sale of goods for cash:
Enter the following transactions in the journal.

	Rs.
1. Bought goods for cash	4,000
2. Sold goods for cash	800
3. Purchased goods for cash from Hari	2,500
4. Sold goods to Krishna for cash	1,200

solution

JOURNAL

Date	Particulars		L.F.	Dr.	Cr.
				Rs.	Rs.
1.	Goods Account	Dr.		4,000	
	To Cash Account				4,000
	(Being cash purchase of goods)				
2.	Cash Account	Dr.		800	
	To Goods Account				8000
	(Being cash sale of goods)				
3.	Goods Account	Dr.		2,500	
	To Cash Account				2,500
	(Being cash purchase of goods)				
4.	Cash Account	Dr.		1,200	
	To Goods Account				1,2000
	(Being cash sale of goods)				

Illustration 3 : Transactions relating to purchase and sale of assets for cash :
Journalise the following transactions

	Rs.
1. Purchased Machinery	25,000
2. Sold old Typewriter	250
3. Bought furniture from Ramesh & Compnay for cash	15,000

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Solution

JORUNAL

Date	Particulars		L.F.	Dr.	Cr.
				Rs.	Rs.
1.	Machinery Account	Dr.		25,000	
	To Cash Account				25,000
	(Being Machinery purchased)				
2.	Cash Account	Dr.		250	
	To Typewriter Account				250
	(Being typewriter sold for cash)				
3.	Furniture Account	Dr.		15,000	
	ToCash Account				15,000
	(Being furniture purchased)				

Illustration 4 : Credit transactions.

Journalise the following transactions

	Rs.
1. Sold goods to Anand on credit	6,000
2. Purchased furniture from Rao & Company	4,000
3. Bought furniture from Gopi & Co., on Credit	5,000
4. Bought goods on account from Raman	3,000

Solution

JOURNAL

Date	Particulars		L.F	Dr.	Cr.
				Rs.	Rs.
1.	Anand's Account	Dr.		6,000	
	To Goods Account				6,000
	(Being goods sold on credit)				
2.	Furniture Account	Dr.		4,000	
	To Rao & Company's Account				4,000
	(Being furniture purchased on credit)				
3.	Furniture Account	Dr.		5,000	
	To Gopi & Company's Account				5,000
	(Being furniture purchased on Credit)				
4.	Goods Account	Dr.		3,000	
	To Raman's Account				3,000
	(Being goods purchased on Credit)				

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Illustration 5: Transactions relating to recepits and payments of cash.
Enter the following transactions in the Journal

		Rs.
1.	Received cash from Anand on account	3,000
2.	Paid to Raman on account.....	2,000
3.	Took a loan from Hiralal.....	10,000

Solution

JORNAL

Date	Particulars	L.F.	Dr.	Cr
			Rs.	Rs.
1.	Cash Account Dr. To Anand Account (Being cash received on account)		3,000	3,000
2.	Raman's Account Dr. To Cash Account (Being cash paid on account)		2,000	2,000
3.	Cash Account Dr. To Hiralal's Loan Account (Being loan taken)		10,000	10,000

Illustration 6 : Transactions relating to return of goods.
Journalise the following transactions.

		Rs.
1.	Anand returns goods	150
2.	Returned goods to Raman	200

Solution

JORNAL

Date	Particulars	L.F.	Dr.	Cr
			Rs.	Rs.
1.	Goods Account Dr. To Anand's Account (Being goods returned by Anand)		150	150
2.	Raman's Account Dr. To Goods Account (Being goods returned to Raman)		200	200

Illustration 7 : Transactions relating to payment of expenses and receipt of incomes.
Journalise the following transactions.

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		Rs.
1.	Paid Salaries.....	5,000
2.	Paid rent to Land lord, Raghavan	500
3.	Received interest on Investments.....	400
4.	Received commission from Mehta.....	600

Solution

JORNAL

Date	Particulars		L.F.	Dr.	Cr
				Rs.	Rs.
1.	Salaries Account To Cash Account (Being salaries paid)	Dr.		5,000	5,000
2.	Rent Account To Cash Acount (Being Rent paid)	Dr.		500	500
3.	Cash Account To Interest Account (Being Interest received on investments	Dr.		400	400
4.	Cash Acount To Commission Account (Being Commission received)	Dr.		600	600

Illustration 8 : Transactions with the proprietor.

Enter the followig trasnactions in the Journal

		Rs.
1.	V.K. Iyer commenced business with a capital of.....	40,000
2.	He withdrew for his personal use	500
3.	He introduced additional capital.....	5,000
4.	He took goods for domestic use.....	400

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Solution

JORNAL

Date	Particulars		L.F.	Dr.	Cr
				Rs.	Rs.
1.	Cash Account	Dr.		40,000	
	To Capital Account				40,000
	(Being capital brought in)				
2.	Drawings Acount	Dr.		500	
	To Cash Acount				500
	(Being the amount drawn for personal use)				
3.	Cash Account	Dr.		5,000	
	To Capital Account				5,000
	(Being additional capital brought in)				
4.	Drawings Account	Dr.		400	
	To Goods Account				400
	(Being goods taken for personal use)				

2.11 SOME IMPORTANT POINTS REGARDING JOURNALISING

The student is advised to note the following points in connection with Journal entries.

1. In the case of credit transaction, the person with whom we are dealing becomes either a debtor or a creditor as the cash settlement is postponed. Consequently, it becomes necessary to record the transaction through the account of the person concerned. In the case of a cash transaction, no further obligation remains to be fulfilled by the parties to the transaction. Therefore, we are not concerned with the account of the person with whom we are dealing while recording the transaction.

   Similarly, transactions relating to payments of expenses and receipts of incomes are recorded through the 'expense account' or 'the income account' concerned and not through the account of the person involved, since no debtor/creditor relationship is created.

   The following are the examples of some of the transactions in which the personal accounts are not considered while recording.

   i. Purchased goods for cash from Hari..... 2,500
   ii. Sold goods to Krishna for cash..... 800
   ii. Rent paid to landlord, Raghavan..... 500
   iv. Received commission from Mehta..... 600

2. When the name of the person is given in a transaction and when the word 'cash' does not appear, it is implied that it is a credit transaction.
   e.g., Purchased furniture from Rao & Company : Rs.4,000.
   When the name of the party does not appear it is always a cash transaction even if the word 'cash' is not mentioned in the transaction. e.g., Purchased Machinery : Rs.25,000.

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3. While recording transactions involving the taking or giving of loans, the word 'loan' is added to the name of the related party:
e.g., Hiralal's Loan Account.

4. In the illustrations given above 'Goods Account' is used while recording the dealings in 'Goods', viz., purchases, sales and return of goods. In the practical system of Book-Keeping, the 'Goods Account' is not maintained. It is divided into four accounts as given here under:

i.	Purchases Account	–	for recording cash and credit purchases of goods:
ii.	Sales Account	–	for recording cash and credit sales of goods :
iii.	Purchases Returns Account (also called Returns Outward Account)	–	for recording goods returned to suppliers :
iv.	Sales Returns Account(also called Returns Inward Account)	–	for recording goods returned by customers.

5. In respect of certain items like rent, commission, etc., where both payments (i.e., expenses) and receipts (i.e., incomes) take place, two separate accounts may be maintained, one for recording payments and the other for receipts: e.g., Commission Allowed Account and Commission Received Account. Alternatively, only one account may be maintained in which case the account is debited with payments and credited with receipts.

We have seen how different types of business transactions are recorded through the Journal. We shall now take up some comprehensive problems.

Illustration 9

Rama Rao commenced business on 1st January, 1989. His transactions for the month are given below. Journalise them.

1989		Rs.
Jan. 1	Commenced business with a capital of	30,000
" 2	Bought goods from Chand & Company.....	7,500
" 3	Sold goods for cash	1,000
" 4	Purchased furniture	1,500
" 6	Purchased goods on account from Gopal & Co.....	5,000
" 7	Returned goods to Gopal & Company.....	150
" 10	Paid for advertisement	400
" 14	Cash Sales	800
" 17	Sold goods on account to Venkat	1,000
" 18	Venkat returns goods	75
" 23	Paid Chand & Company on account	3,000
" 24	Paid Office expenses	50
" 27	Received from Venkat on account	500
" 31	Paid salaries	800
" 31	Drew cash for private expenses	600

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Solution

JORNAL

Date	Particulars		L.F.	Dr.	Cr.
1989				Rs.	Rs.
Jan. 1	Cash Account	Dr.		30,000	
	To Capital Account				30,000
	(Being capital brought in)				
Jan. 2	Purchases Account	Dr.		7,500	
	To Chand & Company's Account				7,500
	(Being credit purchase)				
Jan. 3	Cash Account	Dr.		1,000	
	To Sales Account				1,000
	(Being Cash sales)				
Jan. 4	Furniture Account	Dr.		1,500	
	To Cash Account				1,500
	(Being furniture purchased)				
Jan. 6	Purchases Account	Dr.		5,000	
	To Gopal & Company's Account				5,000
	(Being credit purchases)				
Jan. 7	Gopal & Company's Account	Dr.		150	
	To Returns Outward Account				150
	(Being goods returned to Gopal & Company's)				
Jan.10	Advertisement Account	Dr.		400	
	To Cash Account				400
	(Being payment for Advertisement)				
Jan.14	Cash Account	Dr.		800	
	To Sales Account				800
	(Being Cash Sales)				
Jan.17	Venkat's Account	Dr.		1,000	
	To Sales Account				1,000
	(Being credit sales)				
Jan.18	Returns Inward Account	Dr.		75	
	ToVenkat's Account				75
	(Being goods returned by Venkat)				
Jan.23	Chand & Company's Account	Dr.		3,000	
	To Cash Account				3,000
	(Being cash paid on Account)				

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Jan.24	Office Expenses Account To Cash Account (Being office expenses paid)	Dr.		50	50
Jan.27	Cash Account To Venkat's Account (Being Cash received on account)	Dr.		500	500
Jan.31	Salaries Account To Cash Account (Being salaries paid)	Dr.		800	800
Jan.31	Drawings Account To Cash Account (Being cash withdrawn for personal use)	Dr.		600	600

Illustration 10 : Journalise the following transactions.

1989

		Rs.
Mar. 1	Cash sales to A	450
Mar. 2	Bought goods form B	2,500
Mar. 2	Paid cartage on these goods	75
Mar. 3	Old newspapers sold	50
Mar. 4	Paid Municipal Taxs	250
Mar. 5	Paid repairs for Machinery	200
Mar. 6	Received Commission	400

Solution

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Date	Particulars		L.F.	Dr.	Cr
1989				Rs.	Rs.
Mar. 1	Cash Account To Sales Account (Being Cash Sales)	Dr.		450	450
Mar.2	Purchase Account To B's Account (Being credit purchase)	Dr.		2,500	2,500
Mar. 2	Cartage Account To Cash Account (Being cartage paid)	Dr.		75	75
Mar. 3	Cash Acount To Miscellaneous Income Account (Being the income received by sale of Old newspapers)	Dr.		50	50

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Mar. 4	Municipal Taxes Account To Cash Account (Being municipal taxes paid)	Dr.		250	250
Mar. 5	Repairs Account To Cash Account (Being payment for repairs to machinery)	Dr.		200	200
Mar. 6	Cash Account To Commission Account (Being Commission received)	Dr.		400	400

2.12 SUMMING UP

Accounts are mainly classified as personal, real and nominal accounts. Every trasnaction consists of two aspects, viz., i) The giving aspect and ii). the receiving aspect. The recording of these two aspects of each transaction is called the principle of double entry.

The three types of accounts have their own rules of debit and credit. For personal accounts the rule is 'debit the receiver and credit the giver', for real accounts debit what comes in and credit what goes out, and for nominal accounts 'debit expenses and losses and credit incomes and gains'.

The effect of the transactions and the principle of double entry can also be understood by studying its impact on the accounting equation (Assets=equities).
The word 'Journal' means a daily record. It is the book of prime entry in which the transactions are recorded first. We analyse the two fold effect of each transaction while recording in the journal. The process of recording in the journal is called journalising'. Mainly there are three steps involved in journalising i.e., i) finding out the two accounts that are affected by the transaction, ii) finding out the type to which each account relates and iii) deciding which account is to be debited and which is to be credited.

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2.13 ANSWERS TO CHECK YOUR PROGRESS

1. i) Personal Acounts – a, b, g, h.
   Real Accounts – c, d, i.
   Nominal Accounts – e, f,
   ii) Personal Acounts – b, d, f, h,
   Nominal Accounts – a, c, e, g.
   Real Accounts – –
2. i) (a) debit; (b) credit (c) debit
   ii) (a) decreased (b) increased
   iii) (c) retained earnings
   iv) (c) keeps total assets unchanged.

2.14 MODEL EXAMINATION QUESTIONS

A. Short Answer Questions

1. What is an account ?

2. Give the form of an account .
3. What are the various types of accounts ?
4. What are the advantages of double entry system ?
5. Give the form of Journal.
6 What is narration ?
7. What are the steps to be taken for journalising ?

B. Essay Answer Questions

8. What is the principle of double entry ? Explain with illustrations .
9. Give the rules of debit and credit and explain them with examples.
10. What is the modern approach to the double entry principle ? Explain with examples.
11. What are the important points you will bear in mind, while writing journal entries ?

PROBLEMS

1. Journalise the following transactions :

1989		Rs.
Jan. 2	Purchased goods for cash	2,000
" 4	Purchased goods from Rama on credit	4,500
" 5	Sold goods to Hari	1,500
" 6	Cash sales	800
" 7	Cash Sales to Mohan	750
" 9	Returned goods to Rama	200
" 10	Hari returned goods	50

2. Enter the following transactions in the journal

1989		Rs.
Mar.1	Bought furniture from Gopi & Co. for cash	4,000
" 3	Purchased machinery on credit from Sony & Co.	25,000
" 4	Sale of old furniture	500
" 7	Paid to Ramavatar	1,000
" 9	Govind paid	500
" 10	Paid Wages	200
" 12	Bought Stationery	50
" 15	Paid rent	500
" 15	Received Commission	80

3. Give journal entries to record the following transactions.

1989		Rs.
June.1	Misra commenced business with a capital of	1,50,000
" 1	Purchased a motor truck	50,000
" 2	Purchased goods from Ahmed	20,000
" 3	Sold goods	1,000
" 4	Returned goods to Ahmed	500
" 7	Sold goods to Chand	2,500
" 8	Chand returned	100
" 11	Cash purchases	5,000
" 14	Purchased postage stamps	50
16	Paid for advertising	500

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"	20	Paid Office expense	.....	40
"	25	Drew cash for personal use	.....	1,000
"	26	Cash sales	.....	800
"	27	Paid insurance premium	.....	200
"	30	Paid rent	.....	1,000
"	30	Paid salaries	.....	5,000

12.15 GLOSSARY

1. **Account** : An account is a summarised record of transactions relating to a particular person or thing.
2. **Capital Type Accounts** : Accounts which represent receipts and payments, the benefit of which is felt not only in the year of their occurrence but also in the subsequent years.
3. **Credit** : Represents the giving aspect of the benefit in a transaction.
4. **Creditor** : A party whose account shows a credit balance. It means, the business owes him money.
5. **Debit** : Represents the receiving aspect of the benefit in a transaction.
6. **Debtor** : A party whose account shows a debit balance. It means the party owes money to the business.
7. **Double Entry Principle** : The principles that both aspects, i.e., the receiving aspect (debit) and the giving aspect (credit) must be recorded to show the two-fold effect of each transaction.
8. **Entry** : An item recorded in the 'Journal'.
9. **Folio** : A page of a Ledger/Journal/any other book of account.
10. **Journal** : A book where daily record of transaction is intitially made the book of ' Original entry'.
11. **Journalising** : The process of Recording the transactions in the journal.
12. **Nominal Accounts** : Accounts of expenses and losses and incomes and gains.
13. **Personal Accounts** : Accounts of persons, firms, institutions etc.
14. **Real Account** : Accounts of Assets or properties.
15. **Revenue Type Accounts** : Accounts which represent receipts and payments, the benefit of which is enjoyed fully in the year of their occurance.

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UNIT-3 : LEDGER

Contents

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3.0 AIMS AND OBJECTIVES

This unit aims at recording entries in the ledger, based on journalising and balancing of accounts in order to find out the net effect of transactions.

Having studied and worked through this unit, we expect you to be aware of
- posting the entries into the ledger
- balancing of accounts.
- tribal balance and its purpose.

3.1 INTRODUCTION

We have learnt that business transactions are recorded in two stages. In unit2, we have discussed the first stage of recording, viz., 'Journalising'. In this unit we will discuss the second stage of recording, viz., Ledger posting and balancing of ledger accounts, which is necessary to get the information regarding the net effect of various transactions.

3.2 LEDGER

The Journal is a daily record in which transactions are entered as and when they occur. The limitation of the 'Journal' is that one cannot readily get the information regarding the net effect of the various transactions affecting any account from it. Suppose one wants to know the amount due to a particular supplier or the amount due from a particular customer on any given date. As transactions are recorded in the journal date-wise, the required information is not found at one place and one has to search through all the pages of the journal to find it. With a view to overcoming this limitation, transactions relating to a particular account are brought together and recorded at one place in another book called the "Ledger".

Thus, all cash transactions are grouped together and are recorded at one place under 'Cash Account' in the ledger. Likewise, transactions pertaining to different persons are recorded separately in the name of each person. Thus, the ledger contains a classified record of all business transactions relating to personal,

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real and nomial accounts. The process of entering the transactions (which have already been recorded in the journal) in the ledger is technically called 'posting'. The posting is usually made immediately after journalising.

Check Your Progress ——1.

What do you understand by 'posting' ?

3.3. FORM OF THE LEDGER ACCOUNT

An account is a sumarised record of transactions relating to a particular person or thing. The rulings of an account is given below :

Dr. NAME OF THE ACCOUNT Cr.

Date	Particulars	Folio	Amount	Date	Particulars	Folio	Amount
			Rs. Ps				Rs. Ps

The columns of the Ledger Account are explained below :

1. The date of each transaction is entered in the date column. The method adopted is similar to that adopted in the case of the journal.
2. The debit aspect of the transaction is posted to the debit side (left-hand side) of the account and the credit aspect is posted to the credit side (right-hand side). The particulars column is meant for indicating the name of the account that has got the other aspect of the transaction. Thus, we write on the debit side the name of the account indicated in the credit part of the journal entry with the word 'To' before it. On the credit side the name of the account indicated in the debit part of the journal entry is written with the word 'By' before it.
3. 'F' stands for 'Folio'. The 'Folio' column is used for writing the page number of the Journal in which the transaction has been originally recorded.
4. The amount of the transaction is shown in the amount column.

Notes :1) Narration is not written in the Ledger accounts. Again, the dividing line which is used in the 'journal' to separate transactions from one another is not drawn in the ledger accounts.

ii) An account once opened is used throughout for posting the subsequent transaction affecting it.

Illustration - 1

Purchased furniture for cash, Rs.5,000 on 2nd March, 1989. This transaction will appear in journal and the Ledger as under :

JOURNAL

Date	Particulars		L.F.	Dr. Amount	Cr. Amount
				Rs.	Rs.
1989 Mar. 2	Furniture Account To Cash Account (Being furniture purchased)	Dr.		5,000	5,000

LEDGER

Dr. **FURNITURE ACCOUNT** Cr.

Date	Particulars	Folio	Amount	Date	Particulars	Folio	Amount
1989			Rs.				Rs.
Mar.2	To Cash Account		5,000				

LEDGER

Dr. **CASH ACCOUNT** Cr.

Date	Particulars	Folio	Amount	Date	Particulars	Folio	Amount
			Rs.	1989			Rs.
				Mar. 2	By Furniture Account		5,000

We shall now take up some transactions, and see how they are journalised and posted into the ledger

Illustration - 2

Journalise the following transactions and post them into the ledger.

1989			Rs.
April.	2	Cash sales	6,500
"	5	Paid salaries	2,500
"	8	Sold goods to 'P'	4,000
"	12	Cash purchases	3,000
"	14	Paid for stationery	50
"	17	Goods taken by proprietor for personal use	800
"	22	Bought goods from 'Q'	6,000
"	23	Received grom 'P' on account	2,000
:	27	Sold goods for cash	1,000
"	30	Received interest on Investments	600

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Solution

JOURNAL

Date	Particulars	L.F.	Dr. Amount	Cr Amount
1989			Rs.	Rs.
April. 2	Cash Account Dr. To Sales Account (Being Cash sales))		6,500	6,500
" 5	Salaries Account Dr. To Cash Account (Being salaries Paid)		2,500	2,500
" 8	P's Account Dr. To Sales Account (Being goods sold to P on credit		4,000	4,000
" 12	Purchases Account Dr. To Cash Account (Being Cash Purchases)		3,000	3,000
" 14	Stationery Account Dr. To Cash Account (Being the Stationery purchased)		50	50
" 17	Drawings Account Dr. To purchase Account (Being goods taken for personal use)		800	800
" 22	Purchase Account Dr. To Q's Account (Being goods purchased from Q on credit)		6,000	6,000
" 23	Cash Account Dr. To P's Account (Being the amount received from P' on credit)		2,000	2,000
" 27	Cash Account Dr. To Sales Account (Being Cash Sales)		1,000	1,000
" 30	Cash Account Dr. To Interest Account (Being interest received on investments)		600	600

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LEDGER

CASH ACCOUNT

Dr. Cr.

Date	Particulars	Folio	Amount Rs.	Date	Particulars	Folio	Amount Rs.
1989 Apr. 2	To Sales Account		6,500	1989 Apr.5	By Salaries Account		2,500
" 23	To P's Account		2,000	" 12	By Purchase Account		3,000
" 27	To Sales Account		1,000	" 14	By Stationery Account		50
" 30	To Interest Account		600				

SALES ACCOUNT

Dr. Cr.

			Rs.				Rs.
				1989 April 2	By Cash Account		6,500
				" 8	By P's Account		4,000
				" 27	By Cash Account		1,000

SALARIES ACCOUNT

Dr. Cr.

			Rs.				Rs.
1989 April 5	To Cash Account		2,500				

P'S ACCOUNT

Dr. Cr.

1989 April 8	To Sales Account		4,000	1989 April 23	By Cash A/c		2,000

PURCHASE ACCOUNT

Dr. Cr.

1989 April 12	To Cash Account		3,000	1989 April 17	By Drawings Account		800
" 22	To Q's Account		6,000				

STATIONERY ACCOUNT

Dr. Cr.

1989 April 14	To Cash Account		50				

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Dr. **DRAWINGS ACCOUNT** Cr.

1989 April 17	To Purchases Account		800				

Dr. **Q'S ACCOUNT** Cr.

				1989 April 17	By Purchases Account		6,000

Dr. **INTEREST ACCOUNT** Cr.

				1989 April 30	By Cash Account		600

3.4 BALANCING OF ACCOUNTS

Whenever one wants to know the net effect of the various transactions affecting any account (say, the amount due from a particular customer on any given date), the concerned account is balanced. 'Balance' is the difference between the total debits and the total credits of an account. After finding out the balance, it is written on the side showing the smaller total so as to make the totals of the two sides equal. This is called the 'Balancing' of an account. 'Balancing' is done periodically. It may be done daily as in the case of cash account, and weekly, monthly, quarterly, half-yearly, as and when it is necessary or required.

Procedure

The following procedure is followed for balancing an account.

1. Find out the totals of the amount columns of the two sides and the difference between the two totals. This difference is called the 'balance'. For this purpose a separate sheet may be used. If the credit side total is greater than the debit side total, the difference is called 'credit balance'. If on the otherhand, the debit side total is greater than the credit side total, the difference is known as 'debit balance'.

2. Write the above balance on the side showing the smaller total. Now, both sides will have the same total.

3. Write the date of 'balancing' in the date column.

4. If the balance is entered on the debit side, write 'To Balance c/d' in that particulars column ; and if the balance is entered on the credit side, write 'By Balance c/d' in the particulars column. The abbreviation, 'c/d' means carried down'.

5. After entering the balance in the relevant amount column, write the total of each side. The totals must be written on the same horizontal line. Draw one line above each total and two lines below as shown here : ……

6. The balance thus, entered is known as the 'closing balance' of the account and now the account is said to be 'closed'.

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7. The 'closing balance' is now brought down and written below the total on the side having the bigger total. The balance is brought down on the date following the balancing date. After entering the date in the date column, write 'To Balance b/d' or 'By Balance b/d' as the case may be, in the particulars column. The abbreviation, 'b/d' means 'brought down'. Supose the date of balancing is March 31, and the closing balance is entered on the debit side as 'To Balance c/d'. Now, it must be brought down on April 1, and entered on the credit side, below the total, as 'By Balance b/d'. The balance thus brought down becomes the 'opening balance' for the new period. Similarly, if the closing balance is entered on the credit side as 'By Balance c/d' the same must be brought down and entered on the debit side as 'To Balance b/d'.

Notes : i) We have seen that the abbreviation, 'c/d' is used when closing an account and 'b/d' when opening the account on the next date. These abbreviations are used when the balance is carried down on the same page. In case the balance is carried forward to the next page or some other page, the abbreviations 'c/f' (carried forward) and b/f' (brought forward) are used in place of 'c/d' and b/d'.

ii) Sometimes, the balance of an account may be nil when the totals of both sides are the same. In such cases we will only enter the totals on both sides of the account.

3.5 INTERPRETATION OF LEDGER ACCOUNTS

1. **Personal Accounts** : These are more frequently balanced than others so as to know the amounts owed and owing. When the account of a person shows a debit balance, it indicates that he is a debtor. If, on the other hand, the account of a person shows a credit balance, it means that he is a creditor.

2. **Real Accounts** : Real Accounts are normally balanced at the end of each accounting period, i.e., before preparing the final accounts. They generally show a debit balances, and are Asset Accounts.

3. **Nominal Accounts** : When nominal accounts are balanced, debit balances in such accounts indicate expenses or losses and credit balances, incomes and gains. Nominal accounts are closed by transfer to Profit & Loss Account at the end of the accounting period.

Let us now take up a comprehensive problem, where the ledger accounts are balanced and further, a Trial Balance prepared.

Illustration - 1

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

1989		Rs.
Jan.1	S.Suraj commenced business with Cash	20,000
" 2	Purchased furniture for cash from A & Co.	4,000
" 2	Purchased goods from B.	6,000
" 3	Sold goods for cash	800
" 4	Paid rent	500
" 6	Sold goods to C	1,500
" 7	C returned goods	75
" 10	Bought goods from D	4,000
" 11	Returned goods to D	100
" 14	Paid for advertising	250
" 15	Paid for Stationery	50
" 17	Drew for personal use	400
" 20	Cash Sales	1,600
" 21	Received from C	425

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" 23	Paid to B	2,000
" 24	Sold goods to E	2,500
" 28	Cash Sales	1,000
" 31	Paid salaries	1,000
" 31	Paid Municipal taxes	200
" 31	Paid printing charges	250

Solution

JOURNAL

Date	Particulars		L.F	Dr. Amount	Cr. Amount
				Rs.	Rs.
1989 Jan.1	Cash Account To Capital Account (Being capital brought in)	Dr.		20,000	20,000
" 2	Furniture Account To Cash Account (Being furniture purchased)	Dr.		4,000	4,000
" 2	Purchases Account To 'B's Account (Being credit purcahses)	Dr.		6,000	6,000
" 3	Cash Account To Sales Account (Being cash sales)	Dr.		800	800
" 4	Rent Account To Cash Account (Being rent paid)	Dr.		500	500
" 6	C's Account To Sales Account (Being credit sales)	Dr.		1,500	1,500
" 7	Returns Inward Account To C's Account (Being goods returned by C)	Dr.		75	75
"10	Purchases Account To D' Account (Being credit purchases))	Dr.		4,000	4,000
" 11	D's Account To Returned Outward Account (Being goods returned to D)	Dr.		100	100

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" 14	Advertising Account Dr. To Cash Account (Being the amount paid for advertising)		250	250
"15	Stationery Account Dr. To Cash Account (Being the payment made for stationery)		50	50
" 17	Drawings Account Dr. To Cash Account (Being the amount drawn for personal use)		400	400
"20	Cash Account Dr. To Sales Account (Being cash sales)		1,600	1,600
" 21	Cash Account Dr. To C's Account (Being the amount received from C)		425	425
" 23	B's Account Dr. To Cash Account (Being the amount paid to B)		2,000	2,000
" 24	E's Account Dr. To Sales Account (Being credit sales)		2,500	2,500
" 28	Cash Account Dr. To Sales Account (Being cash sales)		1,000	1,000
" 31	Salaries Account Dr. To Cash Account (Being salaries paid)		1,000	1,000
" 31	Municipal Taxes Account Dr. To Cash Account (Being municipal taxes paid)		200	200
" 31	Printing Charges Account Dr. To Cash Account (Being printing charges paid)		250	250

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Dr. **CAPITAL ACCOUNT** Cr.

Date	Particulars	F	Amount	Date	Particulars	F	Amount
1989			Rs.	1989			Rs.
Jan.31	To Balance c/d		20,000	Jan.1	By Cash Account		20,000
				Feb.1	By Balance b/d		20,000

Dr. **FURNITURE ACCOUNT** Cr.

1989			Rs.	1989			Rs.
Jan.1	To Cash Account		4,000	Jan.1	By Balance c/d		4,000
Feb.1	To Balance b/d		4,000				

Dr. **CASH ACCOUNT** Cr.

1989			Rs.	1989			Rs.
" 1	To Capital A/c		20,000	" 1	By Furniture A/c		4,000
" 3	To Sales A/c		800	" 4	By Rent A/c		500
" 20	To Sales A/c		1,600	" 14	By Advertising A/c		250
" 21	To C's A/c		425	" 15	By Stationery A/c		50
" 28	To Sales A/c		1,000	" 17	By Drawings A/c		400
				" 23	By B's Account		2,000
				" 31	By Salaries A/c		1,000
				" 31	By Municipal TaxesA/c		200
				" 31	By Printing charges A/c		250
				" 31	By Balance C/d		15,175
			23,825				23,825
Feb.1	To Balance b/d		15,175				

Dr. **PURCHASES ACCOUNT** Cr.

1989			Rs.	1989			Rs.
Jan.2	To B's A/c		6,000	Jan.31	Balance c/d		10,000
Jan.10	To D's A/c		4,000				
			10,000				10,000
Feb.1	To Balance b/d		10,000				

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Dr. **B's ACCOUNT** **Cr.**

1989		Rs.	1989		Rs.
Jan.23	To Cash A/c	2,000	Jan.2	By Purchases A/c	6,000
Jan.31	To Balance c/d	4,000			
		6,000			6,000
			Feb.1	By Balance b/d	4,000

Dr. **SALES ACCOUNT** **Cr.**

1989		Rs.	1989		Rs.
Jan.31	To Balance c/d	7,400	Jan.3	By Cash A/c	800
			Jan.6	By C's A/c	1,500
			Jan.20	By Cash A/c	1,600
			Jan.24	By E's A/c	2,500
			Jan.28	By Cash A/c	1,000
		7,400			7,400
			Feb.1	By Balance b/d	7,400

Dr. **RENT ACCOUNT** **Cr.**

1989		Rs.	1989		Rs.
Jan.4	To Cash Account	500	Jan.31	By Balance c/d	500
Feb.1	To Balance b/d	500			

Dr. **C'S ACCOUNT** **Cr.**

1989		Rs.	1989		Rs.
Jan.6	To Sales Account	1,500	Jan.7	By Returns Inward A/c	75
			Jan.31	By Cash Account	425
			Jan.31	By Balance c/d	1,000
		1,500			1,500
Feb.1	To Balance b/d	1,000			

Dr. **RETURNS INWARD ACCOUNT** **Cr.**

1989		Rs.	1989		Rs.
Jan.7	To C's Account	75	Jan.31	By Balance c/d	75
Feb.1	To Balance c/d	75			

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Dr. **D'S ACCOUNT** Cr.

1989		Rs.	1989		Rs.
Jan.11	To Returns Outward Account	100	Jan.10	By Purchases A/c	4,000
Jan.31	To Balance c/d	3,900			
		4,000			4,000
			Feb.1	By Balance b/d	3,900

Dr. **RETURNS OUTWARD ACCOUNT** Cr.

1989		Rs.	1989		Rs.
Jan.31	To Balance c/d	100	Jan.11	By D's Account	100
			Feb.1	By Balance b/d	100

Dr. **ADVERTISING ACCOUNT** Cr.

1989		Rs.	1989		Rs.
Jan.14	To Cash Account	250	Jan.31	By Balance c/d	250
Feb.1	To Balance b/d	250			

Dr. **STATIONERY ACCOUNT** Cr.

1989		Rs.	1989		Rs.
Jan.15	To Cash Account	50	Jan.31	By Balance c/d	50
Feb.1	To Balance b/d	50			

Dr. **DRAWINGS ACCOUNT** Cr.

1989		Rs.	1989		Rs.
Jan.17	To Cash Account	400	Jan.31	By Balance c/d	400
Feb.1	To Balance b/d	400			

Dr. **E'S ACCOUNT** Cr.

1989		Rs.	1989		Rs.
Jan.24	To Sales Account	2,500	Jan.31	By Balance c/d	2,500
Feb.1	To Balance b/d	2,500			

BRAOU

Dr. **SALARIES ACCOUNT** Cr.

1989			Rs.	1989			Rs.
Jan.31	To Cash Account		1,000	Jan.31	By Balance c/d		1,000
Feb.1	To Balance b/d		1,000				

Dr. **MUNICIPAL TAXES ACCOUNT** Cr.

1989			Rs.	1989			Rs.
Jan.31	To Cash Account		200	Jan.31	By Balance c/d		200
Feb.1	To Balance b/d		200				

Dr. **PRINTING CHARGES ACCOUNT** Cr.

1989			Rs.	1989			Rs.
Jan.31	To Cash Account		250	Jan.31	By Balance c/d		250
Feb.1	To Balance b/d		250				

Note : Nominal Accounts are balanced for the purpose of preparing the Trial Balance.

3.6 TRIAL BALANCE

After posting the journal entries in the ledger and balancing the accounts, the next step is to check the arithmetical accuracy of the books of account. For this purpose, a statement of balance of various accounts is prepared. Such a statement is known as 'Trial Balance'. In the Double entry system as shown earlier every debit entry has a corresponding credit entry. Therefore, the total debits given to various accounts must be equal to the total credits. Similarly, the total of debit balances must equal the total of credit balances. This fact is ensured by preparing the 'Trial Balance'. The Trial Balance will be discussed in a detailed manner later.

The 'Trial Balance' prepared from the above mentioned ledger balances will be as under :

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Trial Balance as on 31st January, 1989

S.No.	Name of Account	L.F	Dr.	Cr.
			Rs.	Rs.
1.	Cash Account		15,175	
2.	Capital Account			20,000
3.	Furniture Account		4,000	
4.	Purchases Account		10,000	
5.	B's Account			4,000
6.	Sales Account			7,400
7.	Rent Account		500	
8.	C's Account		1,000	
9.	Returns Inward Account		75	
10.	D's Account			3,900
11.	Returns Outward Account			100
12.	Advertising Account		250	
13.	Stationery Account		50	
14.	Drawings Account		400	
15.	E's Account		2,500	
16.	Salaries Account		1,000	
17.	Municipal Taxes Account		200	
18.	Printing Charges Account		250	
			35,400	35,400

3.7 SUMMING UP

After journalising the transactions relating to a particular account are brought together and recorded at one place in another book called the 'ledger'. The process of entering the transactions in the ledger is technically called 'posting'. The two aspects of every transaction have to be posted to the respective accounts in the ledger.

In order to know the net effect of various transactions posted to an account, balancing has to be done. After finding out the totals of both sides, i.e., credit and debit, the difference between the two sides is written on the side showing the smaller total so as to make the totals of the two sides equal. This is called the balancing of an 'account'. It is done periodically. After balancing the various accounts, a trial balance is prepared to prove the arithmetical accuracy of a double entry.

3.8 ANSWERS TO CHECK YOUR PROGRESS

1. The process of entering the business transactions (which have already been recorded in the journal) in the ledger is technically called 'posting'.

3.9 MODEL EXAMINATION QUESTIONS

A. Short Answer Questions

1. What is a Ledger ?

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2. Give form of the Ledger Account.

3. What is balancing ?
4. What is a trial balance ?

B. Essay Answer Questions

5.Write a note on Ledger posting with an Example.
6.Write the procedure followed for balancing an account with an example.

PROBLEMS

1. Give journal entries to record the following transactions

1989			Rs.
June	1	Misra commenced business with cash	1,50,000
"	1	Purchased a motor truck	50,000
"	2.	Purchased goods from Ahmed	20,000
"	3.	Sold goods	1,000
"	4.	Returned goods to Ahmed	500
"	7.	Sold goods to Chand	2,500
"	8.	Chand returned goods	100
"	11.	Cash purchases	5,000
"	14.	Purchased Postage stamps	50
"	16.	Paid for advertising	500
"	20.	Paid office expenses	40
"	25.	Drew cash for personal use	1,000
"	26.	Cash sales	800
"	27.	Paid insurance premium	200
"	30.	Paid rent	1,000
"	30.	Paid salaries	5,000

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

1989			Rs
Sept.	1	Manohar started busines with	2,00,000
"	1	Bought machinery	50,000
"	2.	Bought furniture from Rahim & Co.	10,000
"	2.	Purchased Typewriter	2,500
"	3.	Purchased goods	17,000
"	7.	Paid wages	2,000
"	9.	Bought packing materials	1,000
"	10.	Cash sales	3,000
"	11.	Credit sales to Krishna	5,000
"	14.	Paid wages	2,000
"	15.	Purchased goods from Ramji	10,000
"	16.	Returned goods to Ramji	500
"	20.	Purchased stationery	200
"	21.	Bought postage stamps	80
"	23.	Paid for repairs	400
"	24.	Paid miscellaneous expenses	150
"	27.	Paid printing charges	200
"	30.	Paid salaries	6,000
"	30.	Paid to Rahim & Co.	5,000

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3. Prepare a Trail balance with the ledger balances of problem 2

3.10 RECOMMENDED BOOKS

1. RL Gupta and VK Gupta : 'Principles and Practice of Accountancy' (Sultan Chand & Sons, New Delhi).
2. T.S.Grewal : 'Introduction to Accountancy' (Sultan Chand & Co., New Delhi).
3. VA Patil and JS Korlahali : 'Principles and Practice of Accountancy' (S.Chand & Co., New Delhi).
4. SN Maheswari : 'Advanced Accountancy' Volume One, (Vani Educational Books, New Delhi).

3.11 GLOSSARY

1. **Balance** : Balance is the difference between the total debits and total credits recorded in an account. It reveals the net effect of the various transactions posted to an account.
2. **Ledger** : The book of final entry, containing accounts in which all the transactions relating to a particular account are brought together and recorded at one place.
3. **Posting** : To enter the effect of a transaction in the concerned account in the Ledger.
4. **Trial Balance**: A statement of balances in various Ledger Accounts.

* * *

BRAOU

BLOCK - II : SUBSIDIARY BOOKS

UNIT - 4 : SUB -DIVISION OF JOURNAL

Contents

4.0 Aims and Objectives
4.1 Introduction
4.2 Subsidiary Books
4.3 Subsidiary Ledgers
4.4 Advantages of Subsidiary Books
4.5 Purchases Book
4.6 Purchases Returns Book
4.7 Sales Book
4.8 Sales Returns Book
4.9 Bills of Exchange
4.10 Bills Receivable and Bills Payable Books
4.11 Journal Proper
4.12 Types of Transactions Recorded in Journal Proper
4.13 Summing Up
4.14 Answers to Check Your Progress
4.15 Model Examination Questions
4.16 Recommended Books
4.17 Glossary

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4.0 AIMS AND OBJECTIVES

This unit aims at discussing the subsidiary books, recording of transactions in these books and their posting into the ledger.

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

- identify various types of subsidiary books
- explain the advantages of subsidiary books
- record the transactions in various subsidiary books.

4.1 INTRODUCTION

The Journal, as seen already, is the book of prime entry in which all transactions are recorded and their debit and credit aspects analysed. The debit aspects recorded in the journal are posted to the debit side and credit aspects to the credit side of the respective accounts in the ledger. The system of having only one journal and one ledger may work in a small business where the number of transactions is usually small. But when the number of transactions is very large, it is practically impossible to record all the transactions in one Journal. Moreover, the journal can be handled by only one person and the work becomes too heavy for him. The day-to-day transactions may not be recorded promptly in it. In order to overcome this difficulty and to facilitate speedy recording of a large volume of transactions the journal is divided into a number of separate journals. These are called Subsidiary Books.

4.2. SUBSIDIARY BOOKS

In any business many of the transactions are usually repetitive in nature. Broadly, the transactions can be grouped into two categories, viz., cash and non-cash transactions. Cash transactions are those which involve cash inflows (receipts) and cash outflows (payments). Non-cash transactions are those which do not directly or immediately involve cash flows. Many of the non-cash transactions are credit transactions of purchase and sale of goods. Credit purchases and sales, other than goods, are few in number and not repetitive, i.e., may occur occasionally. The cash receipts and payments may be grouped into one category, credit purchase of goods into another category and credit sale of goods into yet another category and recorded in special journals. Thus, in practice, the main journal is sub-divided in such a way that a separate journal or book is used for each category or group of transactions which are sufficiently large in number and also repetitive in nature. By and large, in any large scale business the following special journals are found. Depending on the need, the number of journals may be reduced or inreased.

1. *Purchases Book.* It is used to record credit purchases of goods only.
2. *Purchases Returns Book* : It is used to record the returns of goods to suppliers.
3. *Sales Book* : It is meant for recording credit sale of goods only.
4. *Sales Returns Book* : It is meant for recording goods returned by the customers.
5. *Bills Receivable Book* : It is used to record Bills or Promissory Notes received by the business.
6. *Bills Payable Book* : It is used to record Bills accepted or Promissory Notes issued by the business.
7. *Cash Book* : In this book, only cash transactions are recorded i.e., all receipts and payments of cash including cash sales and cash pruchases of goods.
8. *Journal Proper* : In addition to the above mentioned, the original journal, now called 'Journal Proper', is also used. In this book all other transactions which cannot be recorded in any of the above mentioned special books are recorded.

Each of the above mentioned subsidiary books is a special journal and a book of original entry. That is why they are differently called as "Books of Prime Entry" or "Sub-Divisions of Journal", or "Subsidiary Books" or "Special Journals" or "Subsidiary Journals" or Day Books*". Transactions of a particular type are entered in the book/journal specially meant for it and then posted to their respective ledger accounts. This system is known as the 'Practical System of Accounting' or sometimes as the "English System". It must, however, be noted that even though the usual type of debit-credit form journal entries are not passed in these special journals, the fundamental double-entry principles of accounting are strictly followed.

Chech Your Progress - 1

List out the subsidiary books

4.3. SUBSIDIARY LEDGERS

Just as the Journal is sub-divided into separate journals or books, the Ledger too may be sub-divided into two or more Subsidiary Ledgers if the volume of accounts demands it. Usually the ledger is sub-divided into 'Debtors Ledger', 'Creditors Ledger' and General Ledger'.

* The word 'Jour' means 'daily' in French, from which the English word Journal is derived. Hence Journals are also called 'Day Books'.

Debtors Ledger : This ledger contains personal accounts of all customers to whom goods are sold on credit. It is also called 'Sales ledger' or Sold ledger".
Creditors Ledger : This ledger contains personal accounts of all suppliers from whom goods are purchased on credit. It is also known as 'Purchase Ledger' or Bought Ledger'.
General Ledger : This ledger contains besides real, and nominal accounts, all other personal accounts. It is also referred to as 'Nominal Ledger'. Cash Book, as you will see later, is both a journal and a ledger. Cash Book is considered a part of the General Ledger.

However, we proceed on the assumption that there is one ledger and many journals.

4.4 ADVANTAGES OF SUBSIDIARY BOOKS

There are many advantages of having **subsidiary** books. They are summarised below :

1. *Division of Work* : The division of journal and ledger into separate books facilitates the division of work among a number of persons. This leads to simultaneous and prompt recording of transactions.
2. *Improves efficiency of recording* : The division of work prevents waste of time and stationery. The advantage of specialisation i.e., each person attending to one or two books, makes for efficiency.
3. *Reference becomes easy* : As there is a separate book for each type or group of transactions, reference to any of them is made easy. It also facilitates control.
4. *Classification of transactions becomes automatic* : As there is a separate book for each type/group of transactions, a particular type of transactions or a group of related transactions can be recorded at one place, i.e., in one book.
5. *Responsibility can be fixed* : The responsibility for maintaining a particular book can be fixed.
6. *Internal Check* : By having separate books, internal check or control becomes easier, which does not allow the committing of errors or frauds.

Having considered the need for having separate books of different types, we shall discuss 'Purchase Book' 'Purchase Returns Books', 'Sales Book', 'Sales Returns Book', and 'Bills books', in this unit. Cash Book will be taken up in the next unit.

4.5 PURCHASES BOOK

This book is used for recording only credit purchases of goods in which the businessman deals. In the case of manufacturing concerns, credit purchases of raw materials used for producing goods are recorded in this book. Other purchases, i.e., cash purchases of goods or raw materials, and cash and credit purchases, i:e., cash purchases of goods or raw materials, and cash and credit purchases of assets are not recorded in this book. The Purchases book is also called 'Purchases Day Book', 'Purchases Register', 'Bought Book', 'Invoice Book'.

Invoice

According to the objective evidence concept, as seen earlier, there should be evidence for the fact that a transaction has taken place. Without evidence, transactions are not recorded in the books of account. 'Invoice is a business document or bill or statement giving details of the goods such as their quantity, quality, price, and total value given by the seller to the purchaser. It is popularly known as a Bill. It is 'Purchase Invoice', also called 'Inward Invoice' for the purchase and 'Sales invoice' or 'Outward Invoice for the seller.

B R A O U

Trade Discount

Now a days, you might have observed, the price of the article is mentioned on the article (e.g. Retail Price not to exceed Rs....). The Price mentioned on the article or at which it is to be sold is called the 'catalogue' or 'list price'. When a purchase is made, the invoice is prepared first on the basis of its catalogue price and then certain percentage of that price is allowed as rebate or reduction, which is called trade discount. The purchaser pays only the net amount. i.e., what remains after allowing the trade discount, to the seller.

Trade discount, thus, is an allowance given by the seller to the buyer on the catalogue price of the article at the time of selling. This is generally given by the manufacturers and wholesalers to their customers. Since the trade discount is deducted from the catalogue price and only the net amount is received or paid, it is this net amount that is actually recorded in the books Trade discount, therefore, does not appear in the books of account.

Proforma Ruling of Purchases Book

PURCHASES BOOK

Date	Name and Address of the Supplier	Inward Invoice Number	L.F	Amount Rs. Ps.	Remarks
1	2	3	4	5	6

Recording in the Purchases Book

The credit purchases of goods are recorded in the Purchases book in the following manner :

1. In the first column, i.e., date column, the year and month of purchase is recorded in the left hand side sub-column and the day of purchase is recorded on the right hand side sub-column.
2. In the second column, the name and address of the party or supplier of goods are recorded.
3. In the third column, inward invoice number is to be entered. When goods are purchased on credit the businessman receives from the suplier (seller) a written statement (invoice/credit memo/bill) giving the details of the goods supplied. It is an inward invoice for the businessman. The invoices so received are consecutively numbered and filed. they have to be carefully preserved for future reference and for audit by the auditors. The consecutive number given to each inward invoice is to be entered in the inward invoice column of the Purchase Book in order that the details required may be easily obtained.
4. In the fourth column, the ledger folio or page number of the account in ledger is to be entered. This is done while posting the amounts to the individual ledger accounts of the suppliers.
5. In the fifth column, the amount payable to the supplier is to be recorded. It must be remembered that the invoice is prepared first with catalogue prices, before reduction in the form of trade discount is allowed. The amount, after deducting the trade discount, is the net sum payable. This net sum is to be recorded in the amount column. But sometimes sales tax is also levied. In some cases packing and forwarding charges are also charged. In such cases the invoice price payable is the catalogue price 'minus' trade discount 'plus' sales taxes 'plus' packing & forwarding charges, etc.
6. In the Remarks column, any other relevant information is recorded : forexample, the date on which the amount of the bill is payable (if there is a due date), the date of actual payment, etc.

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Posting the Purchases book

The transactions recorded in the Purchases book are posted to their respective accounts in the ledger. The double-entry is completed in the following way.

1. *Credit the Suppliers Account* : Separate accounts in the name of each supplier of goods are opened in the ledger. After recording a transaction in the Purchases book, the account of the Supplier in the ledger is credited with the amount by writing "By Purchases Account".
2. *Debit the Purchases Account* : Periodically, say weekly or fortnightly, the Purchases Journal is added up and the total of the purchases for that period is posted to the debit of purchases account in the ledger by writing 'To Sundries' as per the Purchases Book.

We, thus, find that the double-entry is completed by giving individual credits to suppliers accounts and a single debit to purchases account. Of course the total of debits is equal to the total of credits.

Illustration - 1

Record the following transactions in the Purchases Journal of M/s Srihari & Co., and show the ledger posting :

1989		Rs.
Jan. 2	Purchased goods from Ramakrishna - - - - - - - -	2,000
" 3	Bought goods from Sanjeev - - - - - - - - - - -	3,000
" 4	Purchased from Sriram goods worth - - - - - - - -	1,500
" 5	Bought goods from Ramakrishna with trade discount of 10%	1,000
" 6	Purchased from Sanjeev goods subject to a discount of 20%	2,000
" 7	Sriram sold us goods - - - - - - - - - - - - - - - - - -	800

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Solution

M/s Srihari & Co.
PURCHASES BOOK

Date	Name and Address of the Supplier	Inward Invoice Number	L.F.	Amount Rs. Ps.	Remarks
1989					
". 2	Rama Krishna	1	70	2,000-00	
". 3	Sanjeev	2	71	3,000-00	
". 4	Sriram	3	72	1,500-00	
". 5	Rama Krishna	4	70	900-00	
". 6	Sanjeeva	5	71	1,600-00	
". 7	Sri ram	6	72	800-00	
Jan. 7	TOTAL		55	9,800-00	

Note : The inward invoice numbers are imaginary.

M/s. Srihari & Co. Ledger
PURCHASES ACCOUNT (Page No. 55)

Dr. Cr.

1989 Jan. 7	To Sundries as per Purchases book	36	9,800			

RAMA KRISHNA'S ACCOUNT (Page No. 70)

Dr. Cr.

			1989 Jan. 2	By Purchases A/c	36	2,000
			Jan. 5	By Purchases A/c	36	900

SANJEEVA'S ACCOUNT (Page No. 71)

Dr. Cr.

			1989 Jan. 3	By Purchases A/c	36	3,000
			Jan. 6	By Purchases A/c	36	1,600

SRIRAM'S ACCOUNT (Page No. 72)

Dr. Cr.

			1989 Jan.4	By Purchases A/c	36	1,500
			Jan. 7	By Purchases A/c	36	800

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Check Your Progress - 2

i) What type of transactions are recorded in purchases book ?

a) all purchases of goods
b) all credit purchases
c) all cash purchases
d) all credit purchases of goods only

---

ii) State the account name to which the total of the purchases book is posted

a) Sales Account
b) Purchases Account
c) Capital Account

4.6 PURCHASES RETURNS BOOK

The Purchases Returns Book is used for recording the return s of goods to suppliers. It is also used to record allowances for damages claimed in respect of goods purchased. In any business it may become necessay to return the goods purchasd, partly or fully. The reason may be that the goods are defective or of inferior quality or damaged in transit or of short weight or received too late (off-season) or charged more than what has been agreed to, etc. The businessman may, therefore, return them to the supplier. Since goods are going out from the business, to the supplier, they are also called "Returns Outward", and hence the Purchases Returns book is also called 'Returns Outward Book.

Sometimes instead of returning the goods to the supplier for the above mentioned reasons the purchaser may retain the goods but claim some allowance (damages or compensation) to which the supplier may agree.

Debit Note

When goods are returned to a supplier or some allowance is claimed from him a statement called 'Debit Note' is sent to him. It informs him that his account is debited to the extent of the value of goods returned or allowance claimed. The Debit Note also contians the name and address of the supplier, description of the goods returned or nature of allowances claimed and reasons for the same. The Debit Notes are consecutively numbered and their duplicate copies carefully filed. The following is a specimen of a Debit Note :

Book Paradise
Book sellers & stationers

Hydcrabad
2-4-1989.

No. .....

DEBIT NOTE

To
M/s. Text Book Publishers
Daryaguni
NEW DELHI

WE DEBIT YOUR ACCOUNT AS FOLLOWS

	Rs.	Rs.
5 copies of 'Financial Accounting written by Rao & Raja @ Rs.25	125	
Less: Trade discount allowed by you at 20%	25	100

Books damaged, pages missing

(Rupees One hundred only)

Books purchased vide your invoice No.75 dated 15-3-1989, returned through V.P.Post

xxxxxxxx
For Book Paradise.

BRAOU

The Purchases Returns Journal is ruled as shown below :

Proforma of Purchases Returns Book

Date	Name and Address of the Supplier	Debit Note Number	L.F	Amount Rs.	Ps.	Remarks
1	2	3	4	5		6

Recording in the Purchases Returns Book

1. The year, month and day on which the goods are returned or claim is made is entered in the first column.
2. In the second column, the name and address of the supplier to whom goods are returned or from whom some allowance is claimed are entered.
3. The serial number of Debit Note is to be entered in the Debit Note column.
4. The ledger page number of the supplier's account is to be entered in the L.F. column at the time of posting.
5. The net value of the goods returned or the amount of claim made is to be entered in the amount column. It must be remembered that at the time of original purchase, trade discount might have been given in which case the same should be adjusted and only the net amount is to be shown here. In other words, whatever be the amount credited to the supplier's account at the time of purchase on these goods it should be debited now. For example, if the catalogue price of a book is Rs.25 on which 20% discount is given, the actual amount credited originally was only Rs.20 per book. Now, if 5 books are returned, Rs.25x5 = 125 minus 20% discount Rs.25 i.e. Rs.100 only is to be debited to the suppliers account. Therefore, in the amount column only Rs.100 is to be entered now.
6. In the Remarks column, any other relevant information, may be recorded.

Posting the Purchases Returns Book

i. Debit the Supplier's Account : The entries made in the Purchase Returns book are posted to the debit side of the supplier's account already existing, as "To Purchase Returns Account" or "To Returns Outward Account".

ii. Credit Purchases Returns Account : The Purchases Returns book is added up periodically, say weekly or fortnightly, and the total is posted to the credit side of the Purchase Returns account or Returns Outward account in the ledger as "By Sundries as per the Purchases Returns book".

Illustration - 2 : **(Refer illustration 1)**

1989		
Jan. 10	Returns to Ramakrishna (vide invoice I) goods worth	100
Jan. 12	Returned goods to Sanjeev (vide invoice 5) (on which a trade discount 20% was given	200
Jan. 15	Goods returned to Sriram (vide invoice 6)	60

Record the above transactions in the Purchases Returns Book of M/s Srechari & Co., and show the ledger postings.

BRAOU

Solution

M/s Sirhari & Co.
PURCHASE RETURNS BOOK (Page No. 29)

Date	Name and Address of the Supplier	Debit Note No.*	L.F.	Amount Rs. Ps.	Remarks
1989					
Jan. 10	Rama Krishna	10	70	100-00	
Jan. 12	Sanjeev	11	71	160-00	
Jan. 15	Sriram	12	72	60-00	
Jan. 20	TOTAL		89	320-00	

*Debit Note Numbers are Imaginary.

M/S SRIHARI & CO. LEDGER

RAMAKRISHANA'S ACCOUNT (Page No.70)

Dr.						Cr.
1989 Jan.10	To Returns Outward A/c	20	100.00			

SANJEEV'S ACCOUNT (Page No. 71)

Dr.						Cr.
1989 Jan. 12	To Returns Outward A/c	20	160.00			

SRI RAMA'S ACCOUNT (Page No.72)

Dr.						Cr.
1989 Jan. 15	To Returns Outward A/c	20	60.00			

PURCHASES RETURNS ACCOUNT (page No. 89)

Dr.						Cr.
			1989 Jan. 20	By Sundries as per purchases returns book	20	320.00

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The ruling of the Sales Returns Journal is as shown below:

Proforma of Returns Inward Book

Date	Name and Address of the Customer	Credit Note Number	L.F	Amount Rs.	Ps.	Remarks
1	2	3	4	5		6

Recording in the Sales Returns Book

Enter the date of the Credit Note in the first column, name and address of the customer who has returned goods or to whom some allowance is granted in the second column, Credit Note number in the third column, ledger page number of the customer's in the L.F. column, net value of goods returned or amount of allowance granted in the amount column.

Posting the Sales Returns Journal

i) Debit the Sales Returns or Inward Returns Account with the periodical total, by writing "To Sundries as per the Sales Returns Book".

ii) Credit the customer's account (already opened in connection with the sales) who has returned the goods or to whom some allowance is granted by writing "By Sales Returns Account".

Illustration -4 : (Refer illustration No.3)

Enter the following transations in Sales Returns Book and post them into ledger accounts.

1989

April 6 - Fine Rice Traders of Warangal returned 5 quintals saying that they are not super fine rice, but boiled rice. (Quintal Rs.300, discount 10%)

April 9 Fair Price Shop of Cuddapah claimed an allowance for two quintals for short weighing as they have received only 48 quintals (quintal Rs.200, discount 5%).

BRAOU

Solution

SALES RETURNS BOOK OF ANDHRA RICE MILLS, VIJAYAWADA

(PageNo.78)

Date	Name and Address of Customer	Credit Note Number*	L.F.	Amount Rs. P.	Remarks
1989					
April 6	Fine Rice Traders Warangal	14	102	1,350.00	
April 9	Fair Price Shop Cuddapah	15	103	380.00	
April 15	TOTAL		105	1,730.00	

* Note: Credit Note number are imaginary

LEDGER OF ANDHRA RICE MILLS

FINE RICE TRADERS, WARANGAL ACCOUNT

(Page No.102)

				1989 April 6	By Sales Returns a/c	78	1,350.00

FAIR PRICE SHOP, CUDDAPAH ACCOUNT

(Page No. 103)

				1989 April 9	By Sales Returns a/c	78	380.00

SALES RETURNS ACCOUNT

(Page No.105)

1989 April 15	By Sundries as per sales returns Book	78	1,730

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So far each book is presented independently for the sake of simplicity. Let us now consider an example involving all the four types of transactions:

Illustration -5

Enter the following transactions of Narasimham & Co. in proper books :

1989

Jan. 2 Purchased on credit from Electrical Appliance Ltd.
25 Water heaters @ Rs.40 each.
10 Electric Stoves @ Rs.50 each
15 Electric Irons @ Rs.60 each
Trade discount 20%

Check Your Progress -4

In Which book the Sale of goods on credit is recorded in

a) Sales book,

b) Sales returns book

c) Purchases book

4.8 SALES RETURNS BOOK

The Sales Returns Book is used for recording goods returned by the customers. It is also used for recording allowances granted to the customers on account of damages, breakages, short weight, etc. In the case of Purchases Returns Book where a businessman may return goods purchased owing to various reasons, similarly the customers of the businessman may return the goods to him. They constitute Sales Returns. They are also called Returns Inward as goods are coming in. Likewise the allowances claimed by the customers, if agreed by the businessman, are recorded in the journal. The Sales Returns Journal is also called Returns Inward Journal/Book.

Credit Note

When a customer returns goods or is given an allowance, a Credit Note is prepared and sent to the customer. It has the name and address of the customer, description of the goods received which are returned by the customer, etc. It informs the customer that his account is credited to the extent of the value of goods returned or allowance granted to him. The Credit Note is the basis for recording in the Sales Returns Book. Credit Notes are consecutively numbered and their copies filed. The following is a specimen of a credit note(please refer debit not description given earlier).

TEXT BOOK PUBLISHERS
Daryagunj, New Delhi. 10-4-1989.

No. . . . . .

CREDIT NOTE

To
M/s.Book Paradise
Hyderabad

WE CREDIT YOUR ACCOUNT AS FOLLOWS

	Rs.	Rs.
5 copies of 'Financial Accounting written by Rao & Raja @ Rs.25	125	
Less: Trade discount @ 20%	25	100

(Rupees One hundred only)
Book returned through V.P.Post
received on 10.4.89

xxxxxx
For Text Book Publishers

BRAOU

Jan. 5	Sold on Credit to Hariprasad & Sons 10 Water heaters @ Rs.50 each 5 Electric Stoves @ Rs.60 each 5Electric Irons @ Rs.75 each Trade discount 10%
Jan. 7	Returned to Electrical Appliances Ltd, 3 Water heaters and 2 electric irons as defective.
Jan.10	Hariprasad & Sons returned one electric stove as defective.
Jan.12	Returned the same stove to Electrical Appliances Ltd.
Jan.14	Purchased from Stabilizers Ltd. on credit 10 TV stabilizers @ Rs.250 each less 25% trade discount.
Jan. 18	Sold to Sanjeeva Electronics 5 stabilizers @ Rs.300 less 15% discount.
Jan.19	Sold one Stabililizer to Krishna for Cash at the rate of Rs.300.
Jan.22	Purchased on credit 10 table fans from Naresh Engineering Co., @ Rs.350 each less 20% discount.
Jan.26	Sold to Hariprasad & Sons on credit 10 table fans @ Rs.350 each less 10% discount.
Jan.30	Hariprasad & Sons returned one fan as defective which was in turn returned to Naresh Engineering Co., on the same day.

NARASIMHAM & CO., BOOKS

Solution

PURCHASES BOOK

Date	Name and address of the supplier	Rs.	Inward Invoice Number	Amount Rs. Ps.
1989				
	Electrical Appliances Ltd.			
Jan. 2	25 Water heaters @ Rs.40	1,000		
	10 Electrical Stoves @ Rs.50	500		
	15 Electric Irons @ Rs.60	900		
		2,400		
	Less: Discount 20%	480		1,920.00
Jan. 14	Stabilizers Ltd.			
	10 Stabilizers @ Rs. 250	2,500		
	Less: Discount 25%	625		1,875.00
Jan. 22	Naresh Engineering Co.			
	10 Table Fans @ Rs.350	3,500		
	Less: Discount 20%	700		2,800.00
Jan. 31	TOTAL			6,595.00

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PURCHASE RETURNS BOOK

Date	Name and address of the supplier	Rs.	Inward Invoice Number	Amount Rs. Ps.
1989				
	Electrical Appliances Ltd.			
Jan. 7	2 Water heaters @ Rs.40	80		
	2 Electrical Irons @ Rs.60	120		
		200		
	Less: Discount 20%	40		160.00
Jan. 12	Electrical Appliances Ltd.			
	1 Electric Stove @ Rs. 50	50		
	Less: Discount 20%	10		40.00
Jan. 30	Naresh Engineering Co,,			
	1 Table Fans @ Rs.350	350		
	Less: Discount 20%	70		280.00
Jan. 31	TOTAL			480.00

SALES BOOK

Date	Name and address of the customer	Rs.	Outward Invoice Number	Amount Rs. Ps.
1989				
	Hari Prasad & Sons			
Jan. 5	10 Water heaters @ Rs.50	500		
	5 Electrical Stoves @ Rs.60	300		
	5 Electrical Irons @ Rs.75	375		
		1,175.00		
	Less: Discount 10%	117.50		1,057.50
Jan. 18	Sanjeev Electronics			
	5 Stabilizers @ Rs. 300	1,500		
	Less: Discount 15%	225		1,275.00
Jan. 26	Hari Prasad & Sons			
	10 Table Fans @ Rs.350	3,500		
	Less: Discount 10%	350		3,150.00
Jan. 31	TOTAL			5,482.50

Note: Cash Sale to Krishna Rs. 300, will not be recorded in Sales book. It will be recorded in Cash book.

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SALES RETURNS BOOK

Date	Name and Address of the customer			Credit Note Number	Rs.
1989		Rs.			
Jan. 10	Hari Prasad & Sons				
	1 Electronic Stove @ Rs. 60	60			
	Less: Discount 10%	6			
					54.00
Jan. 30	Hari Prasad & Sons				
	1 Table Fan @ Rs.350	350			
	Less:Discount 10%	35			
					315.00
Jan. 31	TOTAL				369.00

LEDGER OF NARASIMHAM & CO.

Dr. ELECTRICAL APPLIANCES LTD. ACCOUNT Cr.

1989				1989			
Jan. 7	To Purchases Returns A/c		160	Jan. 2	By Purchases A/c		1,920
Jan. 12	To Purchases Returns A/c		40				

Dr STABILIZERS LTD. ACCOUNT Cr.

				1989			
				Jan. 22	By Purchases A/c		1,875

Dr NARESH ENGINEERING COMPANY'S ACCOUNT Cr.

1989				1989			
Jan. 30	To Purchases Returns A/c		280	Jan. 22	By Purchases A/c		2,800

Dr PURCHASES ACCOUNT Cr.

1989				1989			
Jan. 31	ToSundries as per the Purchases Book		6,595				

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Dr PURCHASES RETURNS ACCOUNT **Cr.**

				1989 Jan. 31	By Sundries as Per Purchases Returns Book		480

Dr HARI PRASAD & SONS ACCOUNT **Cr.**

1989 Jan. 5	To Sales A/c		1057.50	1989 Jan. 10	By Sales returns A/c		54
Jan. 26	To Sales A/c		3150.00	Jan. 30	By Sales returns A/c		315

Dr SANJEEV ELECTRONICS ACCOUNT **Cr.**

1989 Jan. 18	To SalesA/c		1,275				

Dr SALES ACCOUNT **Cr.**

				1989 Jan. 31	By Sundries as per Sales Book		5482.50

Dr SALES RETURNS ACCOUNT **Cr.**

1989 Jan. 5	To Sundries as per Sales returns Book		369				

Columnar Books

If a business is dealing in more than one product and if it wants to know the sales, purchases, returns of different products, additional columns may be provided in the special journals books to have this analysis. For example, an electronics dealer has three main products, viz., Television Sets, Radios and Tape Recorders. The Purhcases Journal may be as follows:

Multi-columnar Purchases Book

Date	Name of the Supplier	Inward invoice No.	L.F.	Invoice Amount Rs.	T.V.s Rs.	Radios Rs.	Tape Recorders Rs	Misc. Rs.
1.4.89	Vijay Electronics			15,000	8,000	3,000	4,000	

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Direct Posting

Another easy method is to post the transactions directly to their ledger accounts with the help of vouchers. Earlier, we have seen that the transactions are first recorded in a journal / book before they are posted in the ledger. Instead of this procedure the vouchers i.e., business documents of evidence, may be classified as Inward Invoices, Outward Invoices, Debit Notes, and Credit Notes, and filed separately. If the policy of the management is not to have special books, then the various transactions are directly posted to their ledger accounts with the help of these vouchers. For example, when a credit purchase is made, you will receive an Inward Invoice which is filed. With the help of this Inward Invoice, Purchases account will be debited and the suppliers account will be credited. Of course, in this case the vouchers are to be specially designed or a rubber stamp is used to facilitate the recording of additional information such as "debited in ledger page number"..... and "credited in ledger Page number ."..... Generally, this is the practice in commercial concerns.

Check Your Progress - 5

In which book the return of goods sold on account is recorded:

a) Sales book,
b) Sales returns book,
c) Purchases returns book.

4.9 BILLS OF EXCHANGE

Bills of Exchange and Promissory Notes are used to settle business transactions. They are written undertakings given by the debtor to pay a certain amount of money on a definite or determinable future date. These are also called "Negotiable Instruments" because the title can be transferred to a third party for valuable consideration.. These instruments are mostly used in payment against purchase of goods or assets and in the settlement of debts.

The seller wants to increase his sales to get more profits. The seller generally grants credit but would like to have some written commitment from the buyer to pay the amount on a specified date. The written agreement or undertaking takes the form of a Bill of Exchange (or simply bill), or promissory note (or pronote).

A Bill of Exchange is defined as "an instrument in writing containing an unconditional order signed by the maker directing a certain person to pay a certain sum of money only to or to the order to a certain person or to the bearer of the instrument". There are three parties to a Bill of Exchange. They are:

a) Drawer : One who draws a bill (generally the creditor)
b) Drawee : On whom the bill is drawn (generally the debtor)
c) Payee : One who is entitled to receive the amount of the bill (generally the drawer himself, or the endorsee).

The following is an explanation of the process pertaining to a Bill of Exchange:

Suppose X sells goods on credit to Y. Then, X the seller, draws a bill (known as Draft) on Y, the buyer, and sends the same to Y for his acceptance. Y accepts the bill and sends it back to X. In this case, X is the drawer, Y is the drawee as well as the acceptor. If X draws the bill in such a manner that it is payable to himself, then X will also be the payee. If on the other hand the bill is drawn payable to some other party, say Z, then Z will be the payee.

A Bill of Exchange is a bill receivable (B/R) to the drawer or payee, and a bill payable (B/P) to the drawee. A bill receivable is an asset and bill payable is a liability and, therefore, will be shown as an asset or a liability in the Balance Sheet. For accounting purposes a promissory note is also treated as a Bill of Exchange.

Acceptance: an acceptance is the consent by the drawee to the order of the drawer. The consent is indicated by the drawee in writing on the face of the bill with his signature with or without the word, 'Accepted'.

Term of the bill: A bill is written for a fixed period, say 90 days. The period of the bill is called the term or tenor' of the bill.

Due date: The amount of the bill is payable on a fixed date. 'Due date' means the date on which the bill falls due for payment. The due date is also called the 'date of maturity'. To arrive at the due date, three days of grace are added to the term of the bill. For example, a bill is drawn on Ist January, 1989 for 3 months. The term of the bill is 3 months. Add three months to the date of the bill and then add 3 days of grace to arrive at the due date. Therefore, the due date or date of maturity is April 4, 1989.

When a bill is drawn and accepted by the drawee, the drawer has four options to deal with the bill.

i) He may retain the bill till the date of maturity and present it to the acceptor on the due date for payment.

ii) He may endorse it to another party. A bill is said to be endorsed when the holder transfers his right in the bill to some one else by putting his signature on the reverse of the bill. The person endorsing the bill is called 'Endorser' and the person to whom it is endorsed is called 'Endorsee'.

iii) He may discount the bill with his banker. The process of encashing the bill with the banker before its maturity is called discounting a bill. When a bill is discounted, the bank is lending money for the period between the date on which the bill is discounted and the date on which it attains its maturity. The bill may be discounted either on the date of its acceptance or at a later date. The banker calculates the discount (it is nothing but the interest for the period) from the date of its discounting to the date of its maturity.

iv) He may send it to the bank for collection just like a cheque.

On the due date the bill may be honoured or dishonoured. When the amount of the bill is paid on the due date to the holder, the bill is said to be honoured. If the amount is not paid by the acceptor to the holder of the bill on the due date, the bill is said to be dishonoured. When the bill is dishonoured, the holder of the bill may get the fact of such dishonour noted or recorded by a Notary Public, which require the payment of fees called 'Notary Charges'. This is recovered from the acceptor along with the amount of the bill.

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4.10 BILLS RECEIVABLE AND BILLS PAYABLE BOOKS

If the number of bill transactions is few, they can be journalised through the Journal Proper. But if the volume of bill transactions warrants, separate books for bills receivable and for bills payable can be kept. All receipts of bills are entered in the Bills Receivable Journal or Book and all acceptances of bills are entered in the Bills payable Journal or Book. These books have various columns for recording information pertaining to the bills. The profoma of these books are given here under.

PROFORMA OF BILLS RECEIVABLE BOOK

Sl. No.	Date	From whom Received	Name and address of the Acceptor	Date of Bill	Term	Date of Maturity	Where Payable	Amount Rs. Ps.	How disposed of	Remarks

PROFORMA OF BILLS PAYABLE BOOK

Sl. No	Date	Name and address of Drawer	Name and Address of the Payee	Date of Bill	Term	Date of Maturity	Where Payable	Amount Rs. Ps.	Remarks

Posting from the Bills Receivable Book

Each entry in the Book is posted to the credit side of the individual party's account and the periodical total of the Bills Receivable Book is posted to the debit side of the Bills Receivable Account.

Posting from the Bills Payable Book

Each entry in this book is posted to the debit side of each individual account and the periodical total of this book is posted to the credit side of the Bills Payable Account.

The following illustration shows how the bill transactions are recorded in Bill Books :

Illustration : 6

The following are the bill transactions of M/s. Giridharlal & Co. for the month of January 1989. Enter them in the bills books :

1989

Jan. 4 Received acceptance from M/s. Mangaram & Co. for Rs.5,000 at two months, payable at the Corporation Bank, Secunderabad which was discounted @ 10%.

6 Accepted a bill for Rs.3,500 drawn by Kantilal & Co. for 2 months, payable at Andhra Bank, Hyderabad.

9 M/s. Nahatha & Bros sent their acceptance for Rs.2,000 payable after three months at Bank of India, Bombay which was endorsed to Chakravarthy & Co.

15 Sent our acceptance to M/s. Lalluram & Co. at three months for Rs.4,000, payable at Andhra Bank, Hyderabad.

20 Received the bill dated 16-1-1989 duly accepted by Gangaram & Sons for Rs.2,500 at three months payable at Sindicate Bank, Hyderabad.

25 Accepted the bill drawn by Karanjia for Rs.4,000 at two months, payable at Andhra Bank, Hyderabad.

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Solution

BILLS RECEIVABLE BOOK

Sl. No.	Date	From whom Received	Acceptor	Date of Bill	Term	Date of Maturity	Where Payable	Amount Rs.	How disposed of	Remarks
	1989									
1.	Jan4	Mangaram & Co &	Mangaram & Co,	4.1.89	2 months	7.3.89	Corporation Bank, Secbad.	5,000	Discounted	
2.	Jan9	Nahata & Bros.	Nahata & Bros.	9.1.89	3 months	12.4.89	Bank of India Bombay	2,000	Endorsed	
3.	Jan20	Gangaram & Sons	Gangaram & Sons.	16.1.89	3 months	19.4.89	Syndicate Bank Hyderabad	2,500		
								9,500		

BILLS PAYABLE BOOK

Sl. No.	Date	Name of Drawer	Payee	Date of Bill	Term	Date of Maturity	Where Payable	Amount Rs.	Remarks
	1989								
1.	Jan6	Kantilal & Co	Kantilal & Co.	6.1.89	2 months	9.3.89	Andhra Bank Hyderabad.	3,500	
2.	Jan15	Lalluram & Co.	Lalluram & Co.	15.1.89	3 months	18.4.89	Andhra Bank Hyderabad	4,000	
3.	Jan25	Karanjia	Karanjia	25.1.89	2 months	28.3.89	Andhra Bank Hyderabad	4,000	
								11,500	

Note : You will learn more about Bills of Exchange in Units 9 and 10.

4.11 JOURNAL PROPER

In addition to seven books, so far discussed, the original journal, now called "Journal Proper" is also used to record all other transactions which can not be recorded in any of the aforesaid books. The journal proper is similar to the journal in ruling and form.

Sometimes, as some transactions are not numerous a particular sub-division of the journal may not be maintained. For example, if the business man is not in a habit of accepting bills payable, then he would not maintain a Bills Payable Book. However, if occasionally a Bill is accepted, then such a transaction has to be passed through some Journal before the ledger posting is done. Thus, when any one or more of sub-divisions are not maintained by the businessman, he would pass all such transactions in the Journal Proper.

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4.12 TYPES OF TRANSACTIONS RECORDED IN JOURNAL PROPER

The following types of transactions are usually recorded through Journal proper.

1. Opening entries
2. Closing entries
3. Adjustment entries
4. Rectification entries
5. Transfer entries
6. Other entries

In this Journal special attention must be paid to the narration and the necessary explanation should be given as the transactions recorded here are of a special nature.
We shall now discuss the various types of entries listed above :

4.12. 1 Opening Entries

Opening entry is the journal entry passed through the Journal Proper to open the new set of books for a fresh period. It can also be an entry passed at the commencement of a business.

In case the proprietor brings in only cash as capital, this transaction can be passed through the Cash Book. Where the proprietor brings in some amount of cash and the balance in shape of non-cash assets like furniture, stock, etc., the starting entry cannot be recorded through the Cash Book. Thus Journal Proper would be required to record such a transaction. For example, if Ganesh commences his business with a capital of Rs.1,00,000 consisting of cash worth Rs.10,000 ; stock worth Rs.30,000 ; furniture worth Rs.10,000 and Buildings worth Rs.50,000, the recording would be as follows :

1. Cash Rs.10,000 received will be passed through the Cash Book ; and
2. The following opening entry would be passed to record the investment of non-cash assets in business ;

Date	Particulars		L.F	Debit	Credit
				Rs.	Rs.
	Buildings A/c	Dr.		50,000	
	Furniture A/c	Dr.		10,000	
	Stock of goods A/c	Dr.		30,000	
	To Capital A/c				90,000
	(Being introduction of certain non-cash assets as capital)				

The capital account of the businessman will get a credit of Rs.10,000 from the Cash Book and a credit of Rs.90,000 on account of the above entry. Thus, the capital account will show a credit balance of Rs.1,00,000 (Note that each asset account will be debited).

In the journal entry set forth above, cash can also be added, in which case the Cash Book will be debited as "To Capital Account", with Rs.10,000. In the case of a running business also an opening entry is passed at the commencement of a fresh period, a new accounting year. Personal accounts or 'real accounts' representing assets and liabilities that are to be brought forward from a previous period are recorded through the Journal Proper by means of an opening entry. The following examples will make 'Opening Entry' clear :

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Illustration-7

Kiran, a businessman, prepared his Balance Sheet on 31st December, 1989 showing the following assets and liabilites : Pass on the opening entry in his books on 1st January, 1990. His assets were (1) Cash : Rs.2,500. (2) Stock : Rs.8,750, (3) Furniture : Rs.1,900. His liabilities were amounts due to his Creditors - Ravi : Rs.1,000, Shyam Rs. 1,800, Ram : Rs.2,225.

Solution

Kiran's assets are Rs.13,150 and his liabilities are Rs.5,025. Thus his capital will be the balancing figure, which amount to Rs.8,125.

Rule : The rule for the opening journal entry is - Debit all assets, individually, with their respective values,
Credit all liabilities, individually, with their respective values, and
Credit the capital accounts with excess of assets over liabilities.

The 'opening entry' in Kiran's Journal will, therefore, be -

Date	Particulars		L.F.	Debit	Credit
				Rs.	Rs.
1990					
Jan.1	Cash Account	Dr.		2,500	
	Stock Account	Dr.		8,750	
	Furniture Account	Dr.		1,900	
	To Sundry Creditors Account				5,025
	To Kiran's Capital Account				8,125
	(Being the opening entry, to record the opening balances of assets and liabilities of 1989, brought over on the 1st January, 1990).				

From this journal entry each asset account will be debited on January 1st, 1990 with the inscription, "To balance brought forward", and liabilities and capital account will be credited with corresponding inscription "By Balance brought forward".

In this illustration, the cash balance is entered through the Journal Proper to facilitate the passing of one opening entry.

Illustration - 8

The following is the Balance Sheet of Mr. Sharma as on 31st December, 1989 Pass opening entry.

Liabilities	Rs.	Assets	Rs.
Bills Payable	3,000	Cash	9,725
Sundry Creditors	12,000	Sundry Debtors	8,200
Capital	13,975	Stock-in-trade	8,050
		Furniture	3,000
	28,975		28,975

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Solution

Date	Particulras		L.F.	Debit	Credit
				Rs.	Rs.
	Cash Account	Dr.		9,725	
	Sundry Debtors Account	Dr.		8,200	
	Stock-in-trade Account	Dr.		8,050	
	Furniture Account	Dr.		3,000	
	To Bills Payable A/c				3,000
	To Sundry Creditors A/c				12,000
	To Sharma's Capital A/c				13,975
	(Being the opening entry for balance of assets and liabilities of 1989, brought over)				

4.12.2 Closing Entries

At the end of the accounting period the businessman would be interested in knowing the net financial results of his trading operations. For this purpose, the Final Accounts are usually prepared in three parts : (i) the Trading Account, (ii) the Profit and Loss Account and (iii) the Balance Sheet. At the end of each financial period all the nominal accounts and accounts relating to trading goods such as purchases, sales, returns and opening stock are closed by tmasfer to the 'Trading Account' or 'Profit and Loss Account'. The journal entries passed for the purpose of closing these accounts to the 'Trading' or 'Profit and Loss' Account are known as closing entries and are passed through the Journal Proper.

Note : Closing entries are discussed in detail later.

4.12.3 Adjustment Entries

While preparing the Final Accounts it is necessary to bring into the books of account certain unadjusted and unrecorded items like (I) Closing Stock, (2) Expenses due, (3) Income due, (4) Depreciation on fixed assets, etc. These entries are required because without them the Final Accounts will not be complete. Entries passed through the Journal Proper to record such adjustments are known as 'Adjustment Entries". The Adjustment entries are dealt with in greater detail in Units 16 and 17.

4.12.4 Rectification Entries

Errors or mistakes may creep in while journalising, posting, carrying forward, etc., and such errors are rectified through 'Rectifi cation Entries'. 'Rectification Entries' will be discussed in greater detail in units 19 and 20.

4.12.5 Transfer Entries

When it is desired to transfer an amount from one account to another account, a transfer entry is passed through the Journal Proper to effect-such a transfer. A transfer entry will be necessary to transfer any amount from one account to another.

The following illustration will make it clear :

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Illustration - 9

Prabahakar sold goods to Mahesh for Rs.1,200. The debt was guaranteed by Suresh, Prabhakar's regular customer. Mahesh having failed to pay, it was decided to transfer the amount of debt due from Mahesh to Suresh's Account. Pass the necessary transfer entry :

Date	Particulars	L.F.	Debit	Credit
			Rs.	Rs.
	Suresh's Account Dr To Mahesh's Account (Being transfer of debt due from Mahesh to Suresh's Account, in view of his guarantee)		1,200	1,200

4.12.6 Other Entries

In additon to those mentioned above, if there is any other transaction which cannot be passed through other books of original entry, they will be passed throuhg the Journal Proper. Such transactions include :

1. Credit purchases and credit sales of assets such as furniture, machinery, etc. ;
2. Withdrawal of goods by the businessman for his personal use ;
3. Loss of goods by theft, fire, etc. ;
4. Endorsement, renewal, and dishonour of bills ;
5. Consignement of goods to other for sale ; and
6. Other transactions like interest on capital, interest on drawings, bad debts, depreciation, etc.

Illustration - 10

Record the following transactions in the Journal Proper.

1989

" 2 Bought a typewriter from Lipi & Co., for Rs.3,000

" 3 Mr. Black, who owed Rs.1,000, was declared insolvent and nothing could be recovered from his estate.

" 4 Purchased Furniture from Allwyns Ltd., for personal use : Rs.1,200.

Solution

Date	Particulars	L.F.	Debit	Credit
			Rs.	Rs.
1989 Jan. 2	Typewriter's A/c Dr. To Lipi & Co.'s A/c (Being typewriter purchased on credit from Lipi & Co.)		3,000	3,000
Jan.3	Bad Debts A/c Dr. To Black's A/c (Being the entry to record 'Bad Debts' due to debtor's insolvency)		1,000	1,000
Jna.4	Drawings A/c Dr. To Allwyns Ltd., Account (Being purchase of furniture for personal use from Allwyns Ltd.)		1,200	1,200

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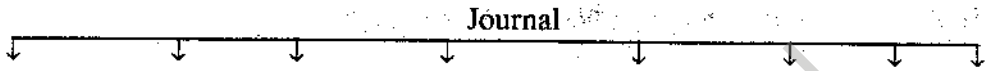
It is important to remember that the Journal Proper is a book of original entry and that transactions that are passed through this book have to be posted to respective accounts in ledger only then the accounting record would be complete.

Check Your Porgress - 6

List out the types of transactions recorded in Journal Proper.

4.13 SUMMING UP

Journal is the book of prime entry in which all transactions are recorded. But when the transactions are numerous, it is impossible to record all the transactions in one journal. Hence, the need for special journals. Usually many of the transactions are of a repititive nature. The main journal is sub-divided in such a way that a separate journal is used for each category of group of transactions which are sufficiently large in number and also repetitive in nature. Generally, in any large scale business the journal is sub-divided into the following special journals, called subsidiary books.



Purchases Book	Purchases Returns Book	Sales Book	Sales Returns Book	Bills Receivable Book	Bills Payable Book	Cash Book	Journal Proper

Purchases book is meant for recording all credit purchases of goods. Sales book is used for recording all credit sales of goods. Returns books are used for recording goods returned. Bills books are used for recording bills transactions.

In the case of purchases book, the account of suplier is individually credited but the purchases account is debited periodically with the totals of the purchases book. A similar procedure is adopted for posting to other books.

All other transactions which cannot be recorded in any of the special books, are recorded in a journal known as 'Journal Proper'.

The types of transactions that are usually passed through a Journal Proper are : i) opening entries, ii) closing entries ; iii) adjustment entries ; iv) rectification entries ; v) transfer entries and vi) other entries ;

4.14 ANSWERS TO CHECK YOUR PROGRESS

1. i) a) Purchases book
   b) Purchases returns book
   c)Sales Book ; d) Sales returns book e) Bills receivable book
   f) Bills payable book ; g) Cash book ; h) Journal proper.

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2. i) All credit purchases of goods only
   ii) Purchases account
3. Purchases returns book.
4. Sales book
5. Sales returns book.
6. (i) Opening entries (ii) Closing entires (iii) Adjustment entries
   (iv) Rectification entries (v) Transfer entries (vi) Other entries.

4.15 MODEL EXAMINATION QUESTIONS

A. Short Answer Questions

1. What is the need for special journals
2. Write a short note on subsidiary books
3. What do you understand by subsidiary ledgers.
4. Distinguish between purchases book and sales book.
5. Distinguish between purchases returns book and sales returns book.
6. Distinguish between debit note and credit note.
7. Explain bills receivable and bills payable
8. What is a 'Journal Proper' ?
9. Distinguish between opening entry and closing entry Give with example?
10. What is a 'Transfer Entry'?
11. Distinguish between adjustment entry and rectification entry.

B. Essay Answer Questions

12. What are the advantages of subsidiary books ?
13. Name various types of special books and give the scope and utility of each of them.
14. Give the proforma of sales book and explain the method of recording of transactions therein along with the method of posting.
15. How is purchase returns book ruled ? What is the procedure of recording and posting ?
16. What are the rules of posting from :
    i) purchases book ii) purchases returns book ; iii) sales book and iv) sales returns book.
17. State the type of transactions that are recorded through the 'Journal Proper'.
18. What is a Journal Proper' ? Explain its uses in accountancy.

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PROBLEMS

Purchases Book

1. Rao & Sons carry on business as wholesale clothdealers. From the following particulars write up their Purchases book for the month of January, 1989.

Jna.5 Purchased on credit from Mafatlal Mills, Bomaby
100 Meters of pant cloth @ Rs. 75 per metre.
100 Meters of Shirting cloth @ Rs. 40 per metre.

Jan.10 Purchased on credit from DCM, Delhi.
50 pieces of bedsheets @ Rs.30 each.

Jan.15 Purchased on credit from NTC, Warangal
50 Sarees @ Rs.100 each.

Jan.20 Purchased for cash from NTC, Warangal.
200 meters of coarse cloth @ Rs.5 per meter.

Jan.25 Purchased a typewriter on credit from Office Equipments Ltd. Rs.4,000

Jan.30 **Purchased on credit from Ajay Mills, Ahmedabad.**
100 Blouse pieces @ Rs.10 each.

(Hint. : Cash purchases and credit purchases of typewriter will not be recorded in Purchases Book)
(Answer : Total of Purchases Book : Rs.19,000)

Sales Book

2. From the following particulars of Woodcrafts prepare their Sales Book :

1989
April 3 Sold on credit to Babu & Co.
5 Wooden Almarahs @ Rs.800 each
April 8 Sold to Reddy & Bros. on credit
5 tables @ Rs.200 each
15 chairs @ Rs.50 each.
April 15 Sold on credit to Ajantha Lodge
20 Cots @ Rs.200
20 Table @ Rs.100
20 Stools @ Rs.30.
April 25 Sold for cash a bookrack to Anand Rs.100

Write up the Ledger accounts also.

(Hints : Omit the Cash sale)

(Answer : Total of Sales Book : Rs.12,350)

Purchases Returns Book

3. M/s. Time Keepers is a watch dealer. From the following particulars prepare their Purchases Returns Book and the ledger accounts.

1989
Feb.4 Returned 5 pieces of HMT 'Janatha Watches to M/s. Laxmi Watches, the Stockists, @ Rs.200 as the quantity received was in excess of the order.
Feb.10 Returned 20 pieces of Sandoz to Ramlal & Co. @ Rs.190.
Feb.18 Claimed an allowance of Rs.100 from Ranga Watches, in respect of 10 watches supplied by them, on which excess price charged. Ranga watches conceded the claim.
Feb.25 Returned to M/s. Sylvania & Co.
5 Sound-well alarms @ Rs.50 purchased at a discount of 20%
3 Wall-clocks @ Rs.600 purchased at a discount of 25%

(Answer : Total of Purchase Returns Book : Rs.6,450)

Sales Returns Book

4. Ramakrishna is a wholesale stationery merchant. From the following particulars prepare the Sales Returns Book and its ledger postings.

1989
May 15 Sanjay & Co. returned 6 dozen pencils
@ Rs. 6 per Doz. and 2 Dozen fine nibs @ Rs.10 per doz.

May 20 M/s Devi stationers returned
4 dozen 100 pages noted books @ Rs.12 per doz.
2 dozens 200 pages note books @ Rs.20 per doz.

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May 25 Rama & Co. returned
1 doz. Gum bottles @ Rs.20 per doz.
3 doz. Ink bottles @ Rs.24 per doz.
3 doz. erases @ Rs. 3 per doz.

(Answer : Total of Sales Returns Book : Rs.221)

Purchases, Sales and Returns Combined

5. Madhusudan gives the following information about his business. Record them in the concerned subsidiary books and post them to ledger accounts :

1989

March	1	Purchased goods from Mohan at the list price of Rs.30,000 less 10% trade discount.
"	5	Sold goods to Ramesh for Rs.10,000 less 5% trade discount.
"	8	Returned goods to Mohan at list price Rs.5,000.
"	10	Ramesh returns us goods at the list price Rs.1,000.
"	13	Purchased goods from Srikanth at the catalogue price of Rs.10,000 less 20% trade discount.
"	15	Sold goods to Sreedhar at the catalogue price of Rs.5,000 less 10% trade discount.
"	18	Returned goods to Srikanth at the list price Rs.2,000.
"	20	Sreedhar returns us goods at the list price Rs.1,000
"	22	Purchased goods from Mohan at Rs.15,000 less 10% trade discount.
"	25	Sold goods to Ramesh for Rs.10,000
"	27	Sold goods to Mohan for Rs.5,000
"	28	Purchased goods from Sreedhar at the list price Rs.5,000 less 5% trade discount.
"	29	Ramesh returns us goods Rs.1,000
"	30	Returned goods to Sreedhar at the list price Rs.500

(Answer : Total : Purhcases Book : Rs.53,250, Sales Book : Rs.29,000, Purchase Returns Book : Rs.6,575, Sales Returns Book : Rs.2,850).

Bills Receivable and Bills Payable Books

6. The following are the Bill transactions of M/s. Naresh Traders, Hyderabad. All the Bills accepted by M/s. Naresh Traders are payable at the State Bank of Hyderabad. Prepare Bills Receivable and Bills Payable Books.

1989

Jan.2	Received a bill duly accepted by S.P.Jain payable at Syndicate Bank, Hyderabad, after 3 months for Rs.3,000.
Jan.5	Sent our acceptance to Krishna Mohan of Khammam, payable after one month for Rs.2,000
Jan.9	Drew a bill on M/s. Ram & Co. Warangal for Rs.1,500 payable after 2 months at State Bank of Hyderabad, Warangal.
Jan.12	Accepted a Bill dated 8-1-89, drawn by Mohan Babu of Guntur for Rs.5,000 payable after 3 months.
Jan.18	Received an acceptance from Ram narayan for Rs.4,000 payable at Canara Bank, Hyderabad two months after date, which was endorsed to Sreedhar Babu on the same day.
Jan.22	Accepted the bill drawn by Raja Ram for Rs.2,500 payable after two months.
Jan.25	Drew a bill on M/s Saptagiri Traders for Rs.4,500 payable after 90 days at State Bank of Hyderabad, Tiruapthi.
Jan.30	A Bill is drawn on M/s. Hariram & Sons payable at Bank of India, Hyderabad for Rs.5,000 at 3 months. The Bill is duly accepted and is discounted with State Bank of Hyderabad, Hyderabad @ 10%.
Jan.31	Accepted the Bill dated 28-1-89 drawn by Poddar& Co. for Rs.2,500 payable after 2 months.

(Answer : Total of B/R Book Rs.18,000, B/P Book Rs.12,000)

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7. The position of Rajesh on 31st December, 1989 was as follows Cash : Rs 1,600 Stock of goods : Rs.4,000 ; Furniture : Rs.5,000 ; Sundry Debtors : Rs.6,000 ; Sundry Creditors : Rs.2,000.

Record the said balance in the books of Rajesh as on 1st January 1990.

8. The following is the Balance Sheet of Suresh as on 31st December, 1989

Liabilities		Assets	
	Rs.		Rs.
Creditors	2,250	Cash	500
Capital	8,350	Stock of goods	3,700
		Sundry Debtors	4,200
		Furniture	2,200
	10,600		10,600

Pass the opening entry on the 1st of January, 1990.

9. Prashant had the following assets and liabilities as on 31-12-1989. Pass the necessary entries to incorporate in the books of Prashant as on 1-1-1990.

Cash balance : Rs.2,200 ; Bank balance : Rs.6,000 ; Machinery : Rs.10,500 ; Buildings : Rs.25,000 Furniture : Rs.1,500 ; Sundry Creditors : Rs.9,700 ; Bills Payable : Rs.5,200 ; and Bank loan Rs. 4,100.

a. Transfer debit balance of Rs.800 in account of Miss Hema who has become Mrs. Mohan after marriage.
b. Transfer Rs.5,000 due from Mr.Aiyar, our debtor, to Mr.Mudaliar's account, our creditor.
c. Ajit agrees to pay the debt of Rs.1,200 due from Mohan. As such Mohan's account is to be transferred to Ajit's account.

10. Pass journal entries in the books of Rao & Bors.

1989

April 2	Purchased machinery for Rs.80,000 on credit from Narayana.
April 8	Sold old furniture for Rs. 1,200 on credit to Mahesh.
April 9	Bought Stationery for personal use for Rs.250.
April 13	Dues from one of the debtors, i.e., Kapoor amounting to Rs.5,000 which are not recoverable.

4.16 RECOMMENDED BOOKS

1. RL Gupta and VK.Gupta — 'Principles and Practice of Accountancy' (Sultan Chand & Co., 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.

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4.17 GLOSSARY

1. **Adjustment Entry** : is the entry passed to bring into record certain unrecorded items like closing stock, outstanding expenses, etc., at the time of the preparation of fianl accounts.
2. **Bill of Exchange** : It is an instrument in wirting containing an unconditional order, signed by the maker, directing a certain person to pay a certain sum of money only to or to the order of a certain person or to the bearer of the instrument.
3. **Bill Payable** : It is a bill of exchange payable by the businessman.
4. **Bill Receivable** : It is a bill of exchange receivable by the businessman.
5. **Credit Note** : It is a note sent to the customer informing him that his account is credited to the extent of the value of goods returned by him or any allowance granted to him.
6. **Closing Entry** : is passed to transfer various nominal accounts at the end of each financial period to the 'Trading Account' and Profit and Loss Account'.
7. **Debit Note** : It is a note sent to the supplier by the customer informing the supplier that his account is debited to the extent of the value of goods returned or allowance claimed.
8. **Drawee** : The person on whom a bill or cheque is drawn.
9. **Drawer** : The maker of a bill or cheque.
10. **Due date** : The date on which a bill of Exchange is to be paid.
11. **Invoice** : It is a business document or statement giving the details of goods issued by a seller to the purchaser.
12. **Journal Proper** : a book to record transactions which cannot be recorded in any of the special journals / books.
13. **Opening Entry** : refers to (i) the journal entry passed at the commencement of a business and ii) entry passed to open a new set of books for fresh accouting period.
14. **Payee** : The person named in an instrument to whom the money is to be paid.
15. **Purchases book** : It is a special journal used only for recording credit purchases of goods.
16. **Purchases returns book** : It is used to record the return of goods to suppliers.
17. **Rectification Entry** : is the entry required to rectify any error in the books of accounts.
18. **Sales book** : It is one of the subsidiary books meant for recording credit sale of goods.
19. **Sales Returns Books** : It is meant for recording goods returned by the customers.
20. **Trade Discount** : It is an allowance given by the seller to the buyer on the catalogue price of the articles.
21. **Transfer Entry** : is the entry to record the transfer of an amount from one account to another account.

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UNIT - 5 : CASH BOOK - I

Contents

5.0 Aims and Objectives
5.1 Introduction
5.2 Dual Role of the Cash Book
5.3 Kinds of Cash Books
5.4 Single Column Cash Book
5.5 Cash Discount
5.6 Double Column Cash Book
5.7 Treatment of Discounts Disallowed Subsequently
5.8 Summing Up
5.9 Answers to Check Your Progress
5.10 Model Examination Questions
5.11 Glossary

5.0 AIMS AND OBJECTIVES

The aim of this unit is to explain the need for a separate cash book, the dual role of cash book, the different kinds of cash books, the recording of transactions in the cash book and their posting into the ledger.

After studying this unit you will be able to :
- explain the dual role of the cash book
- identify the kinds of cash books
- recognise the treatment of discounts disallowed.

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5.1 INTRODUCTION

In any business there will be numerous cash transactions. Cash transactions involve either receipts of cash or payment of cash. Sale of goods for cash, receipts of cash from debtors, cash purchases, payment to creditors, payment in connection with various expenses are all examples involving cash. Cash transactions like cash sale or cash purchase involve immediate flow of cash, various credit transactions like credit sale or credit purchases do not involve immediate movement of cash. Ultimately these credit transactions will resolve them selves into cash transactions where cash is actually paid or received. As cash transactions are likely to be numerous, it is justifiable to have a separate book to record them proper maintenance of cash book helps preventing theft of cash. Generally, there will be a separate book called "Cash Book" to record all cash receipts and cash payments including payments into and withdrawals from the bank account.

5.2 DUAL ROLE OF THE CASH BOOK

Credit purchases, credit sales and returns of goods as indicated in the previous unit are first recorded in separate subsidiary books meant for them. A separate account is maintained in the ledger for each of these items and postings are made with periodical totals. But this is not the case with the Cash Book.

The Cash Book unlike other subsidiary books, is both a book of prime entry, i.e., subsidiary journal and a book of final entry, i.e., ledger. It plays the dual role of a journal as well as a ledger. It is a book of original or prime entry because cash receipts or payments are not normally entered in any other subsidiary book. They are entered only in the Cash Book. It is also a book of final entry i.e, ledger, because cash transactions once entered in the Cash Book need not again be posted to a separate cash account in the ledger. The Cash Book itself serves as both a journal and a ledger account. It thus plays the dual role of a Journal and Ledger, and its ruling is similar to that of a ledger account.

5.3 KINDS OF CASH BOOKS

Cash Books are of various kinds. The following are the most common ones :

1. Simple or Single Column Cash Book
2. Two or Double Column Cash Book
3. Three or Triple Column Cash Book

Let us now consider the method of recording transactions and posting in respect of these books.

5.4 SINGLE COLUMN CASH BOOK

The simple Cash Book is also called 'Single Column Cash Book' because it has (besides other columns) only one amount column representing cash with the office. This cash book is ruled just like an ordinary ledger account. The following is the proforma of a simple Cash Book.

Dr. CASH BOOK Cr.

RECEIPTS					PAYMENTS				
Date	Particulars	Vr. No.	L.F.	Amount Rs.	Date	particulars	Vr. No.	L.F	Amount Rs.
	To (write the name of the account to be credited)					By (write the name of the account to be debited)			

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Recording in the Cash Book

The left hand side or debit side is used for recording receipts of cash (as cash comes in) and the right hand side or credit side is used for recording payments of cash (as cash goes out). When cash is received it is recorded on the debit side. The date of receipt is recorded in the date column; the person or the account concerned is mentioned in the particulars column. When cash is received a voucher (receipt) is generally given and when cash is paid a voucher is obtained and if it is so desired a separate column may be provided in the Cash Book to record the voucher number. The LF column is meant to record the page number of the Account in the ledger, where the posting is made. The amount received is recorded in the amount column. Similarly, payments are recorded on the credit side of the Cash Book.

Posting the Single Column Cash Book

Since the Cash Book plays the dual role of a journal as well as a ledger account, there is no need to open a separate cash account in the ledger. Therefore, when a transaction is recorded in the Cash Book, is simultaneously results in journalising and posting of the cash aspect of the transaction in the cash account. But in respect of the other aspect of the transactions, the double entry has to be completed. In order to complete the double-entry the following procedure is to be adopted :

a) Credit the concerned accounts in the ledger from the debit (receipts) side of the Cash Book by wirting 'By cash account', and
b) Debit the concerned accounts in the ledger from the credit (payments) side of the cash book by writing 'To cash account'.

Balancing of Single Column Cash Book

The Cash Book is balanced just like any other ledger account. It should be kept in mind that the Cash Book debit side total will always be more than or at least equal to the credit side total. This is so because the cash payments can never exceed the amount of cash available. The Cash Book, therefore, generally shows a debit balance, and occasionally a nil balance, but it will never show a credit balance. The balance is entered on the credit side by writing "By balance c/d". The amount columns are then totalled. After closing the Cash Book the balance is shown on the debit side by writing "To balance b/d". It becomes the opening balance of cash for the next period.

The following illustration will show the recording, posting and balancing procedure in respect of the Cash Book.

Illustration - 1

From the following transactions of Shri Raghuram prepare a single column Cash Book and balance the same.

1989				Rs.
June	1	Raghuram started with a capital of	.....	10,000
"	2	Opened a Bank account and deposited	.....	2,000
"	4	Purchased goods for cash	.....	3,000
"	5	Sold goods for cash	.....	4,000
"	7	Purchased furniture	.....	500
"	9	Purchased goods from Krishna on credit*	.....	2,500
"	12	Sold goods on credit to Rao*	.....	2,000
"	15	Sold goods for Cash	.....	1,000
"	18	Paid to Krishna	.....	1,500
"	22	Received from Rao	.....	1,000
"	25	Paid electricity bill	.....	30
"	30	Paid wages	.....	170

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Solution

Dr. **CASH BOOK** Cr.

Date	Particulras	L.F	Amount Rs.	Date	Pariculars	L.F	Amount Rs.
1989				1989			
June 1	To Capital A/c		10,000	June 2	By Bank A/c		2,000
" 5	To Sales A/c		4,000	" 4	By Purchases A/c		3,000
" 15	To Sales A/c		1,000	" 7	By Furniture A/c		500
" 22	To Rao's A/c		1,000	" 18	By Krishna's A/c		1,500
				" 25	By Electricity A/c		30
				" 30	By Wages A/c		170
				" 30	By Balance c/d		8,800
			16,000				16,000
July 1	To Balance b/d		8,800				

Notes :

1) Transactions marked with asterisk (*) mark in the illustration are credit transactions and therefore will be passed through appropriate books. They will not appear in the Cash book as it records only cash receipts and payments.

2) Normally the Cash Book is balanced every day because daily transactions are likely to be many and also becuase the businessman may be interested in knowing and verifying the balance.

LEDGER

Dr. **CAPITAL ACCOUNT** Cr.

				1989 June 1	By Cash A/c.		Rs. 10,000

Dr. **SALES ACCOUNT** Cr.

				1989 June 5	By Cash A/c.		Rs. 4,000
				June 15	By Cash A/c.		1,000

Dr. **RAO'S ACCOUNT** Cr.

				1989 June 22	By Cash A/c.		Rs. 1,000

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Dr. **BANK ACCOUNT** **Cr.**

1989			Rs.				
June 2	To Cash A/c		2,000				

Dr. **PURCHASES ACCOUNT** **Cr.**

1989			Rs.				
June 4	To Cash A/c		3,000				

Dr. **FURNITURE ACCOUNT** **Cr.**

1989			Rs.				
June 7	To Cash A/c		500				

Dr. **KRISHNA'S ACCOUNT** **Cr.**

1989			Rs.				
June 18	To Cash A/c		1,500				

Dr. **ELECTRICITY ACCOUNT** **Cr.**

1989			Rs.				
June 25	To Cash A/c		30				

Dr. **WAGES ACCOUNT** **Cr.**

1989			Rs.				
June 30	To Cash A/c		170				

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5.5 CASH DISCOUNT

Cash discount is a rebate or an allowance or a deduction made usually by the receiver of cash (creditor) to the payer of cash (debtor) for, prompt payment. When credit sales are made, the seller makes an offer to the buyer that he will be prepared to grant an allowance to him if he pays the amount on or before the due date. It is allowed only when cash is paid promptly. It, therefore, occurs only on and along with cash receipt or payment. hence, it is called cash discount'. It is a loss to the receiver and a gain to the payer of cash.

Cash discount must clearly be distinguished from trade discount. Trade discount is not shown in the books of account, since it is deducted in the invoice itself and the net amount alone is taken into account. The payment will be only for the net amount. But in the case of cash discount, there is uncertainty. The debtor may make use of this facility by paying promptly or may not. Therefore, the full amount has to be recorded in the books when the sale is made. When the buyer pays promptly this deduction is allowed and recorded in the books of account.

Since 'cash discount' is allowed only when cash is received and cash discount is received only when cash is paid, it will be convenient to record the cash discount in the Cash Book itself by adding an extra amount column for discount, in addition to the existing amount column on either side of the Cash Book.

Check Your Progress - 1

What do you understand by Cash discount ?

5.6 DOUBLE COLUMN CASH BOOK

Double Column Cash Book with Discount and Cash Columns

This book contains one extra column for discount on either side of the Cash Book, in addition to the usual columns of a Simple Cash Book. Since cash received and discount allowed go together, there is a discount allowed column on the debit side of the Cash Book. similarly, as discount received and cash paid go together, there is discount received column on the credit side of the Cash Book. As there will be two amount columns now, one for the discount and the other for cash, the Cash Book of this type is referred to as two-column or double column Cash Book. The proforma is given below :

Dr. TWO COLUMN CASH BOOK Cr.

Date	Particulars	LF	Discount allowed	Cash	Date	Particulars	LF	Discount received	Cash
			Rs	Rs.				Rs.	Rs.

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Recording : All cash receipts and discounts allowed, if any, are recorded on the debit side. All cash payments and discounts received, if any, are recorded on the credit side.

Posting : The entries in the cash column of this Cash Book are posted to the respective accounts in the ledger in the same way as in the case of Simple Cash Book. But as regards the discount column, the entries in the discount allowed column will be posted to the credit side of the respective personal accounts as "By discount allowed" and the entries in the discount received column will be posted to the debit side of the respective personal accounts as "To discount received".

While balancing the two Column 'Cash Book, only cash columns are to be balanced as usual, and discount columns are not to be balanced but are to be merely totalled. The total of the discount allowed column on the debit side of the Cash book is to be posted on the debit side of the discount allowed account in the ledger as "To Sundries". Similarly, the total of the discount received column on the credit side of the Cash Book is to be posted on the credit side of the discount received account in the ledger, as "By Sundries".

The following illustration shows how entries are to be made in and posted from the Cash Book with discount and cash columns :

Illustration - 2

Record the following in two-column cash book and post them into ledger.

1989

June 1 Cash in hand Rs.5,000

" 4 Received from Krishna Rs.980 and allowed him a discount of Rs.20

" 8 Cash sales Rs.1000

" 12 Paid to Ramachandra Rs.1,960 and received a discount of Rs.40

" 15 Received from Narasimha Rs.490 in full settlement of his account for Rs.500.

" 18 Purchased an old typewriter for Rs.1,000

" 22 Received for cash sales Rs.600

" 25 Settle the account of Venkatesh Rs.600, by paying the necessary amount after receiving a discount of 5%

" 30 Paid Wages to employees Rs. 600

Solution

Dr. **THE CASH BOOK WITH DISCOUNT AND CASH COLUMNS** Cr.

Date	Particulars	LF	Discount allowed	Cash	Date	Particulars	LF	Discount received	Cash
			Rs.	Rs.				Rs.	Rs.
1989					1989				
June 1	To Balance b/d			5,000	June12	By Ramachandra's A/c		40	1,960
" 4	To Krishna's A/c		20	980	" 18	By Typewriter's A/c			1,000
"8	To SalesA/c			1,000	" 25	By Venkatesh's A/c		30	570
"15	To Narsimham's A/c		10	490	" 30	By Weges A/c			600
"22	To Sales A/c			600	" 30	By Balance c/d			3,940
			30	8,070				70	8,070
July 1	To Balance b/d			3,940					

NOTE :

The Cash in hand Rs.5,000 on June 1, is not a transaction but a mere statement of fact. It is a balance brought down from the previous period just as the balance on July 1, it will be shown on the debit side of the cash column and no further posting to any other account is necessary.

LEDGER

Dr. **KRISHNA'S ACCOUNT** Cr.

				1989				Rs.
				June.4	By Cash A/c			980
				June.4	By Discount Allowed A/c			20

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Dr. **SALES ACCOUNT** Cr.

				1989			Rs.
				June 8	By Cash A/c		1,000
				June22	By Cash A/c		600

Dr. **NARASIMHAM'S ACCOUNT** Cr.

				1989			Rs.
				June 15	By Cash A/c		490
				June 15	By Discount Allowed A/c		10

Dr. **DISCOUNT ALLOWED ACCOUNT** Cr.

1989			Rs.				
June 30	To Sundries as per Cash Book		30				

Dr. **RAMACHANDRA'S ACCOUNT** Cr.

1989			Rs.				
June 12	By Cash A/c		1,960				
June 12	To Discsount Recived A/c		40				

Dr. **TYPEWRITER'S ACCOUNT** Cr.

1989			Rs.				
June 18	To Cash A/c		1,000				

Dr. **VENKATESH'S ACCOUNT** Cr.

1989			Rs.				
June 25	To Cash A/c		570				
June 25	To Discount Received A/c		30				

Dr. **WAGES ACCOUNT** Cr.

1989			Rs.				
June.30	To Cash A/c		600				

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Dr.	DISCOUNT RECEIVED ACCOUNT						Cr.
				1989			Rs.
				June.4	By Sundries as per Cash Book		70

5.7 TREATMENT OF DISCOUNTS DISALLOWED SUBSEQUENTLY

Sometimes, a payment made by a party, after deducting its cash discount may not have reached the other party in time, inwhich case the discount may be disallowed. then, the following procedure is adopted.

In the case of a payment made by us, when we are informed that we are not entitled to the discount, (which we have already deducted while making payment), the following entry is passed in the Journal to cancel the credit already given to Discount Received Account :

Discount Received A/c ..... Dr.
To Creditor's A/c
(Being the cancellation of discount received)

Similarly, when discount allowed to a debtor is subsequently disallowed for some reason, the following entry is passed in the Journal.

Debitor's A/c ..... Dr.
To Discount Allowed A/c
(Being the cancellation of discount allowed)

5.8 SUMMING UP

As cash transactions are numerous in any business, they are recorded in a separate book called, the 'cash book'. Unlike other subsidiary books, it is both a book of prime entry (journal) and a book of final entry (ledger). All the cash transactions are directly recorded in the cash book. It is written in the same manner as the cash account. It, therefore, plays the dual role of a journal as well as a ledger. All the receipts are entered on the debit side and all the payments on the credit side of the cash book.

Cash books are of various kinds. The most common of them are : Single Column Cash Book, Double Column Cash Book and Three Column Cash Book. In addition, a Petty Cash Book is also maintained.

The single column cash book has only one amount column representing the cash with the office. Double column cash book contains one extra column for discount on either side,i.e., discount allowed column on debit side, and discount received column on credit side. While balancing, only cash columns are to be balanced as usual, and discount columns are not to be balanced but are merely to be totalled and posted to the relevant accounts in the ledger. Discounts are of two kinds, viz., cash discount and trade discount. Trade discount is not shown in the books of account, whereas cash discount is shown in the books of account. The postings are made from the debit side of the cash book to the credit side of respective accounts and the credit side of cash book to the debit side of respective accounts in the ledger. Cash columns of the cash book represent the cash account, hence, it is not necessary to open a separate cash account in the ledger.

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5.9 ANSWERS TO CHECK YOUR PROGRESS

1. Cash discount is a rebate or an allowance made by the receiver of cash tothe payer of cash for prompt payment.

5.10 MODEL EXAMINATION QUESTIONS

A. Short Answer Questions

1. What is a Cash Book ?
2. Distinguish between trade discount and cash discount.
3. How do you treat the discounts disallowed subsequently ?
4. Explain the dual role of cash book.

B. Essay Answer Questions

5. Cash Book is both a 'Journal and Ledger' Discuss.

PROBLEMS

Single Column Cash Book

1. Enter the following transactions in the Single Column Cash Book of Mr.Vijay and balance the same:

1989		Rs.
Jan.1	Started business with a capital of	10,000
" 2	Purchased goods for cash	2;000
" 3	Purchased furniture	2,500
" 4	Sold goods for cash	3,000
" 5	Cash sales	700
" 6	Paid for goods	500
" 6	Paid for cartage	15
" 9	Received from Mr.James	800
" 10	Paid to Mr.Ahmed & Co.	785
" 12	Paid for Stationery	120
" 14	Paid wages	80
" 15	Paid rent to the landlord	300

(Answer : Cash Balance : Rs.8,200)

2. Post the above entries from the Cash Book to the respective ledger accounts.

3. Mr. Hussain starts business with Rs.15,000 on the 20th of January, 1989. Of this he pays Rs.10,000 into his bank account. His cash transactions during the month were as follows :

1989		Rs.
Jan.21	Purchased office table and chair for cash	500
" 22	Purchased stationery and paid cash	50
" 23	Purchased goods for cash	750
" 24	Sold goods for cash	950

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" 25	Paid for signboard	.....	225
" 26	Cash purchased goods	.....	650
" 27	Cash Sales	.....	825
" 28	Purchased an old typewriter for cash	.....	1,500
" 28	Paid Auto Charges	.....	10
" 30	Paid Wages	.....	150

Compile the Cash Book of Mr.Hussain and post the entries into their respective ledger accounts.

(Answer: Cash Balance Rs.2,940)

4. Enter the following transactions in the Cash Book of Shri Ramesh and post them into ledger.

1989			Rs.
Feb. 1	Cash in hand	.....	700
" 3	Received from Sekhar on account	.....	1,000
" 6	Cash purchases of goods	.....	700
" 7	Cash Sales to Mr. Bora	.....	900
" 9	Purchased goods from Raja&Co. for Cash.	.....	200
" 13	Sales of goods for cash	.....	700
"15*	Bought goods on credit from Ali &Sons	.....	900
" 18*	Sold goods on credit to Patel &Bros	.....	700
" 21	Paid on account to Ali & Sons	.....	900
" 24	Received on account from Patel&Bros	.....	700
" 27	Paid in to Bank account	.....	800
" 28	Paid Salaries to Clerks	.....	400
" 28	Paid rent for February	.....	200

(Hint:*Credit transactions. Hence they will not appear in the Cash Book)

(Answer: Cash on Hand: Rs.800)

Cash Book with Discount and Cash Columns

5. Enter the following transactions in the Double Column Cash Book of Shri Rajgopal of Hyderabad.

1989			Rs.
April 1	Sri Rajgopal started business with cash	.....	8,000
" 3	He purchased goods for cash	.....	5,000
" 5	He sold goods for cash	.....	100
" 6	Sold goods for cash	.....	1,500
" 8	Paid for Stationery	.....	35
" 10	Paid for Office furniture	.....	185
" 12	Received cash from Mr.Mohanthaiah	.....	360
	and allowed him discount	.....	20
" 14	Paid cash to Hari & Co	.....	215
	and they allowed discount	.....	10
" 16	Paid into Bank	.....	3,000

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		Rs.
April 21	Received from Mr.Kailash Chand	680
	and allowed him discount	20
" 23	Paid advertisement	90
" 25	Purchased Postal Stamps	10
" 27	Paid Electricity	15
" 30	Paid rent	100

(Answer: Cash in hand: Rs.1,990, Discount: Dr Rs.40, Cr Rs.20)

6. The following are the cash transactions of M/s. Devi Traders of Vijayawada. Enter them in their Cash Book with Cash and Discount columns and balance the same:

1989

Mar. 1	Balance of Cash in hand 2,500
" 2	Bought goods for cash from Ramesh & Co., worth Rs.1,500 at 10% trade discount
" 4	Sold goods worth 3,000 to Santosh & Bros. for cash at a trade discount of 10%
" 6	Cash Sales Rs. 400, Cash Purchases Rs.500
" 8	Paid to Manohar Rs.680, discount allowed by him Rs.20
" 10	Received from Mr. Rakesh Rs.770, in full settlement of his debt Rs. 800
" 12	Old office furniture sold for Rs.300
" 13	Cash sales (payment received by cheque) Rs.1,000
" 15	Paid into the Bank the cheque received on 13th March.
" 18	Paid to Ram Rs. 395 in full settlement of the amount due to him Rs. 410.
" 20	Sale of old news papers Rs.20
" 22	Received from Mr. Popins Rs.980 in full discharge of his account for Rs.1,000
" 25	Paid to landlord rent of office Rs.250 and rent of residence Rs.150.
" 27	Received from Latiff Rs.300 against a debt previously wrtten off as bad.
" 31	Received from Vinod Mchata a cheque for Rs.250 on account, which could not be paid into the bank on the same day.

Hints (1) Trade discount will not appear in the books. Amount actually paid or received after trade discount should be recorded in the Cash Book.
(2) Cheque is equivalent to cash, if it is not deposited in the bank on the day of receipt, it will be entered in the cash column debit side on the day of its receipt. When it is sent to the bank, on that day it will be entered as payment on the credit side of the cash column.
(3) When a bad debt written off previously is recovered, enter it on the debit side of the cash book by writing "To Bad Debts Recovered A/c".

(Answer: Cash in hand: Rs.4,895, Discount: Dr. Rs.50; Cr. Rs.35.)

5.11 GLOSSARY

1. **Cash Book** : It is one of the subsidiary books wherein all receipts and payments are recorded.

2. **Cash Discount** : Cash discount is a rebate or an allowance or a deduction made by the receiver of cash to the payer of cash for prompt payment.

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UNIT 6 : CASH BOOK - II

Contents

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6.0 AIMS AND OBJECTIVES

The aims of this unit are to explain 1) the nature of transactions with Banks and the method of recording in cash books with bank columns and
2) the petty cash book.

After studying this unit you will be able to :
— record the banking transactions
— prepare three column cash book
— prepare petty cash book.

6.1 INTRODUCTION

In the previous unit we have discussed about cash transactions and kinds of cash books. In this unit we will learn about a Bank and Banking transactions and recording of banking transactions in the books of a business.

6.2 BANKING TRANSACTIONS

Now let us learn about a Bank and Banking transactions, which will be useful in the preparation of the Cash Book with bank column and Bank Reconciliation Statement.

According to the Banking Regulation Act of 1949, banking means "accepting, for the purpose of lending or investment, deposits of money from the public, repayable on demand or otherwise and withdrawable by cheque, draft, order or otherwise" . In other words, a bank is an institution which deals in money by accepting deposits from the public and lending it to those who are in need of it. The bank performs various

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functions such as accepting deposits, lending money and rendering agency services. The bank accepts demand deposits. i.e.,payble on demand, on current account and savings bank account. Accepting deposits of money is the primary function of a bank.

Lending of money is the secondary function of a bank. Banks lend money to interested parties in the form of long-term loans, short-term advances, overdraft (allowing the customer to withdraw more than what he has in his account), etc.

The bank also collects the amounts due, and makes payments on behalf of the customer. Further, it performs various miscellaneous services such as (i) the issue of letters of credit, travellers cheques (ii) underwriting of capital issues (iii) acceptance, collection, payment and discounting of Bills of Exchange (iv) safe custody of valuables, (v) furnishing guarantees on behalf of customers. The bank collects interest for the amount lent and charges for various services rendered by it to the customers.

In view of the various advantages listed below, a modern business generally retains a small sum of money with itself for immediate use and deposits the balance of money by opening an account with a bank.

Advantages of having a Bank Account

1 Money is safe in a bank and may also earn some interest.
2 Handling of large sums of money , either receiving or paying can be avoided
3 It is easy and safe to make payments by issuing cheques
4. Money can be sent or transferred to other places at a nominal charge.
5 The Bank helps businessmen by providing various types of loans.
6 The Bank also discounts Bills of Exchange obtained by businessmen from their customers. It also collects bills, cheques, etc., on behalf of its customers.
7. If 'Standing Instructions' are given by the customers, the bank collects various amounts due to them such as interest on investments and dividends and also makes payments such as Bills of Exchange, insurance premia, pension, and subscriptions.
(In this regard if any amount is collected, the bank credits the customer's account and if any payment is made, debits his account with the bank).

Types of Bank Accounts

A trader can open either a Savings Bank Account or a Current Account with a bank for the purpose of regular operations. In the case of Savings Bank Account there are certain restrictions on the number and amount of withdrawals and on deposits. It is intended to encourage savings. Usually, no business transactions are allowed in the respect of the Savings Bank Account. Hence it is not suitable for business purposes.

In the case of a Current Account, there are no restrictions on the number and amount of withdrawals or deposits. Any amount can be withdrawn or deposited any number of times. Business houses, therefore, open a Current Account generally.

Opening a Bank Account

When a businessman wants to open an account with a bank, he has to apply in the prescribed Account Opening form. He is also required to get himself introduced to the bank by a person known to the bank. The banker after satisfying himself about the applicant, takes his specimen signatures, receives the initial deposit in cash and opens an account in his/her firm's name. The businessman then becomes a customer of the Bank. Every account would be given a number for easy identification. When an account is opened, the banker gives to his customer (i) a Pass book (ii) a Pay-in-slip book and (iii) a cheque book.

i. The Pass-Book is nothing but a copy of the transactions as they appear in the Customer's account in the bank's ledger. In other words, it is a copy of customer's account as maintained

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by the banker. In the case of CurrentAccounts banks do not usually give a Pass Book but instead send a periodical statement of account. Whether it is a Pass Book or a statement of account the ruling is as follows :

Date	Particulars	With - drawals Dr.	Deposits Cr.	Dr. or Cr.	Balance
		Rs.	Rs.		Rs.

ii. The Pay-in-slip book contains slips which are used for depositing money, and cheques for collection into the bank.

iii. A cheque book contains a number of leaves called 'Cheques' which are to be used for withdrawing money from the bank. A cheque is an unconditional order on the bank made by its customer instructing the bank to pay the amount specified therein to the person named in the cheque or to his order or to the bearer of the cheque.

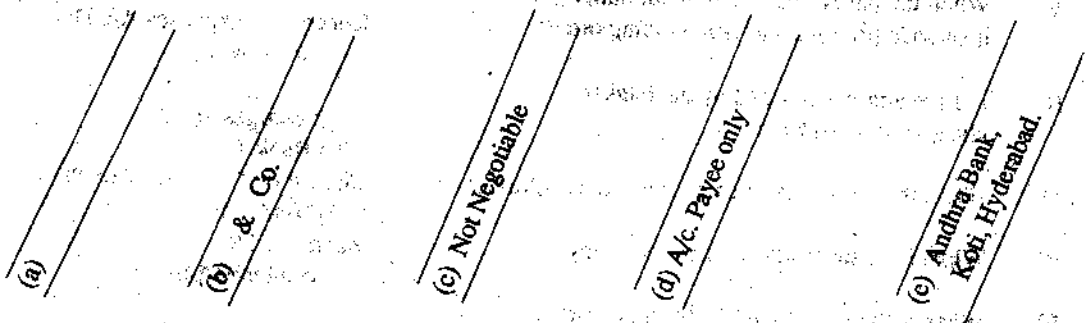
While writing a cheque care must be taken to write the date, the name of the party to whom payment has to be made, and the amount to be paid both in words and figures. It must be signed by the customer, i.e., the account holder and the signature must tally with the specimen signature with the bank.

A cheque can be an order cheque (e.g. pay to Ramesh or order) or a bearer cheque (e.g., Pay to Ramesh or bearer). When the word "order" is written the identification of the party claiming the payment is necessary but in case of a bearer cheque no such identification is required and the bank pays the amount of the cheque to the holder. However, payment can be obtained across the counter in the case of both order and bearer cheques.

Crossing of Cheques

Crossing is done by drawing two parallel lines usually on the left-hand top corner of the cheque and such a cheque is called ' a crossed cheque'. Crossing improves the safety of payment, because a crossed cheque cannot be encashed directly across the counter. A crossed cheque has to be deposited for collection with a bank which in turn collects it from the other bank.

Crossing can be 'General' or 'Special'. General or ordinary crossing is one where two parallel lines are drawn on the face of the cheque with or without the words '& co. ' Not Negotiable' ' A/c Payee', etc., as shown below (a.b.c&d). In the case of special crossing (e) the name of a particular bank is also stated.



In 'General Crossing' payment can be made to any bank which presents the cheque for payment. But in the case of 'Special Crossing' the amount of the cheque is payable by the drawee (i.e., customer's bank) only to the bank named in the 'crossing'. In other words, the specially crossed cheque has to be presented for payment, by the bank named in the crossing only.

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Endorsement of Cheques

A cheque is a negotiable instrument. It can be transferred to another person by endorsement. Signing on the back of the cheque for the purpose of negotiation is known as 'Endorsement'. The Person who endorses is called the 'Endorser' and the person to whom it is endorsed is called the 'Endorsee'

Honour or Dishonour of Cheques

A cheque presented for payment if paid by the banker is said to be 'honoured' and if refused payment, it is said to be 'dishonoured'. The bank may dishonour a cheque (1) if it is presented before the date mentioned on it. (2) or if the amount written in words and in figures are not the same. The banker also refuses payment in some special circumstances like the death or insolvency of the customer or when the court orders the stoppage of payment, etc.,

6.3 RECORD OF BANKING TRANSACTIONS

The following are the journal entries required for recording the banking transactions in the books of business:

1.	When cash is deposited in the Bank a/c	: BankA/c Dr. To Cash A/c
2.	When a cheque received from a party is deposited with the Bank for collection	: Bank A/c Dr. To Party's A/c.
3.	When a direct payment is made into the bank by a customer	: Bank A/c Dr. To Customer's A/c
4.	When cash is withdrawn from the Bank for office use	: CashA/c Dr. To Bank A/c.
5.	When cash is withdrawn from bank for personal use of the owner	: Drawings A/c Dr. To Bank A/c.
6.	When a cheque is issued to a party	: Party's A/c Dr. To Bank A/c
7.	When a cheque is issued to meet an expense	: Concerned Expense A/c Dr. To Bank A/c.
8.	When the banker collects interest, dividends etc., as per standing instructions	: Bank A/c Dr To Interest/Dividend A/c.
9.	When the banker pays certain amounts (e.g. insurance premium) as per standing orders	: Concerned Expenses A/c Dr. To Bank A/c.
10.	For the amount charged by the banker for the services rendered	: Bank charges A/c Dr. To Bank A/c
11.	When the banker charges interest on overdraft etc	: Interest on Overdraft A/c Dr. To Bank A/c
12.	When the banker allows interest, if any	: Bank A/c Dr. To InterestA/c.
13.	When a cheque which had been deposited, is dishonoured	: Customer's A/c Dr. To Bank A/c
14.	When a cheque issued by us is dishonoured	: Bank A/c Dr. To Creditor's A/c.

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Having learnt something about banking transactions, let us now proceed to three-column cash book.

Check Your Progress - 1

Point out mistakes in the following journal entries.

i) Arun Jyothi Account Dr. Rs. 20
To Cash Account Rs. 20
(Entry for allowing cash discount
to Arun Jyothi on receiving cash

ii) Bank Account Dr.
To Bank Charges Account
(Entry for the amount charged by the
banker for the services rendered)

6.4 THREE COLUMN CASH BOOK

Business firms generally deposit the bulk of their funds in the Current Account of a bank. Practically, there is no difference between cash in hand and cash with bank, just as cash is received from various parties, so also cheques are received from parties. Just as cash is used for making payments, so also cheques are issued for making payments. Thus, in a modern business deposits into the bank and payments through the bank are more in number than mere cash transactions.

Bank transactions are normally recorded in the Cash Book alongwith cash transactions. In other words, the bank account is maintained in the Cash Book alongwith cash account. It means the addition of an amount column for bank on either side of the two column Cash Book. By doing so, we shall have three amount columns on each side of the Cash Book, one each of discount, cash and bank. That is why it is called 'Three Column or Triple Column Cash Book'. It may be noted that there are three different types of accounts. Discount account is a nominal account, cash account is a real account and bank account is a personal account. The proforma of a Three Column Cash Book is given below :

Dr. THREE COLUMN CASH BOOK Cr.

Date	Particulars	LF	Discount Allowed	Cash	Bank	Date	Particulars	LF	Discount Received	Cash	Bank
			Rs.	Rs.	Rs.				Rs.	Rs.	Rs.

The following illustration will show the recording in a Three Column Cash Book and postings therefrom:

Illustration - 1

1989			Rs.
June	16	Cash balance in hand ----------	500
"	16	Balance in bank account ----------	3,000
"	18	Cash Sales ----------	1,900
"	19	Cash deposited into bank ----------	2,000

"	20	Rama Rao has to pay Rs.2,000. He paid us Rs. 950 in cash and given a cheque for Rs.1,000 in full settlement of his account	
"	21	Purchased goods by issuing a cheque for ----------	600
"	22	Paid Sanjeev Dev by cheque ----------	780
		Received discount ----------	20
"	23	Withdrawn for office purpose ----------	400
"	24	Received from Sudhakar ----------	870
		Allowed him discount of ----------	30
"	26	Deposited cash in the Bank ----------	2,000
"	28	Paid to Sanjeev Cash ----------	390
		Received Discount ----------	10
"	29	Paid electricity bill ----------	120
"	30	Paid rent by cheque ----------	500

Recording, Posting and Balancing

While recording transactions in, posting there from and balancing , a Three Column Cash Book, the following points are to be noted.

Recording

(1) *All receipts of Cash or Cheques are recorded on the debit side.* If cash is received, the amount is recorded in the cash column, and if a cheque is received, the amount is recorded in the bank column on debit side. Generally, cheques received from various parties are sent to the bank for collection on the same day. Therefore, bank account is directly debited with the amount of the cheques deposited. If, for any reason, a cheque is not sent to the bank on the day of receipt, that amount should be entered on the debit side of the cash column, treating the cheque as cash. When the cheque is sent to the bank for collection, the bank account should be debited and cash account credited, it then becomes a 'contra'entry.

If any discount is allowed to a party (on receipt of cash or cheque), such an amount is recorded on the debit side in the Discount Allowed Column. The recording in the other columns like date, particulars and folio is as mentioned earlier.

Solution to Illustration- 1.

Dr. CASH BOOK WITH DISCOUNT, CASH AND BANK COLUMNS Cr

Date	Particulars	L.F	Disc. All-owed	Cash	Bank	Date	Particulars	L.F	Disc. Rec-eived	Cash	Bank
1989			Rs.	Rs.	Rs.	1989			Rs.	Rs.	Rs.
June16	To Balance c/d			500	3,000	June19	By Bank A/c	C		2,000	
"18	" Sales A/c			1,900		" 21	"Purchases A/c				600
"19	" Cash A/c	C			2,000	" 22	"Sanjeev Dev A/c		20		780
" 20	" RamaRaoA/c		50	950	1,000	" 23	"Cash A/c	C			400
" 23	" Bank A/c	C		400		" 26	"Bank A/c	C		2,000	
" 24	"SudhakarA/c		30	870		" 28	"Sanjeev Dev A/c		10	390	
" 26	" Cash A/c	C			2,000	" 29	" Electricity Charges A/c			120	
						" 30	" Rent A/c				500
						" 30	" Balance c/d			110	5,720
			80	4,620	8,000				30	4,620	8,000
July1	To Balanceb/d			110	5,720						

LEDGER

Dr. **SALES ACCOUNT** Cr.

Date	Prticulars	L.F	Amount	Date	Particulars	L.F	Amount
			Rs.	1989			Rs.
				June 4	By Cash A/c		1,900

Dr. **RAMA RAO'S ACCOUNT** Cr.

			Rs.	1989			Rs.
				June 20	By Bank A/c		1,000
				June 20	By Cash A/c		950
				June 20	By Discount Allowed A/c		50

Dr. **SUDHAKAR'S ACCOUNT** Cr.

				1989			Rs.
				June 24	By Cash A/c		870
				June 24	By Discount Allowed A/c		30

Dr. **PURCHASES ACCOUNT** Cr.

1989			Rs.				Rs
June 21	To Bank A/c		600				

Dr. **SANJEEV DEV'S ACCOUNT** Cr.

1989			Rs.				Rs
June 22	To Bank A/c		780				
June 22	To Discount Received A/c		20				
June 28	To Cash A/c		390				
June 28	To Discount Received A/c		10				

Dr. **ELECTRICITY CHARGES ACCOUNT** Cr.

1989			Rs.				Rs.
June 29	To Cash A/c		120				

Dr. **RENT ACCOUNT** Cr.

1989			Rs.				Rs.
June 30	To Bank A/c		500				

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Dr. **DISCOUNT ALLOWED ACCOUNT** Cr.

1989 June 30	To Sundries as per Cash Book		Rs. 80				Rs.

Dr. **DISCOUNT RECEIVED ACCOUNT** Cr.

			Rs.	1989 June 30	By Sundries as per Cash Book		Rs. 30

(2) *All payments are recorded on the Credit side.* If cash is paid, the amount is recorded in the cash column, and if payments are made from bank account, i.e., by issuing cheques, the amount is recorded in the bank column. Discount received, if any, at the time of making the payment to a party is entered in the discount received column.

(3) *Contra Entry*. The Latin word 'contra' means 'the other side'. If both the debit and credit aspects of a transaction are recorded in the Cash Book itself, such entries are called Contra Entries. For example, when cash is deposited into the bank account, it is recorded on the debit side in the bank column (as the bank is the receiver), and on the credit side in the cash column (as cash goes out) of the Cash Book. Similarly, when cash is withdrawn from the bank account for office use, it is recorded in the cash column on the debit side (as cash comes in) and in the bank column on the credit side (as bank is the giver) of the Cash Book. It must, however, be noted that if cash is withdrawn from the bank account for personal use of the owner (Drawings account), it is not a 'contra entry'. In other words, a contra entry means an entry where cash account and bank account are affected at the same time. In order to denote contra entries the letter 'C' (capital letter) is written in the L.F column on both sides. It (C) means that the particular entry is posted on the other side (contra) of the same page of the Cash Book, because cash account and bank account are maintained in the Cash Book only. The letter 'C' also means that the particular entry with 'C' needs no further posting in the ledger, as the double entry is completed in the Cash Book itself.

Posting

Except the contra entries, all other entries recorded in the Cash Book are to be posted to their respective ledger accounts. For posting the entries recorded on the debit side of the cash book, credit the accounts concerned by writing 'By Bank a/c' if the entry is in bank column, 'By Cash a/c' if the entry is in the cash column Further, if the entry is made in the Discount Allowed column also for any discount allowed it is necessary to post the same by writing 'By Discount Allowed A/c in the concerned personal account.

For posting the entries recorded on the credit side of the Cash Book, debit the accounts concerned by writing 'To Bank A/c', if the entry is in Bank column, and 'To Cash A/c' if the entry is in the cash column. Further, if the entry is made in the Discount Received column also for any discount received, it is necessary to post the same by writing 'To Discount Received A/c' in the concerned personal account.

Balancing

The cash and bank columns are balanced separately in the usual manner. The cash account (i.e., cash columns of the Cash Book) always shows a debit balance. The bank account (i.e., bank columns) normally shows a debit balance. A debit balance in the bank account indicates the cash held by the businessman in the bank.

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Sometimes the bank account may show a credit balance indicating overdraft. Then the closing credit balance is carried down on the debit side of the bank account for the purpose of balancing and later brought down on the credit side as the starting balance for the next period.
The discount columns are not balanced but merely totalled. The totals are posted to the respective discount accounts in the ledger, i.e., the total of discount column on the debit side is posted to the debit side of the Discount Allowed account as 'To Sundries' and the total of discount column on the credit side is posted to the credit side of the Discount Received account as 'By Sundries'.

Illustration -2

Record the following transactions of Madhusudan in a Triple Column Cash Book with discount, cash and bank columns and balance the same.

1989	
Jan. 1	Madhusudan started business with Rs. 20,000 in cash.
" 2	He deposited Rs. 19,000 into the Bank current account.
" 3	He purchased goods for cash Rs. 800.
" 4	He purchases goods for Rs. 1,500 and issues a cheque.
" 5	Sells goods for cash Rs. 500
" 6	Sells goods to Kirti & Co. for Rs. 800 and receives a cheque for the same.
" 8	Kirti & Co.'s Cheque is deposited into the Bank.
" 9	He pays sundry expenses in cash Rs. 100
" 10	He purchases stationery by cheque Rs. 200
" 11	He gives a cheque to Prasad & Co. for cash purchase of office furniture Rs.1,600
" 12	He receive for cash sales Rs. 900
" 13	Tripathi & Co. paid into his bank account directly Rs. 500
" 15	He receives cash Rs. 100 and cheque for Rs. 400 for Cash Sales.
" 16	He pays into Bank Rs. 1,000
" 17	He received cash Rs. 1,000 and a cheque for Rs.1,500 from Mohan on account and allowed him a discount, of Rs.50.
" 18	He pays Ravikumar on account, Cash Rs.500, cheque Rs.2,000 and Received a discount of Rs.40.
" 19	He receives a cheque for Rs. 980 from John & Co., on account and allows discount Rs.20.
" 20	He withdraws Rs.1,000 from the bank for office use.
" 22	He pays his Son's College fees in cash Rs.500.
" 23	He pays Shankar & Co., on account, by cheque Rs.775 and is allowed Rs.25 discount
" 24	He withdrew from bank Rs.1,200 for personal use.
" 25	John & Co.'s cheque for Rs. 980 is returned dishonoured.
" 27	He pays Jaspal Singh by cheque for commission Rs.300.
" 27	He receives a cheque for commission from Ismail Rs.400.
" 29	His cheque to Shanker & Co., Rs.775 is returned dishonoured because of wrong stamping.
" 29	Issues a cheque for the purchase of machinery Rs. 20,000.
" 30	He pays electricity charges in cash Rs.200.
" 31	Pays rent by cheque Rs.500.
" 31	He issues another cheque to Shanker & Co., for Rs.800.
" 31	He deposits the cash balance in excess of Rs.200 in the bank.

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Solution

Dr. **MADHUSUDAN'S CASH BOOK** Cr.

Date	Particulars	L.F.	Disc. Allowed	Cash	Bank	Date	Particulars	L.F.	Disc. Received	Cash	Bank
1989			Rs.	Rs.	Rs.	1989			Rs.	Rs.	Rs.
Jan. 1	To Capital A/c.			20,000		Jan. 2	By Bank A/c.	C		19,000	
" 2	To Cash	C			19,000	" 3	By PurchasesA/c.			800	
" 5	To Sales A/c.			500		" 4	By Purchases A/c.				1,500
" 6	To Sales A/c.			800		" 8	By Bank A/c.	C		800	
" 8	To Cash A/c.	C			800	" 9	By Sundry Expenses A/c.			100	
" 12	To Sales A/c.			900		" 10	By Stationery A/c.				200
" 13	To Tripathi & Co. A/c.				500	" 11	By Furniture A/c.				1,600
" 15	To Sales A/c.			100	400	" 16	By Bank A/c.	C		1,000	
" 16	To Cash A/c.	C			1,000	" 18	By Ravi Kumar		40	500	2,000
" 17	To Mohan A/c.		50	1,000	1,500	" 20	By Cash A/c.	C			1,000
" 19	To John & Co. A/c.		20		980	" 22	By Drawings A/c.			500	
" 20	To Bank A/c.	C		1,000		" 23	By Shanker & Co.A/c.		25		775
" 27	To Commission A/c.				400	" 24	By Drawings A/c				1,200
" 29	To Shankar & Co. A/c.				775	" 25	ByJohn & Co. A/c				980
						" 27	By Commission Account				300
" 31	To Cash A/c.	C			1,200	" 29	By Machinery A/c				20,000
" 31	To Balance c/d				4,300	" 30	By Electricity Charges A/c.			200	
						" 31	By Rent A/c.				500
						" 31	By Shanker & Co. A/c.				800
						" 31	By Bank A/c.	C		1,200	
						" 31	By Balance c/d			200	
			70	24,300	30,855				65	23,300	30,855
1989						1989					
Feb. 1	To Balance c/d			200		Feb. 1	By Balance b/d				4,300

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Notes : (1) When cheques are received from parties, it is assumed that they are deposited in the bank on the same day and entered in the bank column unless otherwise specified. But in the case of the transaction dated 6th the cheque is received on the 6th of January and deposited in the bank on the 8th of January. Therefore, the receipt of the cheque is recorded in the cash column treating it as cash in the first instance. When the same is deposited into the bank, the cash account is credited and the bank account is debited.

(2) John & Co., owed Rs.1,000, and paid Rs.980 by cheque and received Rs.20 as discount. But the cheque given by them is dishonoured. That means Madhusudan's bank has not received cash. But Madhusudan has already debited his bank account on the 19th of January itself with Rs.980. Since the bank has not received cash, we have to cancel it by crediting the bank account with Rs.980.

Discount is allowed for prompt payment. In this case payment is not to be treated as promptly made, since the cheque given by John & Co., is dishonoured. As the cheque is dishonoured the discount allowed previously has to be disallowed. Therefore, the discount allowed should be written back to John & Co.,'s account.

When a cheque given by a customer is dishonoured, the entry which has already been recorded in the Cash Book has to be cancelled by writing on the credit side 'By Customer's A/c' in the bank column. Further, the following entry should be passed through the Journal for cancelling the amount of the discount allowed.

Debtor's A/c. Dr.
To Discount Allowed A/c.

In the transaction discussed above, the entry is as follows:

John & Co. A/c	Dr	20	
To Discount Allowed A/c			20

(3) When a cheque issued is dishonoured for whatever reason, similar cancellation entries are passed

(4) The balance of cash in hand, in excess of Rs.200 is deposited into the bank. To arrive at the amount deposited in the bank, first find out the cash balance as usual. The debit side total is Rs.24,300. The credit side total of the cash column is Rs. 22,900. So the balance of cash before depositing it in the bank is Rs.1,400(24,300 — 22,900 = 1,400), of which Rs. 200 is retained as cash on hand (i.e., closing balance of cash) the remaining Rs. 1,200 (1,400 — 200 = 200) is deposited in the bank.

(5) The credit side total of the bank column is Rs.30,855 and the debit side total after depositing Rs.1,200 as stated above, is Rs.26,555. So the credit side exceeds the debit side by Rs.4,300, which means that Madhusudan's bank account is having a credit balance of Rs. 4,300. This obviously is a case of overdraft.

Check Your Progress - 2

i) What do you mean by contra entry?
ii) Give three examples of contra entries.
iii) Classify the following under personal, real and nominal accounts:
a) Bank Account
b) Cash Account
c) Discount Account

6.5 CASH BOOK WITH DISCOUNT AND BANK COLUMNS ONLY

In the case of certain big business houses, the practice is that all receipts of cash/cheques are sent to the bank immediately and all payments are made through cheques only. Such business houses maintain a Cash Book with Bank and Discount columns only. For recording Petty Cash payments, a Petty Cash Book is maintained, which will be discussed later. The recording in a Two Column Cash Book with bank and discount columns will be as follows:

Illustration -- 3

Compile a Cash Book with discount and bank columns only from the following transactions, assuming that all receipts are sent to the bank immediately and all payments made by cheques

B R A O U

1989		Rs.
June 10	Opened bank account with a capital of	10,000
" 12	Made cash purchases of goods	1,800
" 15	Sold goods for cash	1,500
" 20	Rceived cheque from Suresh & Co.	480
	and allowed discount	20
" 21	Paid Harries & Co.	790
	They allowed us discount	10
" 22	Purchased office furniture	1,000
" 24	Robinson paid us cash	1,170
	We allowed him discount	30
" 25	Issued cheque to Ahmed & Co.	980
	and received discount	20
" 27	Received for cash sales	500
" 28	Paid for cash purchases	400
" 29	Drew cheque for petty cash	300
" 30	Drew for personal use	200
" 30	Paid Office rent	400
" 30	Paid staff salaries	1,000

Solution

Dr. **CASH BOOK WITH DISCOUNT AND BANK COLUMNS** Cr.

Date	Particulars	LF	Disc. Alld.	Bank	Date	Particulars	LF	Disc. Recd.	Bank
1989			Rs.	Rs.	1989			Rs.	Rs.
June10	To Capital A/c			10,000	June 12	By Purchases A/c			1,800
" 15	To Sales A/c			1,500	" 21	By Harris & Co. A/c		10	790
" 20	To Suresh & Co. A/c		20	480	" 22	By Office Furniture A/c			1,000
" 24	To Robinson A/c		30	1,170	" 25	By Ahmed & Co. A/c		20	980
" 27	To Sales A/c			500	" 28	By Purchases A/c			400
					" 29	By Petty Cash A/c			300
					" 30	By Drawings A/c			200
					" 30	By Office Rent A/c			400
					" 30	By Salaries A/c			1,000
					" 30	By Balance c/d			6,780
			50	13,650				30	13,650
1989 July 1	To Balance b/d			6,780					

BRAOU

Note : The Students should note that the term a two column cash book is popularly used to refer to cash book with cash and discount columns. However, in examination problems when it is clearly stated that "all receipts are banked and that all payments are made by way of cheques", in that context, it is the cash book with bank and discount columns that must be used.

6.6 PETTY CASH BOOK

In every business usually a large number of small payments have to be made in cash. Examples of such payments are postage, Telegrams, cartage, stationery, entertaining of the customer, conveyance, etc. If all these payments are recorded in the Cash Book along with the other payments involving big amounts, the cash book will be overloaded. Therefore, a separate book called 'Petty Cash Book' is maintained for recording all small (petty) payments. A person known as "Petty cashier is entrusted with the work of making the small payments. The sum of money given to the Petty Cashier for making small payments is known as 'Petty Cash".

Imprest system

Generally, Petty cash is maintained on the basis of the imprest system. Under this system an estimate is made of the amount that is likely to cover petty payments for a certain period, say a week or a month. Such an amount, either in cash or by cheque, is handed over to the Petty Cashier to begin with. The Petty Cashier is required to obtain vouchers for the payments made. At the end of the week/month the Petty Cashier submits the Petty Cash Book together with the vouchers to the Head/Chief Cashier. The head Cashier then checks the entries in the petty cash book and pays to the petty cashier a sum equal to the amounts spent by him, so that the original amount of the petty cash with which he has started is restored. The advantage of this system lies in the fact that the amount is first entered in the total payments column and then also entered in column meant for it under "Analysis of Payment". The payments are analysed under certain Heads of expenses. These expenses / Heads are periodically totalled. The periodical total of each Head of expenses is posted to the concerned ledger account.

Analytical (OR Columnar) Petty Cash Book

As the receipts by the Petty Cashier are few in number and payments made by him are many, the Petty Cash Book is so designed as to have common date and particulars columns. Further, to facilitate easy postings of payments, additional amount columns are opened on the credit side, which are used for analysing the various payments made under different Heads. Therefore, this type of Petty Cash Book is known as 'Columnar or Analytical Petty Cash Book'.

Entries and Posting

Whenever the Head Cashier makes payment to the Petty Cashier, either in cash or by cheque, the petty cash account (appearing in the ledger) is debited by writing 'To Cash or Bank a/c and the Cash Book (cash or bank column) is credited by writing "By Petty Cash Account".

On receipt of the Petty Cash, the Petty cashier records the same in the particulars column of the Petty Cash Book by writing "To Cash A/c or Bank A/c" and enters the amount in the debit side amounts column. When the Petty Cashier makes payments, each payment is recorded in the Particulars column by writing "By...(expenses)". The amount is first entered in the total payments column and then also entered in column meant for it under "Analysis of Payment". The payments are analysed under certain Heads of expenses. These expenses / Heads are periodically totalled. The periodical total of each Head of expenses is posted to the concerned ledger account.

The Petty Cash Book is balanced periodically, say weekly or monthly. The various expenses accounts in the ledger are individually debited with periodical totals (as per the columns in the Petty Cash Book) by writing "To Petty Cash A/c" and petty cash account in the ledger is credited with the total of payments made by wiriting "By Sundries as per the Petty Cash Book". The Petty Cash account balance will be qual to the cash balance with the Petty Cashier. The following illustration will make the procedure clear :

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Illustration - 4

Prepare an analytical Petty Cash Book from the following transactions :

1989		Rs.
July 1	Gave an imprest cheque to the petty cashier to begin with	200
	During the Month, the petty cashier made the following payments :	
" 3	Purchased postage stamps	25.00
" 5	Paid for cool drinks offered to customers	6.00
" 7	Paid for stationery	30.00
" 10	Paid for cartage on goods bought	8.00
" 14	Paid for Taxi-fare	12.50
" 16	Paid tips to office peons	9.50
" 19	Sent telegram to Vijayawada	6.75
" 22	Paid to Subba Rao on account	27.50
" 24	Paid cartage	18.50
" 26	Coffee expenses to customers	4.50
" 27	Paid printing bill	34.75
" 29	Paid Auto-fare	6.25
" 30	Paid for Coolies	3.50

Balance the Petty Cash Book at the end of July and show the amount of the cheque that would be issued to the Petty Cashier on the first of August, 1989.

Solution

ANALYTICAL PETTY CASH BOOK

Amount Received	Cash Book folio No.	Date	Particulars	Voucher No.	Total payments	"Analysis of Payment"								
						Postage & Telegrams	Printing & Stationery	Conveyance	Cartage	Entertainment	Miscellaneous	Ledger* accounts	LF	Remarks
		1984			Rs.	Rs.	Rs.	Rs.	Rs.	Rs.	Rs.	Rs.		
200.00		July 1	To Bank											
		" 3	By Postage Stamps		25.00	25.00								
		" 5	By Cool Drinks		6.00					6.00				
		" 7	By Stationery		30.00		30.00							
		" 10	By Cartage		8.00				8.00					
		" 14	By Taxi Fare		12.50			12.50						
		" 16	By Tips to Peons		9.50						9.50			
		" 19	By Telegram		6.75	6.75								
		" 22	By Subba Rao's a/c		27.50							27.50		Subba Rao's
		" 24	By Cartage		18.50				18.50					
		" 26	By Coffee Expenses		4.50					4.50				
		" 27	By Printing		34.75		34.75							
		" 29	By Auto fare		6.25			6.25						
		" 30	By Coolies		3.50						3.50			
					192.75	31.75	64.75	18.75	26.50	10.50	13.00	27.50		
					7.25									
200.00		" 31	By Balance c/d		200.00									
7.25		1989	To Balance b/d											
192.75 **		Aug. 1	To Bank											

Note :
* In addition to providing columns for usual items of expenses, a separate column called "Ledger Accounts" column is provided to record infrequent items and the concerned account is mentioned in the Remarks column
** On August 1, 1989 the petty cashier will be given a cheque for Rs. 192.75 only and when he receives it, the recording is as shown in the illustration.

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Dr. **PETTY CASH ACCOUNT** Cr.

Date	Particulars	LF	Amount	Date	Particulars	LF	Amount
1989			Rs.	1989			Rs.
July 1	To Bank A/c		200.00	July 31	By Sundries as per Petty Cash Book		192.75
				July 31	By Balance c/d		7.25
			200.00				200.00
1989							
Aug.1	To Balance b/d		7.25				
Aug.1	To Bank A/c		192.75				

Dr. **BANK ACCOUNT** Cr.

				1989			Rs.
				July 1	By Petty Cash A/c		200.00
				Aug. 1	By Petty Cash A/c		192.75

Dr. **POSTAGE ND TELEGRAMS ACCOUNT** Cr.

1989			Rs.				
July.31	To Sundries - as per Petty Cash Book		31.75				

Dr. **PRINTING AND STATIONERY ACCOUNT** Cr.

1989			Rs.				
July 31	To Sundries		64.75				

Dr. **CONVEYANCE ACCOUNT** Cr.

1989			Rs.				
July 31	To Sundries		18.75				

Dr. **CARTAGE ACCOUNT** Cr.

1989			Rs.				
July 31	To Sundries		26.50				

Dr. **ENTERTAINMENT ACCOUNT** Cr.

1989			Rs.				
July 31	To Sundries		10.50				

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Dr.	MISCELLANEOUS EXPENSES ACCOUNT						Cr.
1989 July 31	To Sundries		Rs. 13.00				

Dr.	SUBBA RAO'S ACCOUNT						Cr.
1984 July 22	To Petty Cash		Rs. 27.50				

6.7 SUMMING UP

Three column cash book will be having an extra amount column for bank on either side of the two column cash book. Thus, three column cash book will have three amount columns on each side of the cash book, one each for discount, cash and bank. When both the debit and credit aspects of a transaction are recorded in the three column cash book itself, it is called 'Contra entry'. Except the contra entries, all other entries recorded in the cash book are to be posted to their respective ledger accounts.

The cash and bank columns are balanced separately in the usual manner. The cash account (i.e., cash columns of the cash book) always shows a debit balance. The bank account (i.e., bank columns) normally shows a debit balance. But some times it may show a credit balance, indicating overdraft (withdrawal of more than what has been deposited).

Big business houses which prefer to pass all the transactions through the bank, maintain a cash book with bank and discount columns only.

For recording payments of petty expenses, the petty cash book is maintained. The use of the analytical petty cash book saves enormous amount of labour involved in analysing periodical petty payments and in posting them to the ledger accounts.

6.8 ANSWERS TO CHECK YOUR PROGRESS

1. i) Entry is wrong, Discount account will be debited and Arun Jyothi Account will be credited.

   ii) Entry will be reversed.

2. i) When ever a transaction relates to cash and bank, both the aspects (i.e., debit and credit) are recorded in the cash book itself. Such entries are called 'Contra Entries'.

   ii) a) When cash is deposited into the Bank account. (it is recorded on the debit side in the bank column, as the bank is the receiver, and on the credit side in the cash column, as the cash goes out). Similarly,

   b) When cash is withdrawn from the bank account for office use. (debit cash account and credit bank account).

   c) When a cheque is received and deposited on different dates. (debit cash account and credit party's account on receipt of cheque. When the cheque is deposited, the entry is debit bank account and credit cash account).

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(iii) a) Bank Account - Personal Account
b) Cash Account - Real Account
c) Discount Account - Nominal Account

6.9 MODEL EXAMINATION QUESTIONS

A. Short Answer Questions

1. What is the crossing of cheque ?
2. What are the advantages of having bank account ?
3. What are the types of bank accounts ?
4. What is a petty cash book ?
5. Explain the following
   i) Cheque (ii) Endorsement
   iii) Dishonour of a cheque.
6. What do you mean by analytical petty cash book?
7. What is a petty cash book ? How will you maintain the petty cash book on imprest system?

B. Essay Answer Questions

8. What is a contra entry ? Give three examples. How is contra entry distinguished in the cash book from other entries.
9. State the reasons for the following :
   a) The balance in the cash columns of the cash book is always a debit balance, whereas that in the bank columns is sometimes credit also.
   b) The cash account and the bank account are not opened in the ledger.
   c) All the entries in the three column cash book are not posted into the ledger.
10. What are the different kinds of cash books ? How do they differ from one another? Under what conditons each of them is maintained ?
11. Explain the procedure of posting the entries from a triple column cash book to the ledger accounts.
12. What is the need for petty cash book ? How is it maintained in a columnar form?

PROBLEMS

1. Compile the Cash Book of Mr.Solkar from the following transactions :

1989		Rs.
April 1	Cash in hand	1,500
April 3	Purchased goods	400
April 5	Paid to Ram	300
	discount allowed by him	20
April 7	Sold goods	500
April 9	Received from Babu Gupta	980
	discount allowed to him	20
April 12	Received cash from Kamath in full settlement of his account Rs.500, he having deducted cash discount of 3%	485
April 15	Paid to Martin after deducting 2 1/2% discount	585
April 18	Paid wages	50
April 24	Received from Sharma	295
	discount allowed to him	5
April 27	Paid for stationery	30
April 29	Paid to Narayana in full settlement of his account Rs.400	390
April 30	Deposited cash into Bank, in excess of Rs.400	

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(Answer : Cash in hand ; Rs.400 Cash deposited into the bank ; Rs.1,605, Discount Dr. Rs.40 ; Cr. Rs.45)

Three Column Cash Book

2. Enter the following transactions in Triple Column Cash Book of M/s. Dayal & Sons.

1989

May 1	Cash in hand Rs.2,530 and cash at Bank Rs.1,450.
May 2	Received cash from Devi & Co. Rs.2,950 and allowed discount Rs.50
May 5	Paid into Bank Rs.2,800
May 9	Paid Bangaru & Co. by cheque Rs.935 in full settlement of their account for Rs.950.
May 12	Sanjay enterprises paid directly into our Bank account Rs.1,700.
May 15	Paid to Hansraj & Co. by cheque for cash purchase of furniture Rs.1,835.
May 18	Received a cheque for interest on investment which was sent to Bank for collection for Rs.350.
May 20	Drew a cheque for personal use Rs.1,000.
May 23	Received for cash sales from Lotus & Co. a cheque for Rs.200 and cash Rs.875.
May 25	Gave donation by cheque to Shishu Vihar Rs.1,116.
May 28	Lotus & Co.'s cheque paid into the Bank
May 30	Paid Salaries Rs.450 and rent Rs.225. by cheque.

(Answer : Cash in hand : Rs.3,555 ; Cash at Bank : Rs.939. Discount Dr. Rs.50 and Cr. Rs.15)

3. Post the above entries from the Cash Book to their respective ledger accounts.

4. Enter the following transactions in a Three Column 'Cash Book' of M/s. Seven Links :

1989

June 1	Cash in hand Rs.237 ; balance at bank Rs.6,594
June 2	Received from Preetham Singh cash Rs.590, allowed him discount Rs.10.
June 4	Paid to S.C. Bose by cheque Rs.300, Cash purchases Rs.60.
June 5	Cash sales Rs. 134
June 6	Paid Salaries for May, by cash Rs.200
June 7	Paid Mirza by cheque Rs.585, discount received 2 1/2%
June 8	Cash sales Rs. 112
June 9	Paid cartage and coolie Rs.6
June 12	Paid rent in cash Rs.50
June 14	Received from George Rs.194 by cheque ; discount allowed 3%.
June 15	Cash sales Rs.212.
June 18	Purchased one old motor car for business use for Rs.5,800 and issued a cheque for the amount .
June 19	Deposited into Bank Rs.600
June 24	Received a cheque from Robert & Co., for Rs.291 : discount allowed 3%.
June 27	Cash Sales Rs.298.
June 28	Bank informs that Robert & Co.'s cheque has been dishonoured.
June 29	Deposited with bank Rs.300
June 30	Paid wages in cash Rs.72. Bank charges as shown in the Pass Book are Rs.5

(Answer : Cash Balance Rs.295 ; Bank Balance Rs.998 : Discount Dr. Rs.25 ; Cr. Rs.15)

Hint : Discount allowed to Robert & Co. amounting to Rs.9 will be disallowed because of the dishonour of his cheque. But the disallowance of discount allowed will be rectified in the discount allowed a/c in the ledger.

5. Enter the following transactions of Mr. Smith in a Cash Book with Discount, Cash and Bank columns. Also balance the Cash Book and bring down the balance .

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1989		Rs.
July 1	Cash Balance	100
July 1	Bank Balance	1,450
July 1	Cash received from Sale of investments	6,000
July 2	Paid into Bank	5,000
July 3	Paid John & Co. by cheque	1,200
	discount allowed by him	50
July 5	Paid wages by cash	250
July 9	Received from Mr. Allen a cheque for	980
	allowed him a discount	20
July 12	Paid Allen's cheque into Bank	980
July 15	Purchased goods for cash	600
July 17	Paid for Stationery in cash	150
July 18	Drew from bank for office	300
July 19	Cash withdrawn for personal expenses from office	200
July 20	Paid F. Wales by cheque	370
	discount allowed by him	25
July 23	Received from W. Robbins	1,800
	allowed him discount	75
July 24	Received for cash sales	170
July 25	Paid into Bank	1,700
July 26	Gave cheque for Cash Purchase of goods	200
July 26	Received cheque from Alfred and paid it into Bank	400
July 26	Drew cheque for personal use	100
July 27	Drew cheque for office use	300
July 28	Sold goods for cash and banked the same	200
July 29	Paid office salaries by cash	325
July 30	Gave cheque for office rent	60

(Answer : Cash balance : Rs.445, Bank balance Rs.7,200, Discount Dr. Rs.95, Cr. Rs.75)

6. Record the following transactions of M/s. Vijay Trading Company in a Three Column Cash Book. Balance the Cash Book as on the 31st of December, 1989 :-

1989		Rs.
Dec.1	Cash in hand	3,000
Dec.1	Bank overdraft balance	1,470
Dec.4	Received a cheque from Harilal	290
	and allowed him discount	10
Dec. 7	Harilal's cheque deposited into bank	
Dec.10	Paid bills payable by cheque	500
Dec.12	Withdrew from Bank for office use	800
Dec. 15	Received a cheque from Chandrakanth	2,400
	and allowed him a discount	100
Dec. 22	Issued a cheque for petty cash	100
Dec.27	Paid Agarwal by cheque	920
	and discount received	30
Dec. 28	Cash sales	900
Dec. 30	Deposited office cash into bank	3,700

(Answer : Cash in hand Rs.1,000, Cash at bank Rs.2,500, Discount Dr. Rs.140, Cr. Rs.30)

7. From the following particulars of Mr. Avinash, prepare a Triple Column Cash Book and balance the same as on the 31st of December, 1989.

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1989		Rs.
Dec. 15	Cash in hand ----------	230
Dec. 15	Bank overdraft ----------	1,400
Dec. 16	Drew cash from bank for office use ----------	800
Dec. 16	Paid salaries ----------	500
Dec.16	Paid rent ----------	100
Dec. 16	Withdrew cash for domestic use ----------	150
Dec. 18	Cash Purchases ----------	250
Dec. 18	Cash sales ----------	200
Dec. 10	Received a cheque from Anand (in full settlement of his debt Rs.700) ----------	650
Dec. 20	Issued cheque in favour of Nanda in settlement of the amount due to him of Rs.400 less 2 1/2% discount.	
Dec. 21	Received by sale of old packing cases ----------	100
Dec. 21	Received from Sethi & sons a cheque for ----------	400
	Discount allowed to them ----------	10
Dec. 22	Purchased a cycle by cheque ----------	250
Dec. 22	Paid municipal taxes in cash ----------	100
Dec. 24	Issued a cheque in favour of Ahmed & co., discount received 4% ----------	480
Dec. 26	Cheque from Sethi & Bros. returned dishonoured by the bank. The bank charged Rs.5 as expenses.	
Dec. 26	Received from the estate of Mr. Bapineedu against a debt written off previously ----------	250
Dec. 27	His cheque to Ahmed & Co. returned dishonoured, because of wrong stamping.	
Dec. 28	Issued a new cheque to Ahmed & Co., for the full amount of original debt.	

(Answer : Cash in hand : Rs.480, Bank overdraft : Rs.2,695, Discount : Dr. Rs.60 and Cr. Rs.30)

Cash Book with Discount and Bank Columns only

8. Enter the following transactions in the Cash Book, assuming that receipts are paid into the bank daily, and that all payments are made by cheques :

1989

July 1 Balance at Bank Rs. 3,500
July 2 Received from Benjiman a cheque for Rs.1,000 And allowed him discount Rs.50
July 3 Paid Ranjan's account of Rs.40, less discount at 2%
July 4 Drew a cheque for Rs.1,000 of which Rs.900 was for payment of wages and Rs.100 for petty cash.
July 5 Received from Gulab Patil Rs.970 in full settlement of his account of Rs.1000
July 6 Cash purchase of goods Rs.500.
July 6 Cash sale of goods Rs.800
July 7 Received Rs.450 from Williams in full discharge of his debt Rs.480.
July 8 Paid Rs.660 to G.J.Appan in full settlement of his account of Rs.675.
July 9 Paid electricity bill Rs.35
Also show ledger postings of the above cash book entries.

(Answer : Bank balance Rs. 1,133, Discount : Dr. Rs.110, Cr. Rs.23)

9. Enter the following transactions in a Cash Book with Bank and Discount columns only. Assume that all receipts are paid to the Bank and that all payments are made by cheque.

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1989		Rs.
Jan. 1	Opened bank account with	20,000
Jan. 2	Cash Purchases	800
Jan. 3	Cash Sales	1,000
Jan. 5	Purchased furniture for cash	1,200
Jan. 6	Drew cheque for petty cash	200
Jan. 7	Received interest on investments	350
Jan. 9	Paid for advertisement	150
Jan. 10	Purchased goods for cash	400
Jan. 11	Received for cash sales	500
Jan. 12	Paid for stationery	75
Jan. 13	Drew for personal use	300
Jan. 14	Received cash from Desai & Co	475
	and allowed them discount	25
Jan. 15	Paid to Rajesh on account	380
	and was allowed discount	20
Jan. 18	Received cheque from Mr. Grey on account	250
Jan. 20	Paid Mr. Balan in full settlement	555
	and was allowed discount	45
Jan. 22	Received from Mr.Wales to settle his a/c	260
	allowed him discount	25
Jan. 25	Remitted to Das Gupta	435
	He allowed discount	40
Jan. 28	Paid for electric light	200
Jan. 30	Paid office rent	350
Jan. 30	Paid for salaries	650

(Answer : Cash at Bank : Rs.17,140, Discount : Dr : Rs.50, Cr. : Rs. 105)

Petty Cash Book

10. From the following particulars, prepare an Analytical Petty Cash Book :

1989		Rs. Ps.
May 1	Received Rs.100 for petty cash	
May 1	Paid bus fare	1.00
May 2	Paid for cartage	3.50
May 3	Postage and telegram	8.00
May 3	Rikshaw charges	3.00
May 3	Stationery	5.50
May 3	Cool drinks	5.00
May 4	Wages to casual labourers	9.00
May 4	Postal stamps and telegrams	6.60
May 5	Stationery	3.40
May 5	Auto charges	7.50
May 6	Repairs to furniture	15.00
May 6	Bus fare	1.50
May 6	Cartage	3.50

(Answer : Cash balance with the Petty Cashier : Rs.27.50)

11. Enter the following items in a Petty Cash Book which is kept on the basis of the imprest system. At the end restore the imprest amount. Use the Analysis Columns for conveyance, postage, stationery, sundries and ledger accounts.

BRAOU

1989

June 1 Received an imprest cheque from head Cashier Rs.100
June 1 Paid Bus Fare Rs.8 ; paid for postal stamps Rs.4.50
June 2 Given Rs.10 to the proprietor for his personal use.
June 3 Paid for office tea Rs.4.50 ; paid for postal covers Rs.6.50 ; paid for twine Rs.1.20.
June 4 Paid fares Rs.12.50 ; Paid for gum Rs.3.30
June 5 Paid Ramavathar on account Rs.18.50 ; paid office cleaner Rs.2.50
June 6 Purchased a lock Rs.15 ; purchased pencils, refills Rs.2.40

(Answer : Cash balance in hand : Rs.11.00 ; Imprest cheque to be issued for next week Rs.88.90)

12. Prepare an Analytical Petty Cash Book maintained on the basis of the imprest system for the month of July, 1989.

1989		Rs.Ps.
July 1	Balance of cash in hand	4.20
July 1	Received a cheque from the Head Cashier for petty disbursements	195.80
July 2	Paid for printing of letter heads	12.50
July 3	Pencils, pins, gemclips, refils, envelops etc.	22.70
July 4	Bought postage stamps	4.30
July 5	Paid to an electrician for repairs	6.00
July 6	Sent telegrams to suppliers	18.50
July 8	Office cleaning expenses	3.50
July 10	Telephone charges	3.00
July 12	Paid to Mitra on account	17.00
July 14	Paid carriage on goods	7.50
July 17	Refreshments to customers	4.30
July 19	Paid for cartage	5.50
July 21	Postage	6.30
July 24	Paid trips to peons	5.00
July 26	Repairs to chairs	8.00
July 28	Purchased stationery	7.50
July 29	Paid to Ramesh on account	15.00
July 30	Refreshments to customers	6.60
July 30	Telephone charges	4.50

(Answer : Cash in hand : Rs.42.30)

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6.10 GLOSSARY

1. **Contra Entry** : If both the debit and credit aspects of a transaction are recorded in the Cash Book itself, such an entry is called 'Contra Entry'.
2. **Cheque** : It is an order by a customer to his banker to pay on demand a stated sum of money to or to the order of a specified person or to the bearer.
3. **Crossing** : It means drawing two parallel lines on the face of a cheque with or without the words, ' & Company'.
4. **Dishonour** : Refusing to pay an instrument (e.g. Bill or Cheque).
5. **Endorsement** : Signing on the back of the Bill of the cheque for the purpose of negotiation.
6. **Pass Book** : A book supplied to the customer by the bank containing a copy of the entries from the ledger.
7. **Pay-in-slip** : It is a slip 'challan' used to remit cash or to deposit cheques, etc.

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UNIT - 7 : BANK RECONCILIATION STATEMENT -I

Contents

7.0 Aims and Objectives
7.1 Introduction
7.2 Need for Bank Reconciliation Statement
7.3 Procedure for Ascertainment of the causes of disagreement
7.4 Preparation of Bank Reconciliation Statement
7.5 Summing up
7.6 Answers to Check Your Progress
7.7 Model Examination Questions
7.8 Glossary

7.0 AIMS AND OBJECTIVES

This unit aims at discussing i) the need for reconciliation ; ii) the causes of difference between the balance of cash book and the pass book and ; iii) the preparation of bank reconciliation statement.

Having gone through this unit we would expect you to be aware of :
- the procedure for the ascertainment of the cuases of disagreement between cash book and pass book,
- the preparation of bank reconciliation statement.

7.1 INTRODUCTION

In the previous unit we have discussed that a business usually maintains a bank account and thus will have a pass book or a bank statement given by the banker. We have also considered the method of recording different transactions through the bank columns of the cash book. In this unit and in the subsequent unit, it is proposed to discuss the bank reconciliation statement.

The balance of the bank account (or bank column of the cash book) should be equal to the balance shown by the pass book or bank statement. But some times these two balances do not agree. This disagreement may arise because of a mistake or time-lag between the entries made by the bank in its own account books and the entries made by a trader in his books. To reconcile these different balances as shown by the cash book and the pass book, a statement known as 'Bank Reconciliation Statement' is prepared.

7.2 NEED FOR BANK RECONCILIATION STATEMENT

The Cash Book (bank columns, i.e. the bank account) usually shows a debit balance, representing the amount held in deposit with the bank. The banker also records these transactions with his customers in his ledger considered from his point of view. The Pass Book (a copy of the customers' account as it appears in the banker's ledger) usually shows a credit balance representing the amount belonging to the customer in the safe-keeping of the banker. The Cash Book usually shows a bebit balance and the Pass Book shows a credit balance because the transactions are recorded by the two parties, viz., the businessman

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and the banker, considering from their respective points of view. Strictly speaking, both these books should show the same amount as their balance. However, they usually show different amounts as their balances. This difference in the balances arises on account of the fact that the transactions are either first recorded by the businessman in the Cash Book or by the banker and only later, the other party records them. The fact that transactions do not get recorded simultaneously in both the books is the main reason for the recording of different amounts as balances in these books. The interval in the recording of the transactions respectively in the two books can be called 'time-lag'. Let us illustrate this point. A businessman has received a cheque from his customer and has deposited the same with his banker for collection. Before sending it to the banker, he records the transaction in the Cash Book and the Cash Book balance increases immediately. However, it may take three or four days or even more before the banker actually collects the amount and gives credit to his customer in his ledger. Thus there is time-lag in the recording of this transaction by the businessman and the banker respectively. If in between these two dates, the Cash Book and the Pass Book were to be compared, they will be showing two different balances because the Cash Book which has got this transaction recorded shows a higher balance where the Pass Book, which has as yet no record of this transaction, shows lower balance. Note that if the transaction is recorded in both the books at the same time there will not be any difference in the balances shown by these books. Thus, because the transactions do not get recorded simultaneously, the two books are likely to show different amounts as their balances. Whenever these two books show different balances, it is necessary to reconcile these different balances. The businessman compares his Cash Book with the Pass Book periodically, say once in a month, and lists out the various transactions recorded in only one of the two books as on that date which is one of the causes of disagreement. Sometimes he might also notice certain errors or mistakes either committed by him or by the banker which could have caused the difference. After making a list of such causes, that have caused the disagreement, he prepares a statement reconciling the two books showing different balances, and such a statement is called a 'Bank Reconciliation Statement'. The main advantage in preparing such a statement is that the businessman can identify the transactions that have not yet been recorded by the banker and pursue the matter with his bankers. Further, errors in the Cash Book or Pass Book can be located and corrected.

7.3 PROCEDURE FOR THE ASCERTAINMENT OF THE CAUSES OF DISAGREEMENT

Periodically, the businessman compares the entries in his Cash Book with the entries in the Pass Book for the purpose of ascertaining causes of disagreement. It is useful to remember here that the banker is a debtor to the businessman and that the businessman is a creditor to the banker. For the transactions that are recorded on the debit side of the Cash Book, the corresponding entries will be found on the credit side of the Pass Book or in the 'Deposits' column. Similarly, for the transactions appearing on the credit side of the Cash Book, their corresponding entries would appear on the debit side of the Pass Book or in the 'Withdrawals' column. The businessman compares the entries in the Cash Book appearing on the debit side with the items appearing on the credit side of the Pass Book and vice versa. He would tick all those transactions which are appearing in both the books. The fact that the transactions are appearing in both the books is not the cause for disagreement between the two balances. That is to say, if all transactions appearing in one book are also appearing in the other book there cannot be any difference between the two balances.

In the process of ticking the businessman may find that some transactions in the Cash Book are not ticked and some in the Pass Book. This means that the books do not have corresponding entries for these transactions and hence this constitutes the cause for disagreement between the two balances. The businessman would now prepare a list of all such transactions and proceed to prepare the Bank Reconciliation Statement.

The transactions that appear in only one of the two books for the sake of convenience, can be broadly classified as follows :

A) Transactions that appear in the Cash Book with no corresponding entries in the Pass Book ; and
B) Transactions which appear in the Pass Book with no corresponding entries in the Cash Book.

We shall now discuss the nature of such transactions and the reasons why they constitute the causes for disagreement.

A) ***Transactions that appear in the Cash Book but have no corresponding entries in the Pass Book.*** This happens when the businessman as the initiator of the transactions records them first in the Cash Book which immediately affects the balance in the Cash Book. The corresponding entries for these transactions, as explained earlier, will appear in the Pass Book, only when the banker comes into the picture. On any given date there are likely to be certain transactions which appear in the Cash Book but which do not appear in the Pass Book. Such transactions can be explained as follows :

1. Cheques deposited by the businessman in his bank account for collection but are not yet cleared. (i.e., proceeds are not yet collected and credited) :
Customers of the businessman make their payments usually by cheques. The businessman will record the receipt of such cheques by debiting the bank account and crediting the customer's account and then deposit these cheques in the bank for collection. As the bank account is debited even before the cheques are sent to the bank, the bank balance as per Cash Book would immediately increase. The banker on receipt of cheques will not immediately credit the businessman's account but will wait till the cheques deposited are actually collected. In other words, there will be no immediate entry in the Pass Book and the balance as per the Pass Book remains unchanged. Thus cheques deposited but not yet collected and credited, consitute a major cause for the disagreement, as they would be showing a balance as per Cash Book at a higher level with the balance as per the Pass Book remaining unchanged at the previous level.

2. Cheques entered in the Cash Book but not yet sent to the bank for collection :
Cheques received, as stated above, are first entered in the cash book. But sometimes by overisght or misplacement they may not have been sent to the bank for collection. As the cheques have not actually been sent to the bank, the question of collecting them does not arise. However, as the Cash Book has got a debit in respect of such cheques, they would immediately increase the Cash Book balance while the Pass Book balance would remain unchanged.

3. Cheques issued by the businessman but not yet presented for payment to the bank by the parties concerned :
Whenever a businessman issues any cheque the bank account would immediately get credited and thus the Cash Book balance decreases. However, the banker will record such transactions only when the cheques are actually presented for payment. Thus cheques issued by the businessman would immediately lower the Cash Book balance, but the Pass Book balance will be at a higher level (i.e., the previous level).

4. Cheques prepared and entered in the Cash Book but not actually sent to the parties concerned:
As the issue of cheques is recorded in the Cash Book, the Cash Book balance gets reduced immediately while the Pass Book balance will appear at a higher level.

5. Errors in the Cash Book :
Examples of errors in the Cash Book are - (1) the recording of a transaction more than once, (2) the recording of it on the wrong side of the Cash Book, (3) the recording of it in another bank account other than the one to which it pertains, (4) wrong balancing (5) wrong carrying forward, etc.
As these errors affect only the Cash Book, the Cash Book balance only gets affected, not the Pass Book balance.

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6. Dishonour of cheques deposited by the businessman :
It has already been stated that the banker credits the account of the businessman with the proceeds of the cheques depostied only after they are actually collected by him. Sometimes, the cheques get dishonoured for some reason or other and the banker returns such cheques to his customer intimating of it. Thus, dishonoured cheques do not get recorded in the Pass Book and will not affect the Pass Book balance. On receiving the intimation of dishonour the businessman is expected to pass a reverse entry cancelling the receipts of such cheques. However, on the date of comparison if the cancellation entry has not yet been passed the Cash Book balance would then continue to appear at a higher level, even though there is no prospect of the dishonoured cheque being collected.

B) ***Transactions which appear in the Pass Book with no corresponding entries in the Cash Book:***
Certain transactions like the bank charges, interest allowed, if any, are first recorded by the banker and the businessman comes to know of such entries only when he compares the Pass Book or receives an intimation to that effect from the banker. Sometimes, the businessman gives standing instructions for the meeting of certain regular payments on his behalf for the collection of certain amounts due to him. The banker follows the instructions and records the transactions first in the Pass Book and only later the businessman comes to know of them. Thus, certain types of transactions are entered in the Pass Book first and their corresponding entries may not appear in the Cash Book as on the date of comparison. Such transactions can be explained as follows :

1. **Interest allowed, if any, by the Bank :**
If any interest is allowed by the banker he will credit the businessman's account and the Pass book balance would immediately increase. The businessman will record this amount in his Cash Book only subsequently, and hence the Cash Book balance will be at a lower level.

2. **Amounts collected by the Bank :**
The businessman instructs his banker to collect certain amounts like interest, dividends, etc., on his behalf. The banker collects such amounts as per the standing instructions and credits the businessman's account. Such credits immediately increases the Pass Book balance, but pending the record of such transactions in the Cash Book, the Cash Book balance remains unaltered.

3. **Direct payments made by customers into the bank account of the businessman :**
The customers of the businessman sometimes make direct payments into his bank account in respect of amounts due by them. Such direct payments immediately increase the Pass Book balance, but as the businessman is not aware of such direct payments, the Cash Book balance remains unaffected.

4. **Bank Charges :**
The banker debits businessman's account with bank charges for certain services rendered by him. Such debits reduce the Pass Book balance, but pending their recording in the Cash Book, the Cash Book balance remains unchanged.

5. **Interest on Overdraft :**
Sometimes a businessman needs more money than he has got in his bank account. With the prior approval of the banker he is allowed to withdraw more than the balance appearing to his credit and such facility is called an 'Overdraft'. This means that the businessman has utilised the banker's funds as a loan. That is why the banker charges interest on the overdraft allowed by him, and the recording of the interest on overdraft immediately affects the Pass Book balance, which is what causes disagreement.

6. **Direct payments by the Bank :**
The businessman may give standing instructions to his banker asking him to make certain payments on his behalf (examples : rent, insurance premium, subscriptions, etc.). When the

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banker acts on the businessman's standing instructions and makes direct payments, he debits the businessman's account, which immediately reduces the Pass Book balance. But only on receipt of the information the businessman records payments made by the banker and pending the record of such transactions, the Cash Book balance remains unaffected.

7. **Cheques issued for which no record appears in the Cash Book :**
A businessman might have issued some cheques in a hurry and might by oversight have forgotten to enter them in the Cash Book. As there is no record in the Cash Book, the Cash Book balance remains unaffected, and if such cheques were presented for payment to the bank the pass book balance would be at a lower level.

8. **Errors in the Pass Book :**
The banker, by mistake, may omit to record certain transactions in the businessman's account or might have recorded transactions pertaining to other customers in this businessman's account. It may also happen that a businessman maintains two or more accounts in the same bank, designating them as account number : 1, account number : 2. etc. In such a situation it is possible that the banker, by mistake, records transactions pertaining to one account in another account. Such errors committed by the banker will alter the Pass Book balance immediately but do not have any effect on Cash Book balance.

If a transaction is recorded in both cash book and pass book before a particular date, it will not be a cause for disagreement. Similarly, if a transaction recorded after that particular date in both the books, it will not be a cause for disagreement. It is only when one of the two books only contains the entry before a particular date, it will be a cause for disagreement.

Presented below are the Cash Book (Bank columns only) and the Pass Book of a businessman to illustrate the procedure for ascertaining causes of disagreement.

Illustration - 1

Dr. CASH BOOK (BANK COLUMNS ONLY) Cr.

Date	Particulars	Amount	Date	Particulars	Amount
1989		Rs.	1989		Rs.
Jan. 1	To Cash A/c	10,000 √	Jan. 2	By Rent (Cheque issued to Ravi)	350 √
" 3	To Naresh A/c	600 √	" 7	By Mohan A/c	900 √
" 5	To Suresh A/c	700 √	" 13	By Cash A/c	600 √
" 11	To Cash A/c	1,000 √	" 17	By Drawings A/c	900 √
" 25	To Ravi & Bros.A/c	750 √	" 25	By Sohan A/c	850 √
" 29	To Ram & Bros.A/c	500	" 29	By Ramesh A/c	780
" 30	To Cash A/c	2,000 √	" 31	By Balance c/d	12,670
"31	To Sunil	1,500			
		17,050			17,050
Feb. 1	To Balance b/d	12,670			

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PASS BOOK

Date	Particulars	Dr. With-drawals	Cr. Deposits	Dr. or Cr.	Balance
1989		Rs.	Rs.		Rs.
Jan. 1	By Cash	.....	10,000 √	Cr.	10,000
" 3	To Ravi	35√	.....	Cr.	9,650
" 5	By Naresh	.....	600√	Cr.	10,250
" 8	To Mohan	900√	.....	Cr.	9,350
" 8	By Suresh	.....	700√	Cr.	10,050
" 11	By Cash	.....	1,000√	Cr.	11,050
" 13	To Cash	600√	.....	Cr.	10,450
" 17	To Self-cash	900√	.....	Cr.	9,550
" 27	To Sohan	850√	.....	Cr.	8,700
" 27	By Ravi & Bros.	.....	750√	Cr.	9,450
" 30	By Cash	.....	2,000√	Cr.	11,450
" 30	To Insurance Premium as per Standing Instructions	250	.....	Cr.	11,200
" 31	To Bank Charges	15	.....	Cr.	11,185
" 31	By Interest on Government Securities	.....	550	Cr.	11,735

Comparing the transactions that are appearing on the debit side of the cash book with the items appearing on the credit side of the Pass Book (deposits column) and ticking them, we find the following:

1. The cheques from (a) Ram & Bros for Rs.500/- and (b) Sunil for Rs.1,500 which were deposited into the Bank on the 29th and the 31st January respectively have not yet been collected and so are not ticked as they do not appear in the deposits column of the Pass Book. Thus they cause disagreement. But all other items appearing on the debit side of the Cash Book which appear in the deposits column, with a tick will not constitute the cause for disagreement.

2. In the deposits column of the Pass Book you find one item of Rs.550, which is the interest on government securities (dated 31st January), appearing without a tick. This means that the debit side of the Cash Book does not have a corresponding entry for this item. Then this item also constitutes a cause for disagreement.

Comparing the credit side of the Cash Book with the debit side of Pass Book (withdrawals column) we found the following items unticked:

1. A cheque issued to Ramesh for Rs.780 dated 29 January, does not appear in the Pass Book, meaning thereby that it has not been presented for payment before31st January.
Note that all other items on the Cash Book credit side (except of course the balance c/d) have ticks and hence do not constitute the cause of disagreement.

2. A scrutiny of the 'Withdrawls' column of the Pass Book reveals that the following two items do not have ticks: (a) Insurance Premium for Rs.250, dated 30th January and (b) Bank charges Rs.15, dated the 31st of January. Thus these two items are cause for disagreement because they appear only in the Pass Book and not in the Cash Book.

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Thus comparing the Cash Book and the Pass Book, we have identified the items which give rise to disagreement. This fact is revealed when we compare the balance as per the Cash Book i.e., Rs. 12,670 with the balance as per the Pass Book i.e., Rs.11,735.

Having identified the causes for disagreement, the next step is to prepare the Reconciliation Statement incorporating the effect of the identified causes of disagreement.

The Bank Reconciliation Statement can be prepared in either of the two ways mentioned below :

(i) Starting with the Cash Book balance to find out the Pass Book balance.
(ii) Starting with the Pass Book balance to find out the Cash Book balance.

It is important to note that whether we start with Cash Book or the Pass Book, it is the closing balance, not the opening balance that is taken as the starting point in preparing the Reconciliation Statement. The following Explanation will help you to understand the effect of the causes of disagreement in this regard.

We see that the businessman opened a bank account with Rs.10,000 on January 1, 1989. On this day both his Cash Book and Pass Book would show the same balance, viz., Rs.10,000. We find that on the 2nd of January, the businessman issued a cheque for Rs.350 to Ravi towards the payment of rent to Ravi. The issue of this cheque would result in reducing the Cash Book balance to Rs.9,650 immediately. But as the cheque was not presented for payment on the same day, the Pass Book balance on January 2,1989 would be at the previous level of Rs.10,000. Now with the Cash Book closing balance of Rs.9,650 as the starting point, let us consider the effect of the cause of disagreement. The issue of a cheque which has not been presented for payment brings the Cash Book balance to be lower level than that of the Pass Book balance. Now in order to find out the Pass Book balance, the amount of the cheque, i.e., Rs.350, has to be added to the Cash Book balance.

	Rs.
The Banbk balance as per Cash Book	9,650
Add: The amount of the cheque issued but not yet presented for payment :	350
The Bank Balance as per the Pass Book :	10,000

Now let us consider the Pass Book balance as the starting point and study the effect of this cause of disagreement. The issue of a cheque which has not yet been presented for payment has no effect on the Pass Book balance, but the Cash Book balance appears at a reduced level. Thus the effect of this cause of disagreement on the starting point is exactly the reverse, i.e., the amount of the cheque must be deducted from the starting point to arrive at the Cash Book balance.

The Bank Balance as per the Pass Book	10,000
Less: Cheque issued but not presented for payment.	350
The Bank Balance as per the Cash Book :	9,650

Thus, whether the amount involved in the cause of disagreement has to be added or deducted from the starting point will depend upon the starting point. We have seen above that when the Cash Book balance was the starting point we have added Rs.350, but have deducted it when the Pass Book was considered as the starting point. Similarly, we shall study the effect of the causes of disagreement on the chosen starting point, and decide whether they are required to be added (mark them with a 'plus' sign) or deducted (mark them with a 'minus' sign). Having marked the differet causes of disagreement as stated above, the items to be added and deducted, should be grouped together separately and presented in the form of a

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statement. Let us now consider the effect of the causes of disagreement identified in the illustration discussed above in order to decide whether they are required to be added or deducted from the starting point (we shall take the Cash Book balance as the starting point).

1. Cheques received from (a) Ram & Bros. for Rs.500 and (b) Sunil for Rs.1,500, amounting to Rs.2,000 have not yet been collected :
   As the Cash Book has a record of the transactions, the closing balance of the Cash Book must be taken as having been already affected and the Cash Balance having gone up. As the Pass Book which has no record of these transactions shows a balance lower than that of the Cash Book the difference between the two, namely Rs.2,000, should be deducted from the Cash Book balance to arrive at the Pass Book balance. Mark this item with a 'minus' sign.
2. Interest on Government Securities Rs.550 credited in the Pass Book :
   As this item figures only in the Pass Book its balance will be higher than that of the Cash Book. As the Cash Book is the starting point, this amount of Rs.550 should be added to its balance to arrive at the Pass Book balance. Mark this item with a 'plus' sign.
3. Cheque for Rs. 780 issued to Ramesh but not yet presented for payment to the Bank:
   This transaction appears in the Cash Book only and the moment this transaction is recorded, the Cash Book balance decreases. As this cheque has not yet been actually presented for payment, the Pass Book balance would be higher than that of the Cash Book. As the Cash Book balance is lower than that of the Pass Book the amount of Rs.780 which is the difference between the two has to be added to the starting Cash Book balance to arrive at the Pass Book balance. Mark this item with a 'plus' sign.
4. Insurance premium Rs.250 debited in the Pass Book only :
   This payment is made by the banker and consequently the Pass Book balance gets reduced. As the Cash Book has no record of this item, the Cash Book balance will be at a higher level. Hence the amount of Rs.250 must be deducted from the Cash Book balance to arrive at the Pass Book balance. Mark this item with a 'minus' sign.
5. Bank Charges Rs. 15 debited in the Pass Book only:

This debit item in the Pass Book is similar to the one explained above; the Pass Book balance will be lower and the Cash Book balance will be higher. Hence the amount of Rs. 15 must also be deducted from the Cash Book balance to arrive at the Pass Book balance. Mark this item also a 'minus' sign.

Let us now group these items together. Items which have been marked with a 'plus' sign, viz., item 2 and 3, should be considered one group and the items marked with a 'minus' sign, viz., item 1,4 and 5 should be considered another group.

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7.4 PREPARATION OF BANK RECONCILIATION STATEMENT

Let us now consider how these items are actually presented in the form of a bank Reconciliation Statement.

Bank Reconciliation Statement as on 31st January, 1989

		Rs.	Rs.
	Bank balance as per the Cash Book		12,670
Add:	Interest on Government Securities credited only in the Pass Book	550	
	Cheque issued but not yet presented for payment to the Bank	780	1,330
			14,000

Less: Cheques deposited but not collected and credited in the Pass Book			
Ram & Bros.		500	
Sunil		1,500	
Insurance premium debited only in the Pass Book		250	
Bank charges debited in the Pass Book		15	
			2,265
Balance as per the Pass Book			11,735

The bank Reconciliation Statement can also be prepared with the Pass Book balance as the sarting point. If the Pass Book balance is the starting point the effect of the causes of disagreement will exactly be the reverse of what is seen above, and consequently all those items that are added now deducted and vice versa. This becomes clearer if you look at the following presentation of the Bank Reconciliation Statement with the Pass Book balance as the starting point:

Bank Reconciliation Statement as on 31st January, 1989

		Rs.	Rs.
	Balance as per the Pass Book		11,735
Add:	Cheques deposited but not collected and credited in the Pass Book		
	Ram & Bros.	500	
	Sunil	1,500	
	Insurance premium paid by the Bank as per Standing Instructions	250	
	Bank charges debited in the Pass Book	15	
			2,265
			14,000
Less:	Cheques issued but not yet presented for payment	780	
	Interest on Government Securities credited only in the Pass Book	550	
			1,330
	Bank Balance as per the Cash Book		12,670

Note that the heading indicates that this is only a statement meant for reconciliation and hence the additions and deductions shown in the statement are not actually recorded either in the Cash Book or in the Pass Book. It only contains certain transactions, the corresponding entries in respect of such transactions are passed in the Cash Book in order to bring it up-to-date and indicate the actual position. Examples of such transactions are Bank charges, interest charged or collected by the bankers, payments made as per 'Standing Instructions' direct payments made into the bank, etc. Thus the Cash Book balance will be adjusted by incorporating certain transactions appearing in the Pass Book. We shall later discuss this with the help of an illustration.

In actual practice, a businessman has the facility of having both Cash and Pass Books presented before him whenever he thinks of reconciling the two balances. A student of Accountancy on the other hand will not be given the two books but only a list of points causing disagreement along with the closing balance of any one book (i.e., either the Cash Book balance or the Pass Book balance only is given). Considering

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the given balance (known balance) as the starting point the student has to prepare the Reconciliation Statement and find out the balance as per the other book (unknown balance) which constitutes the answer to the question given.

In the illustration discussed above, the theoretical way of studying the effect of each cause of disagreement on the known balance and of deciding whether that item has to be added or deducted from the known balance to arrive at the unkown balance is outlined. Now, a practical method involving the following steps is suggested for this purpose:

Step No : 1 Study the problem to find out what the known balance is and what the unknown balance is. Then, open the two books, i.e., the Cash Book and the Pass Book (in "T" shape). Always remember to open the known book first and the unknown book next. Now put down some imaginary figure say Rs. 10,000 (put the same imaginary figure in both the books) in both the books on appropriate sides. Remember to have the imaginary figure at a higher level than that of the figure involved in the cause of disagreement.

Step No : 2 Read each cause of disagreement given in the problem carefully to find out the book where such an item is usually recorded first. May be it would be an item that will be recorded first either in the known book or in the unknown book. Record it now in the "T" shape account opened by you as per step number 1.

Step No : 3 Now balance the book where the item has been recorded. i.e., note whether the imaginary balance with which you have started has increased or decreased as a result of the recording of the cause of disagreement.

Step No : 4 Now compare the balances of the two books and see whether the known balance is higher or lower than the unknown balance and decide what you have to do to the known balance to arrive at the unknown balance. This would become all the clearer from the following explanation:

a) If the known balance is higher than the unknown balance, the amount of the cause of disagreement has to be deducted from the known balance to arrive at the unknown balance. Now mark this item with a 'minus' sign.
b) If the known balance is lower than the unknown balance, the amount of the cause of disagreement is to be added to the known balance to arrive at the unknown balance. Mark this item with a 'plus' sign.

Step No : 5 Study the effect of all the listed causes of disagreement and mark them either with a 'plus' sign or with a 'minus' sign and then group them according to the marked signs. Thus you would have a group of items to be added and another group of items to be deducted from the known balance to arrive at the unknown balance.

Step No : 6 Now you can present the information in the form of a Bank Reconciliation Statement. It is important to note that in the steps outlined above you are asked to record each item of discrepancy in order to note its effect on the known balance, whereas in the problem given, the given balance is the balance which has been arrived at after recording the item of discrepancy. The procedure outlined above serves merely the limited purpose of helping a student to determine whether a cause of discrepancy is to be added to or deducted from the known balance.

We shall now discuss the same illustration by adopting the practical method mentioned above.

The businessman's Cash Book shows a bank Balance of Rs. 12,670 as on 31st January, 1989. Prepare a bank Reconciliation Statement from the following particulars, and find out the Pass Book balance.

1. Cheque issued to Ramesh but not yet presented for payment : Rs. 780.
2. Cheques deposited but not yet collected by the bank : Ram & Bros. Rs. 500; Sunil Rs. 1,500.
3. Bank charges debited in the Pass Book only : Rs. 15.
4. Insurance premium paid by the bank as per 'Standing Instructions' : Rs. 250.
5. Interest on Government Securities collected by the Bank on behalf of the business : Rs. 550.

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Item No : 1

Step No : 1. We find that the Cash Book balance is known but the Pass Book balance is unknown. So we open the known book, viz., the Cash Book first and then only the Pass Book (unknown) with an imaginary figure of Rs. 1,000 as follows:

Cash Book (known)

	Rs.		Rs.
To Balance b/d	1,000		

Pass Book (unknown)

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

Step No. : 2 and 3 The first cause of disagreement is the cheque issued but not yet presented for payment namely Rs. 780. This is one of those items which are recorded first in the Cash Book, and when we post these items in the "T" shape books shown above, they would appear as follows:

Cash Book

	Rs.		Rs.
To Balance b/d	1,000	By Ramesh cheque issued	780
		By balance c/d	220
	1,000		1,000
To Balance b/d	220		

Pass Book

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

After posting the item, the Cash Book is balanced and we find that the balance has come down from Rs. 1,000 to Rs. 220. However, the Pass Book balance is unaffected as this item does not appear in the Pass Book.

Step No.: 4 Comparing the two balances we find that the known Cash Book balance i.e., Rs. 220, is lower and the unknown Pass Book balance is higher by Rs. 1,000. Thus, it is obvious that we have to add Rs. 780 to the known balance of Rs. 220 to arrive at the unknown balance of Rs. 1,000. This item has to be marked with a 'plus sign.

Item No : 2

Cheques deposited but not yet collected by the bank: Ram & Bros. Rs. 500: Sunil Rs. 1,500.

' Cheques deposited' also is one of those items which are recorded first in the Cash Book. The debiting of the Cash Book with these two cheques deposited will increase the known Cash Book balance by Rs. 2,000. As these cheques have not yet been collected, the Pass Book has no record of these items and consequently the unknown Pass Book balance is lower by Rs. 2,000 than that of the Cash Book. Hence the amount of Rs. 2,000 has to be deducted from the known Cash Book balance to arrive at the unknown Pass Book balance. Mark this item with a 'minus' sign. This is evident from the 'T' shape accounts shown below:

Cash Book

	Rs.		Rs.
To Balance b/d	5000	By Balance c/d	7000
To Ram&Bros	500		
To Sunil	1500		
	7000		7000

Pass Book

	Rs.		Rs.
		By Balance b/d	5000

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Note that the different steps involved are combined and presented above. The same combined presentation is adopted for subsequent items.

Item No : 3
Bank charges debited in the Pass Book : Rs. 15 only.

'Bank Charges' is one of those items which are recorded first in the Pass Book and later in the Cash Book. The recording of the bank charges reduces the unknown Pass Book balance and hence the amount of Rs. 15 has to be deducted from the known Cash Book balance. Mark this item with a 'minus' sign. The position is clarified by the presentation given below:

Cash Book

	Rs.		Rs.
To Balance b/d	100		

Pass Book

	Rs.		Rs.
To Bank charges	15	By Balance b/d	100
To Balance c/d	85		
	100		100

Item No. 4
Insurance premium paid by the Bank, as per the 'Standing Instructions' : Rs. 250.

Any payment made by the banker, on behalf of his customer, reduces the Pass Book balance, while the Cash Book balance, which has no record of this item will be at a higher level. Hence the amount of Rs. 250 has to be subtracted from the known Cash Book balance to arrive at the Pass Book balance. This item also has to be marked with a 'minus' sign. The position is made clear in the following presentation:

Cash Book

	Rs.		Rs.
To Balance b/d	500		

Pass Book

	Rs.		Rs.
To Cash insurance premium	250	By balance b/d	500
To Balance c/d	250		
	500		500

Item No : 5
Interest on Government securities collected by bank on behalf of businessman: Rs. 550.

This item is also an item that is usually first recorded in the Pass Book. Any amount collected by the banker, on behalf of his customer, immediately increases the Pass Book balance but as the Cash Book has no record, its balance will be at a lower level. Thus in this case as the unknown Pass Book balance is higher than the known Cash Book balance the difference i.e., the amount of Rs. 550 has to be added to the known Cash Book balance. Mark this item with a 'plus' sign. The position is made clear by the following:

Cash Book

	Rs.		Rs.
To Balance c/d	2000		

Pass Book

	Rs.		Rs.
To Balance c/d	2550	By Balance b/d	2000
		By Cash (interst on Govt., Securities)	550
	2550		2550

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Having completed the marking of the items, you have to group them together and present them in the form of a Bank Reconciliation Statement. As this problem has already been worked out, it is not given once again here.

Note: The practical method illustrated above for determining whether the given cause of discrepancy has to be added or deducted from the known balance is meant for making you understand the process involved in it. You are advised to use this method while working out the first few exercises so that you may become confident of doing the analysis mentally. The subsequent illustrations are presented without showing the steps illustrated above. You are advised to apply them to be able to use these methods of analysis confidently.

Illustration - 2

On 31st March 1989 the Cash Book of Mr. Ganesh showed a bank balance of Rs. 8,500. A comparison of Pass Book and Cash Book revealed the following:

1. Cheque deposited but not yet cleared by 31st March 1989 : Rs. 1,000.
2. Interest on Investments collected by the bank on behalf of Mr. Ganesh but not yet recorded in the Cash Book: Rs. 400.
3. Cheques for Rs. 5,100 were issued during the month of March but of these cheques for Rs. 1,200 were presented in the month of April, 1989.
4. The bank has made a direct payment of a promissory note for Rs. 600 as per Mr. Ganesh's Standing Instructions. This has not been entered in the Cash Book.
5. A customer deposited Rs. 150 directly into the Bank: this was entered only in the Pass Book.
6. Bank charges debited in the Pass Book but not yet recorded in the Cash Book: Rs. 50.
7. A debit of Rs. 400, in respect of a dishonoured cheque, appears in the Pass Book but not in the Cash Book.

From the above particulars prepare a Bank Reconciliation Statement as on 31-3-1989.

Solution

Bank Reconciliation Statement as on 31st March, 1989

		Rs.	Rs.
	Bank Balance as per the Cash Book		8,500
Add:	Interest on Investments collected and credited by the bank but not yet entered in the Cash Book	400	
	Cheques issued but not presented for payment	1,200	
	Direct payment made by a customer into the Bank Account	150	
			1,750
			10,250
Less:	Cheques deposited but not yet collected and credited	1,000	
	A Promissory Note paid by the banker as per 'Standing Instructions'	600	
	Bank charges debited in the Pass Book only	50	
	Cheques dishonoured and debited in the Pass Book only*	400	
			2,050
			8,200
	Balance as per the Pass Book		

*Usually, cheques deposited are credited by the bankers only after they are collected. However, if the businessman is in a hurry for getting the funds, he may get it discounted and receive the amount even before it is collected. Thus, both the Cash Book and the Pass Book will have a record of such a discounted cheque. If for some reason the discounted cheques get dishonoured, then the banker immediately will give a debit in the Pass Book pending adjustement in the Cash Book. This constitutes a cause of disagreement.

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B. Essay Answer Questions

4. What are the causes of disagreement between the cash book and the pass book balances ? How do you reconcile them ?

5. How is a bank reconciliation statement prepared ?

6. Outline the procedure adopted for finding out the points of disagreement by comparing the cash book with the pass book ?

7. Explain the procedure for preparing the bank reconciliation statement using items and figures of your own.

PROBLEMS

1. On the basis of the following information prepare a Bank Reconciliation Statement of Mr.Suresh as on 31-3-1989 :

   (a) Bank balance as per the Cash Book on 31-3-1989 : Rs.4,000
   (b) Cheques issued but not presented for payment : Rs.1,200
   (c) Cheques deposited but not yet collected by the Bank : Rs.500
   (d) As per Mr. Suresh's Standing Orders, the bank paid an Insurance Premium amounting to Rs.120 and calls on shares amounting to Rs.180, which were not entered in the Cash Book.
   (e) There is a credit in the Pass Book for Rs.500, being cash directly paid by Mr. Mahesh, a customer.
   (f) Dividend of Rs.200 was collected on behalf of Mr. Suresh by the Bank but there was no entry in the Cash Book.
   (g) Bank charges debited in the Pass Book only : Rs.50

   (Balance as per the Pass Book : Rs. 5,050)

2. From the following particulars prepare a Bank Reconciliation Statement of Mr. Shiva Kumar as on 31-12-1989. :

Balance as per the Pass Book on 31st December, 1989 is Rs.11,000. Cheques amounting to Rs.4,500 were deposited in the bank during December but credit was given only for Rs.3,500. The bank paid an insurance premium of Rs.150 to the Life Insurance Corporation on the 20th of December, but it was not entered in the Cash Book. A discounted Bill Receivable of Rs.750 was returned dishonoured to the Bank on the 27th of December, but the corresponding entry was made on the Cash Book in January. A Cheque of Rs.400 received on the 29th of December was enterd in the Cash Book but the cheque was sent to the bank on 3rd January. Of the cheques amounting to Rs.1,500 issued the cheques amounting to Rs.900 only were presented for payment. The bank charges debited in the Pass Book amounted to Rs.25. Interest on securities collected and credited by the Bank was Rs.500, but this was not entered in the Cash Book.

(Balance as per the Cash Book : Rs.12,225).

3. On 31st December 1989 the cash book of a firm showed a bank balance of Rs.2,560. From the following information, prepare a Bank Reconciliation Statement, showing the balance as per Pass Book :

   i) Cheques issued for Rs.1,500 had not yet been presented at bank for payment.
   ii) Cheques amounting to Rs.2,250 were depostied on 28th December but had not been credited by the bank.
   iii) A cheque from Arun for Rs.500 paid in on 26th December was dishonoured but the advice was received on 2nd January 1990.
   iv) Pass Book showed bank charges, Rs.30, debited by the bank. It also showed Rs.950 collected by the bank as interest.

(Balance as per Pass Book : Rs.2,730)

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7.8 GLOSSARY

1.	**Bank Reconciliation Statement**	:	A statement prepared to reconcile the different balances as shown by the Cash Book and the Pass Book, containing the cuases of discrepancy and the effect that, they have on the known balance.
2.	**Bank Statement**	:	This statement is sent by a banker to his customer and is nothing but a copy of the businessman's account as it appears in the bankers ledger.
3.	**Favourable Balance**	:	When the businessman has got his money in the bank account, he is said to be having a favourable balance. In such a case, the Cash Book will have a debit balance and the Pass Book will show a credit balance.
4.	**Pass Book**	:	The Pass Book is a copy of the businessman's account, as it appears in the banker's ledger and is given by the banker to the businessman. This can be prepared in an account form or in a statement form.
5.	**Standing Instructions**	:	When the businessman desires that the banker, on his behalf, should make certain payments or collections, he gives standing instrucions to his banker, requesting him to do as instructed, without being required to remind the bank every time. Such instructions are called 'Standing Instructions".

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UNIT -8 : BANK RECONCILIATION STATEMENT -II

Contents

8.0 Aims and Objectives
8.1 Introduction
8.2 Preparation of Bank Reconciliation Statement with overdraft balances.
8.3 Finding the causes of differences when the Cash Book and the Pass Book are given.
8.4 Correcting the Cash Book Balance
8.5 Summing Up
8.6 Model Examination Questions
8.7 Glossary

8.0 AIMS AND OBJECTIVES

The Aim of this unit is to disscuss the preparation of Bank Reconciliation Statement when overdraft balances are given.

Having studied and worked out this unit you would be able to :

- prepare Bank Reconciliation statement when overdraft balances are given.
- find out the causes of differences when the cash book and the pass book are given
- correct the cash book balance.

8.1 INTRODUCTION

In this unit, which is a continuation of the previous unit, we shall discuss the preparation of bank reconciliation statement when overdraft balances are given. Further we shall consider the method of ascertaining the causes of disagreement when the cash book and the pass book for two consecutive periods are given. This unit will help you to correct the cash book balance by incorporating the necessary entries from the pass book.

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8.2 PREPARATION OF BANK RECONCILIATION STATEMENT WITH OVER DRAFT BALANCES

In the preceding Unit, we have worked out problems which involved a favourable balance, i,e., when the businessman has his money in the bank account. Sometimes, when a businessman needs more funds than are available in his account, by a prior arrangement with the banks, he is allowed to overdraw his account. Thus, when he has an overdraft, the Cash Book shows a credit balance and the Pass Book a debit balance, indicating the amount overdrawn. The overdraft balance is also referred to as the 'unfavourable balance'.

There is no difference either in the analysis or in the presentation of overdraft problems. However, you are expected to note the difference in the effect of a given item of discrepancy, when the known balance is an unfavourable balance. For example, Cheques issued reduce the cash balance . But, when the given Cash Book balance is an unfavourable balance, the effect of the cheques issued will be to further increase the overdraft balance. Thus, if in the Cash Book a favourable balance was

a known balance (starting point) we add the figures of cheques issued, but if on the other hand the known Cash Book balance is an unfavourable one, then the amount of cheques issued has to be deducted from the known balance to arrive at the unknown Pass Book balance. Note that the effect of the cause of disagreement will be exactly opposite because of the difference in the nature of the starting point. The following illustrations are with overdraft balances and you have to apply the steps.

Illustration - 1

On 30th June, 1988, the Pass Book of Mr. Surender showed an overdraft balance of Rs. 30,000. Prepare a Bank Reconciliation Statement using the following information.

1. Out of the two cheques issued to Sreenu on 25th June, 1988, one for Rs.1,000 and another for Rs.2,500. The Cheque for Rs. 2,500 was cashed on 5-7-1982.
2. A wrong credit for Rs. 250 relating to some other account was found in the Pass Book.
3. Out of the three cheques deposited in the bank for collection on 22-6-1988 for Rs. 3,000, Rs. 4,000 and Rs. 5,000 respectively, the cheque for Rs. 4,000 alone was collected by 30-6-1988.
4. There is a debit of Rs.800 for interest and Rs.150 for bank charges in the Pass Book which have not been entered in the Cash Book.
5. The Pass Book showed that Bank had collected Rs.6,000 as interest on Government securities but there was no entry in the Cash Book for interest.
6. A Bill receivable for Rs. 5,000 (discounted with the bank in May) was dishonoured on 28th June, 1988 and was debited in the Pass Book.

Solution

Bank Reconciliation Statement as on 30.6.1988

		Rs.	Rs
	Bank Overdraft as per the Pass Book		30,000
Add:	Cheques issued but not presented for payment	2,500	
	A wrong credit given in the Pass Book	250	
	Interest on securities collected by the Bank but not yet entered in the Cash Book.	6,000	
		---	8,750
			38,750
Less:	Cheques paid in but not yet cleared	8,000	
	Interest on overdraft and bank charges debited in the Pass Book	950	
	Dishonoured bill debited in the Pass Book only	5,000	
		---	13,950
	Bank Overdraft as per the Cash Book		24,800

Illustration - 2

On 31st December, 1988, the Cash Book of Mr. Madhu showed a credit balance of Rs. 10,000 with the Bank of India. Before this date cheques worth Rs.13,200 were issued, but of them cheques worth Rs. 2,500 were only presented at the bank for payment. A cheque for Rs. 1,500 received from a customer was entered in the Bank colum of the Cash Book in December, 1988, but it was not paid into the Bank. In December cheques worth Rs.3,500 were deposited in the bank but cheques amounting to Rs.3,000 only, were credited in the Pass Book. The total of a page on the receipts side of the Cash Book Rs. 8,760

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was carried to the next page as Rs.7,860. A Cheque for Rs. 8,000 which was received from a customer was paid into the bank on the 26th of December, but it was not entered in the Cash Book. The Pass Book is debited with Rs.10 for bank charges, Rs.200 for interest on overdraft and Rs.190 for insurance premium paid as per Madhu's instructions and credited with Rs.1,000 for interest on investments collected by the bankers. But none of these items as yet appear in the Cash Book.

Prepare the Bank Reconciliation Statement.

Solution

Bank Reconciliation Statement as on 31.12.1988.

		Rs.	Rs.
	Bank Overdraft as per the Cash Book		10,000
Add :	Cheque debited in the Cash Book but omitted to be paid into the Bank	1,500	
	Cheques deposited but not cleared	500	
	Bank charges debited in the Pass Book only	10	
	Interest on overdraft debited in the Pass Book only	200	
	Insurance premium directly paid by the bank but not yet entered in the Cash Book	190	
			2,400
			12,400
Less:	Cheques issued but not yet presented	10,700	
	Short carry forward of the total on the receipts side of the Cash Book	900	
	Cheques paid into the bank but not recorded in the Cash Book	8,000	
	Interest on investments collected and credited in the Pass Book only	1,000	
			20,600
	Bank Balance as per the Pass Book		8,200

Note that the starting point in this illustration is the Cash Book overdraft but the Pass Book balance is a favourable balance and not an unfavourable balance. This situation has arisen because the total of the amounts to be deducted is higher than the amount available. Thus, the unfavourable balance gets converted into a favourable balance. Similarly, it might happen that you start with a favourable balance and arrive at an unfavourable balance. This is brought out by the following illustration.

Illustration -3

The Bank Pass Book of Shri Krishna showed a credit balance of Rs.6,000 on 31-12-1989, while the bank column of his Cash Book showed a different balance. You are required to prepare the Bank Reconciliation Statement.

1. Of the cheques amounting to Rs.4,357 deposited in the bank upto 31.12.1989 a cheque of Rs.900 received from Suresh was collected by the bank on 3.1.90.

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2. Cheque of Rs.1,250 issued to Homi & Co., was wrongly entered twice in the Cash Book.
3. Cheques issued during the month amounted to Rs. 4,000 of which cheques for Rs. 1,500 were not presented to the bank upto 31.12.1989.
4. The Pass Book showed a credit of Rs.53 as interest for which there was no entry in the Cash Book.
5. The Pass Book also showed a payment of Rs.483 as Life Insurance Premium for which no entry was made in the Cash Book.
6. The bank Pass Book showed a direct deposit of Rs 5,200 from Ram & Co., on 28-12-1989 which was entered in the Cash Book only on 2-1-1990.
7. A cheque for Rs.2,600 issued to a creditor was entered in the bank column of the Cash Book as Rs.6,200. This cheque was presented on 28th, December.
8. In carrying forward the page totals in the Cash Book, the total of the credit side on one page amounting to Rs.2,501 was carried forward as Rs.2,051.
9. The bank column on the receipt side of the Cash Book was found to be undercast by Rs.500.
10. The bank debited Shri Krishan's account with a cheque for Rs.210 received from Ashik which had been returned 'dishonoured'. The fact of 'dishonoured' was not shown in the Cash Book.

Solution

Bank Reconciliation Statement as on 31-12-1989.

		Rs.	Rs.
	Balance as per the Pass Book		6,000
Add	:Cheque deposited but not credited in the Pass Book.	900	
	Amount of Insurance Premium debited by the Bank but not entered in the Cash Book	483	
	Error in respect of 'carrying forward' in the Cash Book	450	
	Dishonoured cheque debited in the Pass Book but no entry made in the Cash Book	210	
			2,043
			8,043
Less	:Cheque issued but recorded erroneously twice in the Cash Book	1,250	
	Cheques issued but not presented for payment.	1,500	
	Interest credited in the Pass Book and not entered in the Cash Book	53	
	Direct deposit in bank by a customer but not recorded in the Cash Book.	5,200	
	Excess amount recorded in the Cash Book	3,600	
	Error in respect of casting in the Cash Book	500	
			12,103
	Overdraft as per the Cash Book		4,060

8.3 FINDING THE CAUSES OF DIFFERENCE WHEN THE CASH BOOK AND THE PASS BOOK ARE GIVEN

We have discussed the method of comparing the given Cash Book with the Pass Book and finding out

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the causes of discrepancy. The method of comparing the two books, when both the books given relate to the same time period, has already been illustrated. However, when the Cash Book given is for a particular month and the Pass Book given for a subsequent period, the method of comparing and arriving at the causes of discrepancy is slightly different. For example, if the Cash Book given is till the month December and the Pass Book for the first few days of January, you will find that certain items appearing the Deposits column of the Pass Book, to be also appearing on the debit side of the Cash Book such items indicate discrepancy. This happens because the two books are for two different periods: if an item is appearing in both the books, it means that as on December 31 this item did not appear in both the books and thus constitutes an item of discrepancy. This method is illustrated in the following case.

Illustration : 4

From the following extracts, from the Cash Book and the Pass Book, prepare a Bank Reconciliation Statement as on 31-12-1989.

Dr. CASH BOOK (BANK COLUMNS ONLY) Cr.

Date	Particulars	L.F.	Amount	Date	Particulars	LF.	Amount
			Rs.				Rs.
1989				1989			
Dec. 1	To Balance		5,000	Dec. 3	By Wages		1,600
Dec. 3	To Ram		900	Dec. 5	By Petty Cash		100
Dec. 5	To Vinod		840	Dec. 6	By Interest on Loan		33
Dec. 9	ToAjay		550	Dec. 9	By Drawings		500
Dec. 13	To Interest on Securities		600	Dec. 10	By Bank charges		11
Dec. 19	To Rajesh		240	Dec. 19	By Mohan		900
Dec. 23	To Suresh		580	Dec. 28	By Prakash		125
Dec. 30	To Vijay		2,575	Dec. 29	By Ganesh		250
Dec. 31	To Mahesh		482	Dec. 30	By Salaries		1,200
					By Balance c/d		7,048
			11,767				11,767
Jan. 1	To Balance b/d		7,048				

Dr. **BANK PASS BOOK** Cr.

Date	Particulars	Amount	Date	Particulars	Amount
1990			1990		
Jan. 1	To Prakash	125	Jan. 1	By balance c/d	4,366
Jan. 2	To Ganesh	250	Jan. 3	By Vijay	2,575
Jan. 3	To Commission	3	Jan. 4	By Cash	600
Jan. 3	To Telephone Co.	600	Jan. 5	By Manohar	250
Jan. 6	To Shyam	1,200	Jan. 6	By Mahesh	482
Jan. 6	To Commission	2			
Jan. 6	To Prasad	125			

Note: The Pass Book is ruled in the usual form of a ledger account to help you to understand it easily.

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Solution

Bank Reconciliation Statement as on 31st December, 1983

		Rs.	Rs.
Balance as per the Cash Book			7,048
Add: Cheques issued but not presented for payment :			
Prakash	125		
Ganesh	250		
		375	375
			7,423
Less: Cheques deposited but not credited in the Pass Book			
Vijay	2,575		
Mahesh	482		
		3,057	3,057
Bank Balance as per the Pass Book			4,366

8.4 CORRECTING THE CASH BOOK BALANCE

We have seen that there are certain items which appear in the Pass Book only, with no corresponding entries in the Cash Book. It sometimes becomes necessary to incorporate the items appearing in the Pass Book, and thus correct the Cash Book balance. This correction is necessary because there are certain relevant items pertaining to the period under consideration, appearing in the Pass Book. Examples of such items are: Bank charges, Interest allowed or charged, direct payments made by the bank or amounts collected on behalf of the businessman. The real balance in the Cash Book can be ascertained by recording these transactions in the Cash Book. The correction of the Cash Book balance is illustrated below, based on the details of illustration No: 1.

Dr. CASH BOOK Cr.

To Interest on Securities	6,000	By Balance b/d	24,800
To Balance c/d	24,750	By Interest on Overdraft	800
		By Bank charges	150
		By Party's A/c –Dishonour of discounted Bills Receivable	5,000
	30,750		30,750

Thus the correct (adjusted) Cash Book balance will be 24,750.

Note that you have merely to record in the Cash Book items appearing only in the Pass Book to correct the Cash Book balance. Further note that cheques deposited but not yet collected and cheques issued but not yet presented for payment are not to be adjusted.

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8.5. SUMMING UP

The cash book balance may be a favourable or an unfavourable balance. Similarly, the pass book may show a favourable or an un unfavourable balance. Further, when the starting point i s a favourable balance, it may show an unfavourable balance in the unknown book and vice-versa. However the procedure for ascertaining the causes of descrepancy, the method of determining the effect of causes of descrepancy and the presentation of the actual reconciliation statement are the same as discussed in the previous unit.

Usually the two books are compared and a list of causes of discrepancy are given in the problem. However, the student may also be presented with both the cash book and the pass book and asked to identify for himself the causes of disagreement and then prepare the reconciliation statement. Again the two books given may be for the same period or for two consecutive periods. In such a case, the student has first to prepare a list of causes of discrepancy and then prepare the reconciliation statement with either of the two books as the starting point.

After reconciling the two books it is necessary sometime to correct the cash book balance by incorporating in the cash book such of those entries which are appearing in the pass book and relevant to the period concerned.

8.6 MODEL EXAMINATION QUESTIONS

A. Short Answer Questions

1. What is meant by overdraft balance ?
2. How do you correct the cash book balance ?

B. Essay Answer Questions

3. How do you prepare the Bank Reconciliation Statement with overdraft balances?

PROBLEMS

1.On 30th June, 1988, the Pass Book of Ravinder showed a debit balance of Rs.35,000. Prepare a Bank Reconciliation Statement based on the following information:

(a) Cheques for Rs.500, Rs.600 and Rs.700 were issued prior to the above metioned date but the cheque for Rs.500 above was presented before the date.
(b) A direct deposit by a customer of Rs.2,000 does not appear in the Cash Book.
(c) A cheque for Rs.5,000 which was received from a customer was paid into the bank on 15th June, but was not entered in the Cash Book.
(d) Cheques amounting to Rs.9,000 were deposited for collection in June, and cheques for Rs.3,000 only were collected in July, 1988.
(e) Insurance premium paid by the bank as per instructions : Rs.500.
(f) Bank charges of Rs.50 debited in the Pass Book only.

(Answer : Overdraft as per the Cash Book: Rs.39,750)

2. On 31-12-1988 your Pass Book showed a credit balance of Rs.5,000. Before that date you had issued cheques worth Rs.1,000 of which cheques worth Rs.300 were not yet cashed. On the 26th of December you deposited a cheque for Rs.150 in the bank but you did not enter it in the Cash Book. The Pass Book showed a credit of Rs.40 for interest and a debit of Rs.10 for bank charges and the Cash Book had no corresponding entries for them. A cheque for Rs.1,200 deposited in your account No.2 was wrongly credited by the bank to this account. Dishonoured bill was debited in the Pass Book only Rs.500. Cheques for Rs.700 paid into the bank were not yet credited in the Pass Book.

(Answer : Balance as per the Cash Book : Rs.4,520)

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3. From the following particulars prepare a Bank Reconciliation Statement as on 31-12-1989:

	Rs.
Overdraft as per the Cash Book	1,000
Cheques issued but not presented	2,000
Cheques deposited but not collected	5,000
Dividends collected and credited in the Pass Book only	1,200
Bank charges debited in the Pass Book only	20
The Bank paid Promissory Note for Rs.500 according to instructions. This was not entered in the Cash Book	
Amount directly deposited by a customer into the Bank	500

(Answer Favourable balance as per the Pass Book: Rs.2,820)

4. Prepare a Bank Reconciliation Statement from the following particluars:
On the 31st of December 1988 I had an overdraft of Rs.2,000 as shown by my Cash Book. I had issued cheques amounting to Rs.5,000 of which Rs.3,000 only seemed to have been presented for payment . Cheques amounting to Rs.800 were paid in, by me on the 26th of December, 1988, but of these only Rs.500 were credited in the Pass Book. An entry for Rs.300 in respect of a direct payment made by a customer into the Bank appears in the Pass Book. Rs.700 was collected by the bank in respect of interest on my investments, but I had no knowledge of this item. The Pass Book showed the following debits – Rs.150 for interest on overdraft; Rs.200 in respect of insurance premium ; Rs.50 for charges for various services. I had no knowledge of these items. Dishonoured bill debited in the Pass Book only: Rs.800.

(Answer : Overdraft as per the Pass Book : Rs.500)

5. On 30th June, 1988, the Pass Book of Ashok showed a debit balance of Rs.15,000. Prepare a Bank Reconciliation Statement on the basis of the following information:

a) Uncredited cheques: Rs.5,000
b) The total of a page on the receipts side of the Cash Book adding upto Rs.13,990, was carried to the next page as Rs. 13,909.
c) Bankers have given a wrong debit in respect of a cheque for Rs.500 drawn by Ashok against his account No.2 in the Pass Book.
d) Interest on overdraft debited in the Pass Book only : Rs.200.
e) Unpresented cheques amounted to Rs.3,000.
f) Interest on Investments collected by the bankers not yet entered in the Cash Book : Rs.800.

(Answer :Overdraft as per the cash book: Rs.13,181)

6. From the following extracts from the Cash Book and the Pass Book for the month of January, 1989, prepare the Bank Reconciliation Statement and also correct the Cash Book balance:

Dr. CASH BOOK (BANK COLUMNS ONLY) Cr.

Date	Particulars	Rs.	Date	Particulars	Rs
1989			1989		
Jan. 2	To Cash	6,000	Jan. 2	By Patel & Sons	800
" 5	To David & Co.	500	" 3	By Shastry & Co.	1,000
" 16	To Ravi Shanker	700	" 4	By Desai & Sons	2,000
" 20	To Cash	600	" 16	By Ashok & Co.	1,200
" 22	To Roy & Sons	900	" 22	By Cash	500
" 27	To Johnson & Sons	400	" 24	By Rakesh & Co.	300
" 30	To Gopal &Co	550	" 31	By Banalce b/d	3,850
		9,650			9,650
Feb. 1	To Balance b/d	3,850			

PRAOU

PASS BOOK

Date	Particulars	withdrawals Dr.	Deposits Cr.	Dr.or Cr.	Balance
1989		Rs.	Rs.		Rs.
Jan. 2	By Cash	.....	6,000	Cr.	6,000
" 4	To Patel & Sons	800	.....	Cr.	5,200
" 4	To Shastry & Co.	1,000	.....	Cr.	4,200
" 10	By David & Co.	.....	500	Cr.	4,700
" 15	To Deisai & Sons	2,000	.....	Cr.	2,700
" 19	By Ravinshanka'rs Cheque	.....	700	Cr.	3,400
" 20	By Cash	.....	600	Cr.	4,000
" 22	To Cash	500	.....	Cr.	3,500
" 24	By Raj & Sons	.....	900	Cr.	4,400
" 31	To Premium Paid	200	.....	Cr.	4,200
" 31	To Bank Charges	20	.....	Cr.	4,180

(Answer : Corrected Cash Book balance : Rs.3,630)

7. From the following entries in the bank column of Cash Book of Prakash and Corresponding ban Pass Book, prepare a Bank Reconciliation Statement as on the 31st of January.

Dr. CASH BOOK (BANK COLUMNS ONLY) Cr.

Date	Particulars	Rs.	Date	Particulars	Rs
1989			1989		
Jan. 1	To Blance c/d	4,000	Jan. 3	By Drawings	1,200
" 12	" Mohan	1,500	" 4	" Salary	600
" 12	" Prasad	2,000	" 15	" Ashok	2,500
" 19	" Chandu	1,600	" 28	" Manohar	1,250
" 28	" Suresh	3,000	" 29	" Mahesh	4,000
" 29	" Naresh	2,500	" 30	" Prakash	3,000
" 31	" Ajay	2,725	" 31	" Murthy	2,200
				" balance b/d	2,575
		17,325			17,325
Feb. 1	To balance b/d	2,575			

PASS BOOK

1989			1989		
Feb. 1	To Balance b/d	1,350	Feb. 3	By Dividend	800
" 2	" Mahesh	4,000	" 5	" Suresh	3,000
" 3	" Prakash	3,000	" 6	" Praveen	250
" 6	" Salaries	1,000	" 8	" Naresh	2,500
" 9	" Ajit	400	" 9	" Ajay	2,725

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8.7 GLOSSARY

I.	**Overdraft**	:	Overdraft is the amount appearing as overdrawn in the account, i.e. the businessman owes to the bank this amount as by prior agreement he has drawn more than what he has got in the bank. This is also called 'unfavourable balance'. When there is an overdraft, the cash book shows a credit balance and the Pass Book debit balance.
2.	**Unfavourable Balance**	:	Unfavourable balance means overdraft balance i.e., the businessman has drawn more than what he has got in his bank account.

Writer : Prof. Viswanadham.

BRAOU

UNIT - 9 : COMMERCIAL BILLS

Contents

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9.0 AIMS AND OBJECTIVES

The aims of this unit are to discuss the nature and importance of Bills of Exchange and also the accounting entries in the books of various parties to the Bill in different circumstances.

Having gone through this unit, you would be able to :

- define the Bill of Exchange
- identify the parties to a Bill of Exchange
- distinguish between a Promissory Note and a Bill of Exchange
- solve the problems.

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9.1 INTRODUCTION

Many types of goods are produced and sold to meet the particular needs of the community. The sellers supply the required goods, things or articles to the buyers in exchange for cash. These buyers induced ordinary persons like you and me retailers buying small lots of goods from wholesalers and the wholesalers buying goods in huge lots from the manufacturers. The retailers and wholesalers buy goods for the purpose of reselling them. The buyers may not always be in a position to pay cash and take the goods. They may require some more time for arranging payment. That is how the practice of selling goods on credit has developed in the commercial world. In the case of credit sale, the buyer promisses to pay the price of goods which he has bought at a later date.

A mere promise orally given may give rise to complications later. The buyer may go on postponing the making of payment from one date to another indefinitely. He may even refuse payment on some ground or other. Of course, to avoid all these complications the seller can sell goods only for cash and put up a 'NO CREDIT' sale board. But this may adversely affect his sales and consequently his profits. Particularly, the retail traders usually buy goods from wholesalers on credit and make the payment subsequently. Therefore, credit sales are advantageous to both the parties and many trasactions take place on this basis.

In such circumstances it is better to have a firm commitment in writing on the part of the buyer to make payment on a specified day in the future. This commitment is given through the means of a Bill of Exchange. These bills are called Nagotiable Instruments (Cheque is another example). Let us now discuss the Bills of Exchange.

9.2 DEFINITION

The Indian Negotiable Instruments Act defines a Bill of Exchange as "an instrument in writing containing an unconditional order signed by the maker, directing a certain person to pay a certain sum of money only to, or to the order of certain person or to the bearer of the instrument". Following is the specimen (model) of a Bill of Exchange.

Rs. 4,500-00

STAMP

55, Sixth Avenue
Sector-5
Bhilai Nagar
September 1, 1989

The months after date, pay to us or our order, the sum of Rupees Four Thousand and Five hundred only for value received.

SRINIVAS KIRAN

TO

Sri Padma Rao
3-4-7, Lingampally
HYDERABAD.

This Bill shows that Padma Rao has purchased goods of the value of Rs. 4,500/- from Srinivas Kiran on credit. The Bill is an order by Srinivas Kiran (Creditor, i.e., one who has sold the goods) on Padma Rao (Debtor, i.e., one who has bought the goods) to pay the specified sum of money on a specified date. When Padma Rao gives his acceptance to this order, it be comes a firm commitment on his part to pay Rs. 4,500/- to Srinivas Kiran at the end of three months. Thus the Bill of Exchange established the indebtedness (that Padma Rao owes to Srinivas Kiran) and fixes a firm date on which the amount is to be paid. Thus the whole transaction may be considered in sequence of three stages-sale of goods on credit, making of Bill and the debtor making the payment on the specified date.

Essential Features

Following are the essential features of a Bill of Exchange.

1) It must be in writing
2) It must contain an unconditional order by the seller to the buyer to make the payment. The order must not contain any condition. For example it cannot contain words like"provided the goods are sold at a profit"
3) The maker of the Bill(i.e., the seller) must sign it.
4) The buyer must also sign it signifying his acceptance of the order.
5) The amount must be specified in terms of money only (For example, Rs.3,000/-)
6) The person to whom the payment is to be made must be an identifiable person. It may also be made payable to bearer.
7) The Bill must also mention the place where the payment is to be made.
   Ex: Payable at Bank of India, Srinivasnagar, Secunderabad.

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9.3 PARTIES TO A BILL OF EXCHANGE

a) The Drawer : The creditor who makes the bill and signs it is known as the DRAWER. In the specimen given earlier (See Page 153) Srinivas Kiran is the Drawer.

b) The Drawee : The Debtor who is ordered to pay is called the DRAWEE (in the specimen Padma Rao is the Drawee).

As the Debtor will have to sign across the Bill signifying his acceptance of the order he is also called the acceptor.

c) The Payee : The payee is the person to whom the payment of the Bill must be made on the due date. Usually the payment will be made to the Drawer himself in which case he becomes the payee.

However, the Bill may contain the order that the payment must be made to a certain other person. In such a case, that other person becomes the payee.

Check Your Progress - 1.

i) Who are the parties to a Bill of Exchange?

.....

.....

.....

9.4 IMPORTANT POINTS

1. *Due Date* : Every Bill bears the date on which the Bill is drawn and from which the period of the Bill is counted.
   For example, if a Bill is drawn on the 1st of September, 1989 for three months, the period (i.e., three months) will be counted from the 1st of September onwards. Therefore, the payment will become due on the 1st of December, 1989. However, three more days are allowed for making the payment. They are known as days of Grace. Thus the payment of the Bill actually becomes due on the 4th of December, 1989, which is called" the Due Date" or "Date of Maturity". The Drawee is expected to make the payment of Bill on the 'Due Date'.
2. *Term or Tenor* : The period of the Bill is known as 'Term'or 'Tenor'. In the specimen given above the term of the bill was three months.
3. *Stamp* : Every Bill, other than a Bill payable on demand, must be affixed with stamps. The value of stamps depends upon the amount of the Bill.
4. *For Value Received* : The words, "For Value Received" on the bill (See specimen) indicate the indebtedness of the Drawee of the goods which he has earlier purchased from the Drawer.
5. *'Acceptance'*: 'Acceptance' means signing across the face of the Bill by the Drawee. The Drawee's signature is the proof of his having agreed to the terms and conditions of the Bill. Until the Drawee signs his acceptance the Bill is called a 'draft'and is a mere paper without any value. After acceptance it becomes a Bill of Exchange with a value attached to it.

   The Drawee writes 'Accepted' and signs underneath or merely puts his signature across the face of the Bill. This is 'general Acceptance'. When the Drawee adds any further condition (other than the conditions mentioned in the Bill), it is called'Qualified Acceptance'. Specimens given below make the point clear.

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Accepted
R K Hazare

Accepted
payable three months
after the date of Bill. RK Hazare

Cr.

General Acceptance :

Rs. 6,000/-

Stamp

62, Vivekananda Raod,
Hyderabad.
April, 30, 1989.

Two months after date, pay to me or to my order the sum of Rupees Six thousand only for value received.

K. Gangaram

To
R.K.Hazare
12 th Avenue
Ludhiana

Accepted
R K Hazare

Qualified Acceptance :

Rs. 6,000/-

Stamp

62, Vivekananda Road,
Hyderabad.
April 30, 1989.

Two months after date, pay to me or to my order, the sum of Rupees Six thousand only for value received.

K. Gangaram

To
R.K.Hazare,
12 th Avenue,
Ludhiana

Accepted
Payable three months
after the date of Bill.
RK Hazare

6. *Inland and Foreign Bills* : Depending upon where the Drawer and Drawee (reside i.e., in India or elsewhere), bill can be classified as (a) Inland Bills (payble in India) and (b) Foreign Bills (Payable out side India).

a) Inland Bills: When both the Drawer and the Drawee reside in India the Bill is Known as 'Inland Bill'. Even if the Drawee resides outside India, the Bill is still called an Inland Bill when it is made payable in India
The specimen cited earlier is an example of 'Inland Bill' as the Drawer resides in Hyderabad and the Drawee in Ludhiana, both being in India.

b) Foreign Bill : A bill is called a 'Foreign Bill' when the Drawer or Drawee resides outside India or when the Bill is made payable outside India, though drawn in India.

A foreign Bill is made out in a set of three copies. Each copy is called 'via'. All the three copies are sent to destination but by different mails. The object is that at least one copy reaches safely. When the Drawee accepts any one of the three, the other two become inoperative and he makes payment only on that which he has accepted.

7) *Hundies* : These are similar to Bills of Exchange. They are written in vernacular or regional languages. Unlike a Bill, a 'hundi' may sometimes be conditional.

8. *Promissory Note* : The Promissory note is different from a Bill in that in the case of the former

the debtor prepares the instrument giving an unconditional undertaking to pay a specified sum of money to the creditor or to his order or to the bearer. The Indian Negotiable Instrument Act defines a Promissory Note as follows :

"An instrument in writing (not being a bank note or a currency note) containing an unconditional undertaking signed by the maker to pay a certain sum of money only to or the order of a certain person, or to the bearer of the instrument".

Following is a specimen of a 'Promissory Note':

Stamp	155 Vasavi Nagar, Secunderabad.3 26th December, 1989.
Ninety days after date I promise to pay Sri. P.R. Raju or order the sum of Rupees five thousand only for value received.	
Rs. 5,000/-	R. Ramnath

The Promissory Note is commonly called 'Note'. The debtor who under takes to pay is called the promisor or the Maker (In the specimen given above R. Ramnath is the Promisor). The person in whose favour the note is written in other words the creditor is known as 'Promisee' (P.R. Raju, in the specimen).

Essentials of a Promissory Note

Following are the essential features of a Promissory Note:

1. It should be in writing.
2. It should contain an undertaking by the Promisor to make payment in future.
3. It must be unconditional (promise to pay)
4. It must be signed by the maker, i.e., the debtor.
5. The amount must be specified and it must be payable in money alone.
6. It should be properly stamped and dated.

Distinction Between A Promissory Note And A Bill of Exchange

The Promissory Note and the Bill of Exchange serve the same purpose and are in fact, treated alike in accounts, but they differ in the following respects;

1. The Bill is made by the creditor while the Promissory Note is made by the Debtor.
2. The Bill is an unconditional order to pay whereas the Promissory Note is an unconditional promise to pay.
3. The Bill after it is drawn must be accepted by the Drawee. In the case of a Note the question of acceptance does not arise as the Debtor himself prepares the document under his own signature.
4. The Bill usually has three parties, the Drawer, the Drawee and the Payee. But the Promissory Note has only two parties,i.e, the maker or the Promisor and the Payee.
5. No stamp duty need be paid on a Bill of Exchange payable on demand. But Promissory Note, whether payable on demand or otherwise, requires the payment of stamp duties according to value.
6. Foreign Bills are drawn in sets of three while Promissory Notes are drawn only in one set.
7. In case of the dishonour of foreign bills noting and protesting are compulsory, but not necessary in respect of foreign promissory notes.

9.5 ADVANTAGES

Bills and Promissory Notes are instruments, indicating indebtedness on the part of one and in favour of another. Besides being a simple means of borrowing and repaying, they serve the common people as well as the businessmen in a number of ways.

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1. A Bill of Exchange or Promissory Note is an acknowledgement of debt. It can be enforced in a court of law. It is a conclusive proof of the debt.
2. It greatly facilitates credit transactions in business. Thus the business expands as sales increase without causing anxiety regarding the recovery of debt arising out of credit sales.
3. The debtor knows exactly when he has to discharge his debt. The creditor knows when exactly he can expect payment. The debtor can conveniently arrange payment by the date of maturity. He need not live on fear that he might be asked to pay at any time. The creditor need not make a number of trips to the debtor for collections as he would collect the amount only on the due date.
4. The creditor need not actually wait for receiving the amount of the Bill till the due date. He may discount the Bill with his bank and obtain the money immediately. In such a case the bank directly collects the amount from the debtor on the due date.
5. The creditor (or the drawer) can endorse the Bill or promissory note to any other person in discharge of his own indebtedness to that person. This helps in saving on stamp duty also.
6. They help quick settlement of mutual indebtedness arising out of business transactions and thus increase the size of the business.
7. They also serve as a means of raising financial accommodation for short periods to the business people on account the discounting facilities offered by banks.
8. Foreign trade is greatly facilitated by the Bills of Exchange. The seller may ship his goods to the buyer in a foreign country and conclude the sale transaction in the foreign country without meeting the buyer in person through a Bill of exchange whereby the goods are delivered to the buyer only on his acceptance or payment of the Bill.

9.6 DIFFERENT METHODS OF TREATMENT OF THE BILL

Having discussed the various theoretical aspects of the Bills and Promissory Notes, let us now examine how these transactions are actually recorded in the books of accounts of various parties to the bills. First, certain points concerning need to be clarified.

Although a Bill differs from a Promissory Note or Hundi in its form and content to some extent, all the three are treated alike for the purpose of recording in the books of account. In the case of Bill, creditor is the Drawer and the Debtor is the Drawee. However, in the case of Promissory Note, it is the Debtor who draws/makes the Promissory Note.

Whether it is a Promissory Note or a Bill the debtor is required to make payment on it. The debtor has the liability to pay. It is Bills Payable to him and is a debt or liability. For the creditor, it is a Bills Receivable and is an asset, since cash is receivable by him on the instrument at a future date. Thus the same instrument is a liability (Bills Payable) from the debtor's point of view and an asset (Bills Receivable) from the creditor's point of view. Whenever, a 'Bills Receivable' is received by the creditor it is debited and whenever it is given it is credited. Whenever a 'Bill Payable' is given by the debtor he credits this account and whenever he receives it back he debits this account.

Procedure :

The Drawer prepares the Bill, affixes the necessary stamps, signs it and then sends the same to the Drawee for his acceptance. The Drawee accepts the bill by affixing his signature and returns it to the drawer. The Bill acquires value only after acceptance by the Drawee. The Drawee is expected to make payment only on the due date when the Bill is presented to him for payment. It may be recalled that the due date is obtained by adding the term of the bill and three days to the date of the Bill. In the case of a Promissory Note, acceptance is not necessary as the debtor himself prepares and signs the instrument. The Bill or the Note is returned to the Drawee on the due date immediately on payment. Making payment on the Bill and thus discharging the debt is called 'Honouring the Bill'. if, for any reason, the drawee fails to make the payment on the due date, it is known as 'Dishonouring the Bill'.

The Drawer after receiving the acceptance from the Drawee may deal with the Bill in any of the following four ways.

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i. He may retain the Bill with him till the due date, present the same for payment and collect it ;
ii. He may discount the Bill with his Bank and obtain funds immediately;
iii. He may endorse the Bill in favour of a third party to whom he owes money or
iv. He may send it to his bank for collection.

Accounting Entries :

The accounting entries to be recorded in the books of the drawer or the drawee depend upon the particular way in which the Bill is dealt with by the drawer. Further, the Bill might be honoured or dishonoured on the due date, i.e., the drawee may make payment or may fail to pay.

A. Honour of Bills : First, let us consider the accounting entries by taking one example each for each of the four ways of dealing with the Bill, assuming that the Drawee meets the Bill, i.e., honours the Bill on the due date. Later on, we can discuss the entries for dishonour of Bills.

I. **Where the Bill is retained with the Drawer**

Illustration 1

On the 5th of October, 1989, Rao purchased goods on credit worth Rs. 5,000/- from Rana. On the same day, Rao accepted a Bill drawn upon him by Rana for the same amount for a period of 3 months. On the due date the Bill is duly honoured.

Pass journal entries in the books of both parties and show the important ledger accounts.

Solution

In the Books of Rana (Drawer)

JOURNAL

Date	Particulars	L.F.	Amount Dr.	Amount Cr.
			Rs.	Rs.
1989				
Oct.5	Rao's A/c Dr. To Sales A/c (Being goods sold on credit)		5,000	5,000
"	Bills Receivable A/c Dr. To Rao's A/c (Being 3 months acceptance received from Rao)		5,000	5,000
1990 Jan.8	Cash A/c (or Bank A/c) Dr. To Bills Receivable A/c (Being Rao's acceptance duly realised on the due date)		5,000	5,000

Explanatory Note : From the date of the Bill, the 5th of October, 1989, 3 months period will end on the 5th of January, 1990. Adding 3 days of grace to it we get the 8th of January, 1990 as the due date. Rao

made payment on that day. it may be noted that Rao's account is not credited though he paid cash as it was received against Bill receivable. Rao's Account was credited at the time of receiving his acceptance itself.

Important Ledger Accounts

Dr. RAO'S ACCOUNT Cr.

Date	Particulars	J.F	Amount	Date	Particulars	J.F.	Amount
1990 Oct.5	To Sales A/c		5,000	1989 Oct.5	By Bills Receivable A/c		5,000
			5,000				5,000

Dr. BILLS RECEIVABLE ACCOUNT Cr.

Date	Particulars	J.F	Amount	Date	Particular	J.F	Amount
1989 Oct,5	To Rao's A/c		5,000	1990 Jan,8	By Cash A/c		5,000
			5,000				5,000

In the Books of Rao (Drawee)

JOURNAL

Date	Particulars	L.F.	Amount Dr.	Amount Cr.
			Rs.	Rs.
1989 Oct,5	Purchases A/c Dr.		5,000	
	To Rana's A/c			5,000
	(Being goods purchased on credit)			
	Rana's A/c Dr.		5,000	
	To Bills Payable A/c.			5,000
	(Being the Bill sent after our acceptance)			
1990 Jan,8	*Bills Payable A/c Dr.		5,000	
	To Cash A/c. (or Bank if it is paid by cheque)			5,000
	(Being our acceptance is duly met on due date)			

* Explanatory Note : Bills Payable is debited as the Drawer gives back the Bill of Payment.

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Dr. RANA'S ACCOUNT Cr.

Date	Particulars	J.F	Amount	Date	Particulars	J.F.	Amount
			Rs.				Rs.
1989				1989			
Oct,5	To Bills Payable A/c		5,000	Oct,5	By Purchases A/c		5,000
			5,000				5,000

Dr. BILLS PAYABLE ACCOUNT Cr.

Date	Particulars	J.F.	Amount	date	Particulars	J.F.	Amount
				Rs			Rs
1990				1989			
Jan, 8	To Cash A/c		5,000	Oct,5	By Rao's A/c		5,000
			5,000				5,000

II. Where the Bill is discounted by the Drawer

When the drawer is in immediate need of funds, he does not wait for the collection of the Bill amount till the due date. He discounts the same with his Bank. The Bank deducts some amount towards discount and makes the payment to the drawer immediately. On the due date, The Bank presents the Bill to the Drawee and collects the amount and thus recovers the amount on the advance payment made by it. In this case, there will be no further entry on the due date in the books of the Drawer as the bank is in possession of the Bill on which it receives the amount on the due date.

Illustration - 2

On the 18th of July, 1989, Somu purchased Rs. 4,500/- worth of goods from Meenu and accepted a Bill drawn upon him for 3 months. The same day Meenu discounts the Bill with the bank at 12% discount.

Somu duly honours the Bill on the due date. Give the journal entries in the books of Meenu and Somu. Show also the Ledger Accounts.

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Solution

In the Books of Meenu (Drawer)

Date	Particulars	L.F.	Dr. Amount	Cr. Amount
			Rs.	Rs.
1989 July, 18	Somu's A/c Dr. To Sales A/c (Being goods sold on credit)		4,500	4,500
"	Bills Receivable A/c Dr. To Somu's A/c (Being the Bill received after acceptance from Somu)		4,500	4,500
"	Bank A/c Dr. Discount A/c Dr. To Bills Receivable A/c (Being Somu's acceptance discounted with the Bank @ 12%)		4,365 135	4,500

Explanatory Note : The Discount rate, unless otherwise specified, is always per annum. Thus 4,500 X 12/100 X 3/12 = Rs. 135/- As only Rs. 4,365, is received. The Bank from the Bank A/c. is debited with the amount. Discount being a loss, it is also debited with Rs. 135/- As the Bill is being given to the Banker, Bills Receivable A/c is credited with the amount of the Bill, Viz., Rs. 4,500/-

There will be no entry on the due date in the books of Meenu when the amount is paid by Somu, because it is paid to the Bank directly, Bank, as the Holder of the Bill presents it to Somu and collects the amount.

LEDGER ACCOUNTS

Dr. SOMU'S ACCOUNT Cr.

Date	Particulars	J.F.	Amount	Date	Particulars	J.F	Amount
			Rs.				Rs.
1989 Jul. 18	To Sales A/c		4,500	1989 Jul. 18	By Bills Receivable A/c.		4,365
			4,500				4,500

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Dr. BILLS RECEIVABLE ACCOUNT Cr.

Date	Particulars	J.F.	Amount	Date	Particulars	J.F.	Amount
			Rs.				Rs.
1989				1989			
Jul. 18	To Somu's A/c		4,500	Jul. 18	By Bank A/c		4,365
				"	By Discount A/c		135
			4,500				4,500

Explanatory Notes: It may be noted that these two ledger accounts, viz., Somu's A/c. and Bills Receivable A/c. stand closed. Somu's account does not leave a balance as his debt now appears in the Bills Receivable account. Bills Receivable Account was debited when it was received from Somu and is credited when it is handed over to the Bank on discounting and is thus closed.

It snould be noted that the books do not contain any entry for the amount paid by somu on the due date. The reason is that Somu has paid it directly to the Bank as it is the Bank which presents the Bill on the due date after it is discounted.

In the Books of Somu (Drawee)

JOURNAL

Date	Particulars	L.F.	Dr. Amount	Cr. Amount
			Rs.	Rs.
1989				
Jul. 18	Purchases A/c. Dr.		4,500	
	To Meenu's A/c			4,500
	(Being goods bought on credit)			
	Meenu's A/c Dr.		4,500	
	To Bills Payable A/c			4,500
	(Being the Bill sent to Somu after our acceptance)			
1989	Bills Payable A/c. Dr.		4,500	
(Due Date)	To Cash A/c.			4,500
	(Being our acceptance due this day duly honoured)			

Ledger Accounts

Dr. MEENU'S ACCOUNT Cr.

Date	Particulars	J.F.	Amount	Date	Particulars	J.F	Amount
			Rs.				Rs.
1989				1989			
Jul. 18	To Bills Payable A/c		4,500	Jul. 18	By Bills Purchase A/c.		4,500
			4,500				4,500

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Dr. BILLS PAYABLE ACCOUNT Cr.

Date	Particulars	J.F.	Amount	Date	Particulars	J.F.	Amount
			Rs.				Rs.
1989				1989			
Jul. 18	To Cash A/c		4,500	Jul.18	By Meenu's A/c		4,500
			4,500				4,500

Explanatory Note : It may be noted from the ledger accounts that Meenu's A/c. stands closed. This is so because as Somu's debt now appears in the Bills Payable Account, Bills Payable A/c also stands closed since the Bill is returned to Somu after Payment on the due date.

III. Where the Bill is endorsed by the Drawer to a Third Party

The drawer after receiving the Bill duly accepted by the Drawee may endorse the same Bill in favour of his own creditor to whom he might be owing money on account of some earlier transaction or transactions. Let us assume that 'A' has 'B's acceptance with him i.e., it would be a 'Bills Receivable' to 'A'. Now, A endorses this Bill to C, his creditor. 'A' will be now called the 'endorser' and C, the 'endorsee'. The process of transferring the Bill is called 'endorsement of the Bill'. There will be no entries in the books of B, when the Bill is endorsed. Actually, he may not even be aware of the fact that his acceptance has been endorsed by A to some other person. On the due date, when 'A' or any other person who is the holder of the Bill presents it for payment, B makes the payment. Now we should consider the entries as written in the books of the Endorsee in addition to the usual entries in the books of the Drawer and the Drawee.

Illustration - 3

Kamesh sold goods to Ramesh on the 14th of August, 1989 for Rs. 3,800/- and drew a Bill on the latter for a period of 4 months. Ramesh Accepted the Bill on the same day and sent it back to Kamesh. On the 25th of August, 1989, Kamesh endorsed the Bill to his creditor Raghu.

On the due date Ramesh honoured the Bill. Show how these transactions appear in the Journal of Kamesh, Ramesh and Raghu, respectively:

In the Books of Kamesh (Drawee)

JOURNAL

Date	Particulars	L.F.	Amount Dr.	Amount Cr.
			Rs.	Rs.
1989				
Aug, 14	Ramesh A/c Dr.		3,800	
	To Sales A/c			3,800
	(Being goods sold on credit)			
"	Bills Receivable A/c Dr.		3,800	
	To Ramesh A/c.			3,800
	(Being Bill Received after acceptance)			
"	Raghu's A/c Dr.		3,800	
	ToBill Receivable A/c.			3,800
	(Being Ramesh acceptance endorsed to Raghu)			

BRAOU

Explanatory Note : On endorsement the Bills receivable A/c, is credited and Raghu's A/c is debited, since he is the Receiver of the Bill.

On the due date, Ramesh the Drawee, pays the amount of the Bill directly to Raghu when the latter presents it to him as the holder of the Bill for payment, and as such there will be no entry for the same in the books of the Drawer, Kamesh.

Important Ledger Accounts

Dr. RAMESH ACCOUNT Cr.

Date	Particulars	J.F	Amount	Date	Particulars	J.F.	Amount
			Rs.				Rs.
1989 Aug.14	To Sales A/c		3,800	1984 Aug. 14	By Bills Receivable A/c		3,800
			3,800				3,800

Dr. BILLS RECEIVABLE ACCOUNT Cr.

Date	Particulars	J.F.	Amount	Date	Particulars	J.F.	Amount
			Rs.				Rs.
1989 Aug.14	To Ramesh's A/c		3,800	1989 Aug. 25	By Raghu's A/c		3,800
			3,800				3,800

Dr. RAGHU'S ACCOUNT Cr.

Date	Particulars	J.F	Amount	Date	Particular	J.F.	Amount
			Rs.				Rs.
1989 Aug.25	To Bills Receivable A/c		3,800	1989	By Balance b/d		3,800
			3,800				3,800

BRAOU

In the Books of Ramesh (Drawee)

JOURNAL

Date	Particulars	L.F.	Amount Dr.	Amount Cr.
			Rs.	Rs.
1989				
Aug, 14	Purchases A/c Dr.		3,800	
	To Kamesh's A/c			3,800
	(Being goods purchased on credit)			
	Kamesh's A/c Dr.		3,800	
	To Bills Payable A/c.			3,800
	(Being the Bill sent after our acceptance)			
Dec.17	Bills Payable A/c Dr.		3,800	
Due date	To Cash A/c.			3,800
	(Being our acceptance due this day duly meet)			

IMPORTANT LEDGER ACCOUNTS

Dr. KAMESH ACCOUNT Cr.

Date	Particulars	J.F	Amount	Date	Particulars	J.F.	Amount
			Rs.				Rs.
1989				1989			
Aug.14	To Bills Payable A/c		3,800	Aug. 14	By Purchases A/c		3,800
			3,800				3,800

Dr. BILLS PAYABLE ACCOUNT Cr.

Date	Particulars	J.F.	Amount	Date	Particulars'	J.F.	Amount
			Rs.				Rs.
1989				1989			
Dec.17	To Cash A/c		3,800	Aug. 14	By Kamesh A/c		3,800
			3,800				3,800

BRAOU

In the Books of Raghu (Endorsee)

JOURNAL

Date	Particulars	L.F.	Amount Dr.	Amount Cr.
			Rs.	Rs.
1989 Aug, 25	Bills Receivable A/c Dr. To Ramesh's A/c (Being Ramesh's acceptance received from Kamesh on endorsement)		3,800	3,800
Dec.17	Cash A/c Dr. To Bills Receivable A/c. (Being the amount realised on the the Bill endorsed by Kamesh)		3,800	3,800

Explanatory Note : As the amount is now receivable by Raghu (the Endorsee) the Bill is a Bill Receivable just as it has been to the Endorser (or Drawer), Kamesh. The endorsee receives the payment directly from the Drawee on the due date.

Important Note : If the student is asked to open ladger accounts also, he must first open the personal accounts with appropriate opening balances in case of indebtedness between the parties concerned and then only he should start posting from the journal.
For example, in the illustration given above Kamesh had owed money to Raghu before he endorsed the bill to Raghu on the 25th of August, 1989. Therefore, when Raghu's personal account is opened in the ledger of Kamesh it should start with a credit balance of Rs. 3,800/- and then only posting should be done. Similarly, Kamesh's ledger account in the books of Raghu must open with a debit balance of Rs. 3,800/- (The indebtedness may be more, but we take the amount of the Bill only).

Ledger Accounts

Dr. KAMESH'S ACCOUNT Cr.

Date	Particulars	J.F.	Amount	Date	Particular	J.F	Amount
			Rs.				Rs.
1989	To Balance b/d		3,800	1989 Aug.25	By Bills Receivable A/c		3,800
			3,800				3,800

Dr. BILLS RECEIVABLE ACCOUNT Cr.

Date	Particulars	J.F.	Amount	Date	Particulars	J.F.	Amount
			Rs.				Rs.
1989 Aug.25	To Kamesh's A/c		3,800	1989 Dec,17	By Cash A/c		3,800
			3,800				3,800

IV. Where the Bill is sent to the Bank for Collection

In this case, the Drawer after receiving the accepted Bill from the Drawee sends it to his bank a few days before the due date to collect the amount on the due date, on his behalf, just as he sends cheques

for collection. The banker accordingly presents the Bill on behalf of his client to the drawee on the due date, collects the amount and credits the account of his client.

The student should know the difference between the sending of the Bill for collection from the discounting of the Bill as discussed earlier. In the case of the discounting of the Bill, the Drawer receives advance payment of the Bill less discount from the banker before the due date. But in the case of collection of Bills, the Drawer gets the credit in his Bank account only on the due date when his banker has collected the amount. The banker functions merely as an agent here while in the former case he provides financial accommodation to his client by discounting the Bill.

Now we can proceed to consider the entries to be passed on this occasion with the help of an illustration.

Illustration - 4

On the 22nd of October. 1989 Abdul purchased goods worth Rs.4000/- on credit from Joseph and accepted a Bill drawn upon him by the latter for the same amount for 2 months.

Joseph sends the bill to his bank for collection a few days before the due date on the 15th December, 1989. On the due date the banker duly presents the bill and Abdul makes the payment. Journalise the transactions in the books of Joseph as well as those of Abdul.

IN THE BOOKS OF JOSEPH (DRAWER)

JOURNAL

Date	Particulars		L.F.	Amount Dr.	Amount Cr.
				Rs.	Rs.
1989					
Oct.22	Abdul's A/c	Dr.		4,000	
	To Sales A/c				4,000
	(Being goods sold on credit)				
	Bills Receivable A/c	Dr.		4,000	
	To Abdul's A/c.				4,000
	(Being the Bill received after acceptance from Abdul)				
Dec.15	*Bills for collection A/c	Dr.		4,000	
	To Bills Receivable A/c.				4,000
	(Being Abdul's acceptance sent to Bank for collection)				

* It is also styled as " Bank A/c for collection of Bills A/c " or " Bills sent for collection A/c"

Dec. 24	Bank A/c	Dr.		4,000	
	To Bills for collectionA/c				4,000
	(Being amount realised on Abduls's Acceptance at Bank)				

NOTE: Actual Due Date falls on 25th December, but since it is a public holiday on account of X'mas, the preceding business day 24th should be taken as the Due Date.

'Bills for Collection Account' is an account separately opened for that specific purpose. It is debited when a bill is sent for collection and is closed when the amount is collected by crediting the same.

BRAOU

Dr. ABDUL'S ACCOUNT Cr.

Date	Particulars	J.F.	Amount	Date	Particulars	J.F	Amount
			Rs.				Rs.
1989				1989			
Oct. 22	To Sales A/c		4,000	Oct.22	By Bills Receivable A/c		4,000
			4,000				4,000

Dr. BILLS RECEIVABLE ACCOUNT Cr.

Date	Particulars	J.F.	Amount	Date	Particulars	J.F.	Amount
			Rs.				Rs.
1989				1989			
Oct.22	To Abdul's A/c		4,000	Dec.15	By Bills for Collection A/c		4,000
			4,000				4,000

In the Books of Abdul (Drawee)

JOURNAL

Date	Particulars	L.F.	Amount Dr..	Amount Cr.
			Rs.	Rs.
1989				
Oct.22	Puchases A/c Dr.		4,000	
	To Joseph's A/c			4,000
	(Being goods purchased on credit)			
1989				
Oct. 22	Joseph's A/c Dr.		4,000	
	To Bills Payable A/c.			4,000
	(Being the bill drawn by Joseph accepted and sent)			
1989				
Dec.24	Bills Payable A/c Dr.		4,000	
	To Cash A/c			4,000
	(Being our acceptance due this day duly met)			

BRAOU

Dr. JOSEPH'S ACCOUNT Cr.

Date	Particulars	J.F.	Amount	Date	Particulars	J.F	Amount
			Rs.				Rs.
1989				1989			
Oct 22	To Bills Payable A/c		4,000	Oct.22	By Purchases A/c		4,000
			4,000				4,000

Dr. BILLS PAYABLE ACCOUNT Cr.

Date	Particulars	J.F.	Amount	Date	Particulars	J.F.	Amount
			Rs.				Rs.
1989				1989			
Dec.24	To Cash A/c		4,000	Oct. 22	By Joseph's A/c		4,000
			4,000				4,000

Useful Points

It should be noted that the entries in the books of the Drawee remain practically the same whether the Drawer retains the Bills, discounts it, endorses it or sends it to the bank for collection. This is so because the Drawee is not affected by what the Drawer does with the Bills once it has been accepted by him and sent to the Drawer. He is concerned with the Bill again only on the due date when the payment is to be made. He makes payment to the Drawer or to any other person to whom the Drawer has transferred the Bill when the Bill is presented to him on the due date. It must be remembered that it is the duty of the holder of the Bill to present it for payment to the Drawee on the due date. The drawee himself will not find out the holder of the Bill and pay. In the first case, i.e., where the Bill is retained with Drawer, the Drawer himself presents the Bill. In the second and forth cases it is the duty of the bank to present it. And in the case of endorsment, the endorsee presents it and collects payment. Whatever be the case, the drawee makes payment of the Bill on the due date and collects back his acceptance. That is why the entries in his books remain unaltered irrespective of the party presenting the Bill.

The student is advised to study the entries in the books of different parties pertaining to the four different cases carefully.

B. DISHONOUR OF BILLS

When the Drawee, for any reason, fails to pay the amount of the Bill on the due date, it is known as 'dishonouring the Bill'. The effect of dishonour is recorded in accounts by bringing back all the effected accounts to the orginal position, i.e., the position reflected in accounts before the Bill was made and accepted. In other words, reverse entries will be passed in the books depending upon the particular circumstances in each case.

Practically, in the books of the drawee the entry made at the time of his acceptance of Bill(debiting Drawer's A/c and crediting Bills Payable A/c) will be reversed by debiting Bills Payable A/c and crediting the Drawer's personal account on the due date when the bill is dishonoured. The same reverse entry would be passed on dishonour, whatever be the way in which the Drawer might have utilised the Bill, as that will have no effect on the Drawee's books.

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In regard to the books of the Drawer, the entries to bring into effect the dishonour of the Bill, would depend upon the way he has utilised the bill. The drawer might retain the bill with him till the due date or discount it or endorse it or send it to bank for collection. As the drawer credits the personal account of the drawee at the time of receiving his acceptance; on dishonour, the drawee's account will be debited with the amount of the Bill. What account is to be credited depends upon the circumstances. In the first case (where the Bill is retained with the drawer), the Bills Receivable account will be credited; in the second case the bank account, in the third the endorsee's account and the fourth Bills for collection Account.

Let us now see how the entries would appear in the books of the drawer and the drawee in case of dishonour under different cases.

I . When the Bill is retained with the Drawer and Dishonoured on due date:

Illustration 5

Rahim bought Rs. 6,600/- worth of goods from Rahul on the 5th of September. He accepted a Bill drawn upon him by Rahul on the 10th of September for an identical sum for 3 months and returned the same.

On the due date the Bill was dishonoured. Journalise these transactions in the books of both the parties, and show important ledger accounts.

Solution

In the Books of Rahul (Drawer)

JOURNAL

Date	Particulars		L.F.	Amount Dr.	Amount Cr.
				Rs.	Rs.
Sep.5	Rahim's A/c	Dr.		6,600	
	To Sales A/c				6,600
	(Being goods sold on credit)				
Sep. 10	Bills Receivable A/c	Dr.		6,600	
	To Rahim's A/c.				6,600
	(Being Rahim's Acceptance received)				
Dec.13	Rahim's A/c	Dr.		6,600	
	To Bills Receivable A/c.				6,600
	(Being Rahim's Acceptance due this day dishonoured)				

Explanatory Note: The entry on the 13th of December is the dishonour entry. The entry on receiving Rahim's acceptance (Sept. 10th) is reversed on December 13th on dishonour of the bill.

LEDGER ACCOUTS

Dr. RAHIM'S ACCOUNT Cr.

Date	Particulars	J.F.	Amount	Date	Particulars	J.F	Amount
			Rs.				Rs.
Sep.15	To Sales A/c		6,600	Sep,10	By Bills Receivable A/c		6,600
Dec. 13	To Bills Receivable A/c		6,600		By Balance c/d		6,600
			13,200				13,200
	To Balance b/d		6,600				

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Dr. BILLS RECEIVABLE ACCOUNT Cr.

Date	Particulars	J.F.	Amount	Date	Particulars	J.F.	Amount
			Rs.				Rs.
Sep .10	To Rahim's A/c		6,600	Dec. 13	By Rahim's A/c		6,600
			6,600				6,600

In the Books of Rahim(Drawee)

JOURNAL

Date	Particulars	L.F.	Amount Dr.	Amount Cr.
			Rs.	Rs.
Sep.5	Purchase A/c Dr. To Rahul's A/c (Being goods purchased on credit)		6,600	6,600
Sep. 10	Rahul's A/c Dr. To Bills Payable A/c. (Being our Acceptance sent)		6,600	6,600
Dec.13	Bills Payable A/c Dr. To Rahul's A/c (Being our Acceptance due this day dishonoured)		6,600	6,600

Note : On the 13th of December when the Bill is dishonoured the entry for acceptance is reversed.

LEDGER ACCOUNTS

Dr. RAHUL'S ACCOUNT Cr.

Date	Particulars	J.F.	Amount	Date	Particulars	J.F	Amount
			Rs.				Rs.
Sep.10	To Bills Payable A/c		6,600	Sep.15	By Purchases A/c		6,600
	To Balance c/d		6,600		By Bills Payable A/c		6,600
			13,200				13,200
					By Balance b/d		6,600

BRAOU

Dr. **BILLS PAYABLE ACCOUNT** Cr.

Date	Particulars	J.F.	Amount	Date	Particulars	J.F.	Amount
			Rs.				Rs.
Dec.13	To Rahul's A/c		6,600	Sep. 10	By Rahul's A/c		6,600
			6,600				6,600

Important Note: The illustration given above is a case of dishonour when the Bill is retained with the drawer. Similar entries as such above appear in the books of the drawee in other cases also. That is, there will be no change in respect of entries in the books of the drawee whether the Bill is dishonoured after discounting or after endorsement or after it was sent to the Bank for collection by the Drawer.

II. Where the Drawer discounts the Bill and the Bill is dishonoured on the due date.

In this case the drawer obtains funds from the bank by discounting the Bill without waiting till the due date. But if the drawee fails to pay the amount of the Bill on the due date, the bank will collect the full amount from the drawer himself.

Thus, in the books of the drawer, the drawee's account will be debited and the Bank account will be credited with the amount of the Bill on dishonour. This signifies that the drawer has paid the amount to the bank on the due date because of dishonour by the drawee.

Illustration. 6

Jamshedji sold goods to Radhe Shyam for Rs.8,000/- and received Rs. 2,500/- immediately in cash. For the balance, he drew a Bill on Radhe Shyam which he prompily accepted and returned. The bill was discounted for Rs. 5,280/-.

On the due date, Jamshedji had to take up the Bill as Radhe Shyam had failed to honour the bill. Pass Journal entries in the books of the both the parties for the above mentioned transactions and show important ledger accounts.

BRAOU

Solution

In the Books of Jamshedji (Drawer)

JOURNAL

Date	Particulars	L.F.	Amount Dr.	Amount Cr.
			Rs.	Rs.
	1. Radhe Shyams A/c Dr.		8,000	
	To Sales A/c			8,000
	(Being goods sold on credit)			
	2. Cash A/c Dr.		2,500	
	To Radhe Shyam'sA/c.			2,500
	(Being amount received)			

3. Bills Receivable A/c. To Radhe Shyam'sA/c (Being Radhe Shyam's Acceptance received for the balance due)	Dr.		5,500	5,500
4. Bank A/c.	Dr.		5,280	
Discount A/c	Dr.		220	
To Bills Receivable A/c (Being Radhe Shyam's Acceptance discounted)				5,500
On the Due Date:				
5. Radhe Shyam'sA/c To Bank A/c. (Being amount paid to Bank on dishonour of Radhe Shyam's acceptance after discounting it.)	Dr.		5,500	5,500

NOTE: As the dates are not given, the entries are numbered serially.

LEDGER ACCOUNTS

Dr. RADHE SHYAM'S ACCOUNT Cr.

Date	Particulars	J.F.	Amount	Date	Particular	J.F	Amount
			Rs.				Rs.
	To Sales A/c		8,000		By Cash A/c		2,500
	To Bank A/c		5,500		By Bills Receivable A/c		5,500
					By Balance c/d		5,500
			13,500				13,500
	To Balance b/d		5,500				

Dr. BILLS RECEIVABLE ACCOUNT Cr.

Date	Particulars	J.F.	Amount	Date	Particulars	J.F.	Amount
			Rs.				Rs.
	To Radhe Shyam A/c		5,500		By Bank A/c		5,280
					By Discount A/c		220
			5,500				5,500

BRAOU

In the Books of Radhe Shyam (Drawee)

JOURNAL

Date	Particulars	L.F.	Amount Dr.	Amount Cr.
			Rs.	Rs.
	1 Purchases A/c Dr. To Jamshedji's A/c (Being goods purchased on credit)		8,000	8,000
	2. Jamshedji's A/c Dr. To Cash A/c. (Being cash paid)		2,500	2,500
	3 Jamshedji's A/c Dr. To Bills Payable A/c (Being the bill for the balance due accepted)		5,500	5,500
	On the Due Date:			
	5. Bills Payable A/c Dr. To Jamshedji's A/c (Being our acceptance due this day dishonoured.)		5,500	5,500

Ledger Accounts

Dr. JAMSHEDJI'S ACCOUNT Cr.

Date	Particulars	J.F.	Amount	Date	Particulars	J.F	Amount
	To Cash A/c		2,500		By Purchases A/c		8,000
	To Bills Payable A/c		5,500		By Bills Payable A/c		5,500
	To Balance c/d		5,500				
			13,500				13,500
					By Balance b/d		5,500

Dr. BILLS PAYABLE ACCOUNT Cr.

Date	Particulars	J.F.	Amount	Date	Particulars	J.F.	Amount
			Rs.				Rs.
	To Jamshedji's A/c		5,500		By Jamshedji's A/c		5,500
			5,500				5,500

BRAOU

III. Where the Drawer endorses the Bill which is dishonoured on the due date:

In this case the drawer endorses the Bill to a third party, to whom he owes money. At the time of endorsement, he debits the Endorsee's A/c and credits the Bill Receivable A/c.

On dishonour of the Bill by the drawee, this entry is reversed in the books of the drawer immediately. The endorsee may, sometimes, insist on payment of the Bill endorsed to him when he is not willing to wait further. In such a case the drawer pays the endrosee and passes the following entry.

Endrosee's A/c Dr.
To Cash A/c

Illustration - 7

X purchased goods worth Rs. 7,000/- from Y on the 15th May, 1989 and accepted a Bill for 3 months for the same. Y endorsed the Bill to his creditor, Z on the 18th of May.

On the due date the Bill was dishonoured. Y had to pay his crditor, on the next day.

Give journal entries for the above transactions in the books of X.Y.Z

Solution

In the Books of Y (Drawer)

JOURNAL

Date	Particulars		L.F.	Amount Dr.	Amount Cr.
1989					
May.15	X's Account	Dr.		7,000	
	To Sales A/c				7,000
	(Being goods sold on credit)				
	Bills Receivable A/c	Dr.		7,000	
	To X's Account				7,000
	(Being X's Acceptance received)				
May.18	Z 's Account	Dr.		7,000	
	To Bills Receivable A/c.				7,000
	(Being X's Acceptance endorsed to Z)				
Aug.18	X 's Account	Dr.		7,000	
	To Z Account.				7,000
	(Being the dishonour of X's acceptance endorsed to Z)				
Aug.19	Z 's Account	Dr.		7,000	
	To Cash Account				7,000
	(Being the amount paid)				
	Note: If it is paid by cheque the Bank A/c will be credited instead of Cash A/c				
	Note: If the payment is made on the same da then the two entries can be combined as fo'				
	X 's Account				
	To Cash Account				
	(Being the payment to Z on account				

BRAOU

Ledger Accounts

Dr. X'S ACCOUNT Cr.

Date	Particulars	J.F.	Amount	Date	Particulars	J.F	Amount
1989							
May 15	To Sales A/c		7,000	1989 May 18	By Bills Receivable A/c		7,000
Aug. 18	To Z's A/c		7,000		By Balance c/d		7,000
			14,000				14,000
	To Balance b/d		7,000				

Dr. BILLS PAYABLE ACCOUNT Cr.

Date	Particulars	J.F.	Amount	Date	Particulars	J.F.	Amount
1989				1989			
May ,15	To X's A/c		7,000	May, 18	By Z's A/c		7,000
			7,000				7,000

Dr. Z's ACCOUNT Cr.

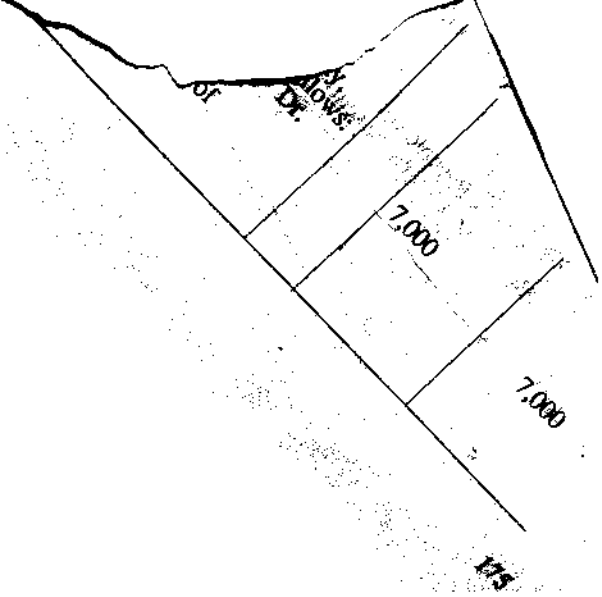
Date	Particulars	J.F.	Amount	Date	Particulars	J.F.	Amount
			Rs				Rs.
1989 May, 18	To Bills Receivable A/c		7,000	1989. Aug, 18	By Balance b/d		7,000
Aug.19	To Cash A/c		7,000		By X's A/c		7,000
			14,000				14,000

B R A O U

In the Books of X (Drawee)

JOURNAL

Date	Particulars	L.F.	Amount Dr. Rs.	Amount Cr. Rs.
1989 May. 15	Purchases A/c		7,000	
	To Y's Account			7,000
	(Being goods p[illegible] on credit)			
	Dr.		7,000	
			7,000	7,000



BRAOU

rchased

Y's Account
To Bills Payable A/c
(Being our acceptance sent)

Dr.

Bills Payable A/c
To Y's Account
(Being our acceptance due
this day dishonoured)

Aug.8

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BRAOU

Ledger Accounts

Dr. **Y'S ACCOUNT** Cr.

Date	Particulars	J.F.	Amount Rs.	Date	Particulars	J.F	Amount Rs.
1989 May 15	To Bills Payable A/c		7,000	1989 May 18	By Purchase A/c		7,000
	To Balance C/d		7,000	Aug, 18	By Bills Payable A/c		7,000
			14,000				14,000
					By Balance b/d		7,000

Dr. **BILLS PAYABLE ACCOUNT** Cr.

Date	Particulars	J.F.	Amount Rs.	Date	Particulars	J.F.	Amount Rs.
1989 Aug.18	To Y's Account		7,000	1989 May, 15	By Y's Account		7,000
			7,000				7,000

In the Books of Z Endorsee

JOURNAL

Date	Particulars		L.F.	Amount Dr.	Amount Cr.
May,18	Bills Receivable A/c	Dr.		7,000	
	To Y's Account				7,000
	(Being X's acceptance received from Y endorsed in our favour)				
Aig.18	Y's Account	Dr.		7,000	
	To Bills Receivable A/c				7,000
	(Being the bill endorsed by Y due this day dishonoured)				
Aug.19	Cash Account	Dr.		7,000	
	To Y's Account				7,000
	(Being Cash received)				

NOTE : When Y's personal account is opened in the ledger (in Z's books) it should be opened with a debit balance of Rs. 7,000 to show that Y owes him the money (Otherwise he would not have endorsed the Bill.)

Similarly, in the books of Y when Z's ledger account is opened it should be opened with a credit balance of Rs. 7,000 to show that the money is owing to Z by Y as a result of some previous transactions which are not covered by the present problem.

BRACU

Dr. Y'S ACCOUNT Cr.

Date	Particulars	J.F.	Amount	Date	Particulars	J.F.	Amount
			Rs				Rs.
1989				1989			
	To Balance b/d		7,000	May,18	By Bills Receivable A/c		7,000
Aug.18	To Bills Receivable A/c		7,000	Aug, 19	By Cash A/c		7,000
			14,000				14,000

IV. Where the Bill is sent to Bank for collection and is dishonoured on the due date.

When the drawer sends the Bill to his bank for the collection of Bill amount on his behalf, the following entry is to be made.

Bills sent for collection A/c. Dr.
To Bills Receivable A/c
(Being _____'s acceptance sent to Bank for collection)

On the due date when the Bill is dishonoured the drawee's account is debited and the Bills sent for collection account is cancelled by crediting it. The entry is :

Drawee's Account Dr.
To Bills sent for collection A/c
(Being _____'s acceptance due this day sent to bank for collection dishonoured)

Illustration - 8

On the 31 st of May, 1989 Bhargava Bought goods on credit from Shamsher Sing for Rs. 5,000/-. On the 6th of June he accepted a bill drawn upon him by Shamsher Sing for 2 months for the same amount.

Mr. Singh sent the Bill to his bank to be collected on the due date. The banker informed him that the Bill was dishonoured on the due date.

Journalise the above transactions in the books of both parties.

In the Books of Shamsher Singh (Drawer)

JOURNAL

Date	Particulars		L.F.	Amount Dr.	Amount Cr.
1989					
May,31	Bhargava's A/c	Dr.		5,000	
	To Sales A/c				5,000
	(Being goods sold on credit)				
June 6	Bills Receivable A/c	Dr.		5,000	
	To Bhargavas A/c.				5,000
	(Being Bhargava's Acceptance received)				
	Bills sent for collection A/c	Dr.		5,000	
	To Bills Receivable A/c.				5,000
	(Being Bharghava's Acceptance sent to Bank for collection.)				
Aug.9	Bharghava's A/c	Dr.		5,000	
	To Bills sent for collection A/c				5,000
	(Being Bhargava's acceptance due this day dishonoured)				

BRAOU

LEDGER ACCOUNT

Dr. BHARGAVA'S ACCOUNT Cr.

Date	Particulars	J.F.	Amount	Date	Particulars	J.F	Amount
			Rs.				Rs.
1989				1989			
May 31	To Sales A/c		5,000	June 6	By Bills Receivable A/c		5,000
Aug. 9	To Bills sent for Collection A/c		5,000		By Balance c/d		5,000
			10,000				10,000
	To Balance b/d		5,000				

Dr. BILLS RECEIVABLE ACCOUNT Cr.

Date	Particulars	J.F.	Amount	Date	Particulars	J.F.	Amount
			Rs.				Rs.
1989				1989			
June,6	To Bhargava's A/c		5,000	June,6	By Bills sent for Collection A/c		5,000
			5,000				5,000

In the Books of Bhargava (Drawee)

JOURNAL

Date	Particulars		L.F.	Amount Dr.	Amount Cr.
				Rs.	Rs.
1989					
May,31	Purchases A/c	Dr.		5,000	
	To Shamsher Sing A/c				5,000
	(Being goods Purchased on credit)				
June 6	Shamesher Singh A/c	Dr.		5,000	
	To Bills Payable A/c.				5,000
	(Being our Acceptance sent)				
Aug.9	Bills Payable A/c	Dr.		5,000	
	To Shamsher Singh A/c				5,000
	(Being our acceptance due this day dishonoured)				

LEDGER ACCOUNTS

Dr. SHAMSHER SINGH'S ACCOUNT Cr.

Date	Particulars	J.F.	Amount	Date	Particulars	J.F	Amount
1989				1989			
June,6	To Bills Payable A/c		5,000	May 31	By Purchase A/c		5,000
	To Balance C/d		5,000	Aug. 9	By Bills PayableA/c		5,000
			10,000				10,000
					By Balance b/d		5,000

BRAOU

Dr. BILLS PAYABLE ACCOUNT Cr.

Date	Particulars	J.F.	Amount	Date	Particulars	J.F.	Amount
			Rs.				Rs.
1989				1989			
Aug.9	To Shamsher Sing A/c		5,000	June.6	By Shamsher Sing A/c		5,000
			5,000				5,000

Noting and Protesting Charges

On the due date or the date of maturity of the Bill, it is the duty of the holder of the Bill (whether it is the drawer himself or the bank after having discounted or the endorsee or the bank responsible for collection) to present it to the drawee for payment.

We have already seen that when the drawee fails to make the payment the Bill is said to be dishonoured. To avoid any future misunderstanding about the fact of the presentation of the Bill and its dishonour, it is customary among business people to get the fact of dishonour noted by a Notary Public. A Notary Public is an official appointed by the Government to authenticate certain documents or facts in legal matters. The Notary Public, therefore, authenticates that such and such a Bill was presented and that it was dishonoured. He issues a certificate to this effect and it is called Protest. The Notary Public is paid certain charges for his services. These are known as Noting and Protesting charges.

The question is : Who pays the charges? Naturally, whoever presents the Bill to the drawee on the due date will have to pay these charges when he gets the fact of dishonour noted by the Notary Public. Such Noting charges are debited to the account of the drawee by the drawer as they are incidental to dishonour by the drawee whoever might have actually paid them. The Journal entry for Notary/Noting charges in the books of the Drawer will be as follows:

a) When the Bill is retained with the drawer and when the Noting charges are paid by the drawer himself:

Drawee's A/c Dr.
To Bank A/c (or Cash A/c)
(Being Noting charges paid on dishonour of the drawee's acceptance)

b) When they are paid by the Bank after the Bill is discounted :

Drawee's A/c Dr.
To Bank A/c
(Being Noting charges paid and debited by the Bank on dishonour of the drawee's acceptance)

c) When they are paid by endorsee :

Drawee's A/c Dr.
To Endorsee's A/c
(Being Noting charges paid by Endorsee on dishonour of drawee's acceptance)

d) When they are paid by the Bank after the Bill is sent to Bank for collection :
The entry will be the same as in case (b). The entries given above are in addition to the entries of dishonour.

In the Books of the Drawee

The Journal Entry would be

Noting Charges A/c Dr.
To Drawer's A/c

(Being Noting charges payable on dishonour of our acceptance)

NOTE : There is no change in this entry in the Books of the Drawee whether the Bill is retained with the Drawer or dealt with by him otherwise.

The treatment of noting charges is illustrated below :

Illustration : 9.

Sandeep accepted a Bill drawn upon him by Vivek for Rs. 2,500/- being the amount due by him on account of credit purchases made earlier. On the due date the Bill was dishonoured. Vivek incurred noting charges of Rs. 30/-

Record the transactions in the books of Vivek and Sandeep.

Solution

In the Books of Vivek

JOURNAL

			Rs.	Rs.
1. Bills Receivable A/c	Dr.		2,500	
To Sandeep's A/c				2,500
(Being Sandeeps acceptance received)				
On the due date				
2. Sandeep's A/c	Dr.		30	
To Cash A/c				30
(Being noting charges paid on dishonour of Sandeep's acceptance)				
3.Sandeep's A/c	Dr.		2,500	
To Bills Receivable A/c				2,500
(Being dishonour of Bill)				
Note : Entries 2 and 3 can be combined as follows :				
Sandeep's A/c	Dr.		2,500	
To Bills Receivable A/c				2,500
To Cash A/c				30
(Being dishonour of Sandeep's acceptance of noting charges paid.				

Ledger Accounts

Dr. SANDEEP'S ACCOUNT Cr.

		Rs.			Rs.
To Balance b/d		2,500	By Bills Receivable A/c		2,500
To Bills Receivable A/c		2,500	By Balance C/d		2,530
To Cash A/c		30			
		5,030			5,030
To Balance b/d		5,030			

BRAOU

Dr. BILLS RECEIVABLE ACCOUNT Cr.

		Rs.			Rs.
	To Sandeep's A/C	2,500		By Sandeep's A/c	2,500

In the Books of Sandeep

JOURNAL

1 Vivek's A/c Dr. To Bills Payable A/c (Being our acceptance sent)			2,500	2,500
On the due date				
2 Bills Payable A/c Dr. To Vivek's A/c (Being our acceptance due this day dishonoured)			2,500	2,500
3 Noting charges A/c Dr. To Vivek's A/c (Being Noting Charges incurrred by Vivek)			30	30
4 Entries 2 & 3 may be combined as : Bills Payable A/c Dr. Noting Charges A/c Dr. To Vivek's A/c (Being dishonour of our acceptance and noting charges)			2,500 30	2,530

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Ledger Accounts

Dr. VIVEK'S ACCOUNT Cr.

		Rs.			Rs.
	To Bill Payable A/c	2,500		By Balance b/d	2,500
	To Balance C/d	2,530		By Bills Payable A/c	2,500
				By Noting Charges A/c	30
		5,030			5,030
				To Balance b/d	2,530

Dr. BILLS PAYABLE ACCOUNT Cr.

		Rs.			Rs.
	To Vivek's A/c	2,500		By Vivek's A/c	2,500

9.7 RETIREMENT OF THE BILL UNDER REBATE

Sometimes the drawee or the Acceptor is willing to make the payment on his acceptance, even before the due date, and requests the drawer to allow him some discount. This is known as 'Retiring the Bill' under rebate. The rebate here is similar to interest. It is calculated for the balance of the period at an agreed rate. The same is illustrated with the help of the following illustration :

Illustration - 10

Azaruddin has earlier accepted a Bill drawn upon him by Gower for Rs. 4,000/- . The due date of the Bill was 4th of September, 1989.

However, Azaruddin retired the Bill one month earlier and he was given a rebate of 9% p.a.

Record the transaction in the books of both the parties.

Journal of Azaruddin

	Bills Payable A/c Dr.		4,000	
	To Cash A/c			3,970
	To Rebate on Bills A/c			30
	(Being our acceptance due on the 1st of Sept. retired today and rebate earned @ 9%)			

Journal of Gower

	Cash a/c Dr.		3,970	
	Rebate on Bills A/c Dr.		30	
	To Bills Receivable A/c			4,000
	(Being Azaruddin's Acceptance retired today and rebate allowed @ 9%)			

Check Your Progress - 2

What do you understand by 'retiring the Bill under rebate ?

BRAOU

9.8 RENEWAL OF BILLS

Sometimes, the Acceptor of a Bill may find himself in a difficult financial position and may be unable to arrange payment of the Bill by the due date. As a result, if he dishonours the Bill, he will have to face the consequences. Not only does he face the ignominy of dishonour but his credit worthiness in the business circles will also be adversely affected.

The Acceptor, therefore, with a view to avoiding the unpleasantness of dishonour may approach the Drawer well before the due date of the Bill which he has accepted and seek extension of time for meeting the Bill, for the extended time, he offers to pay some interest. When the drawer agrees to the proposal the old Bill is cancelled and a fresh Bill is drawn for a fresh period. This is known as 'Renewal of the Bill.

While seeking the renewal, the Acceptor may (1) make part payment of the amount of the Bill and also interest in cash and accept a fresh Bill for the balance amount : or (2) he may pay interest only in cash and accept a fresh Bill for the entire amount or (3) he may accept a fresh Bill for the entire amount plus interest in which case he does not pay any cash at the time of renewal. What exactly is the arrangement depends on the terms of agreement between the drawer and the Acceptor in respect of the renewal. whatever be the mode of agreement, the old Bill is always cancelled on renewal. The drawer will wait for further time on renewal for collection of the amount. If the original Bill has been discounted or endorsed by the drawer, the drawer himself will have to pay the bank or the endorsee as they are not concerned with the renewal. On the due date of the fresh Bill, it may be duly met by the drawee or dishonoured or may be renewed again. Depending on the case concerned entries for honour, dishonour or renewal will be passed.

Illustration - 11

Imran had earlier accepted a Bill drawn upon him by Srikant for Rs.6,000/-. Before the due date Imran requested Srikant to accept Rs. 2,000/- as part payment and Rs. 100/- towards interest in cash and draw a fresh Bill for the balance of Rs. 4,000/- for a further period of 3 months. Srikant agreed to the proposal and drew a fresh Bill.

Journalise these transactions in the books of Imran and Srikant.

In the Books of Srikant (Drawer)

JOURNAL

1	Imran A/c Dr. To Bills Receivable A/c (Being cancellation of the old Bill on renewal)		6,000	6,000
2	Cash A/c Dr. To Imran A/c To Interest A/c (Being part payment and interest received)		2,100	2,000 100
3	Bills Receivable A/c Dr. To Imran A/c. (Being fresh acceptance received for the balance amount)		4,000	4,000

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In the Books of Imran (Drawee)

JOURNAL

1.	Bills Payable A/c Dr. To Srikant's A/c (Being cancellation of the old Bill on renewal)			6,000	6,000
2.	Srikant's A/c Dr. Interest A/c Dr. To Cash A/c (being part payment and interest paid in cash)			2,000	100 2,100
3.	Srikant's A/c Dr. To Bills Payable A/c (Being fresh Bill accepted for the balance amount)			4,000	4,000

NOTE: It is to be noted that the entry for cancellation of the old Bill in the books of the Drawer and the Drawee is similar to the entry passed on dishonour. Interest is credited in Drawer's books as it is income and debited in Drawee's books as it is an expense to him.

Check Your Progress - 3

i) What do you mean by renewal of the Bill

Illustration - 12

Ramakant accepted a bill drawn upon him by Ravikant for Rs. 6,000/- for 3 months.

Before the due date Ramakant requests Ravikant to cancel the bill and draw a fresh bill for a further period of 3 months including interest of Rs. 200/- to which Ravikant agreed.

Journalise these transactions in the books of Ravikant and Ramakant.

In the Books of Ravikant (Drawer)

JOURNAL

1	Bills Receivable A/c Dr. To Ramakant A/c (Being Ramakant's acceptance received)			6,000	6,000
2	Ramakant's A/c Dr. To Bills Receivable A/c (Being Ramakant's Acceptance Cancelled on renewal)			6,000	6,000
3.	Bills Receivable A/c Dr. To Interest A/c To Ramakant's A/c (Being fresh bill drawn including interest)			6,200	200 6,000

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In the Books of Ramakant (Drawee)

JOURNAL

	1 Ravikant's A/c	Dr.		6,000	
	To Bills Payable A/c				6,000
	(Being our acceptance sent)				
	2 Bills Payable A/c	Dr.		6,000	
	To Ravikant's A/c				6,000
	(Being cancellation of our acceptance on renewal)				
	3. Ravikant's A/c	Dr.		6,000	
	Interest A/c	Dr.		200	
	To Bills Payable A/c				6,200
	(Being fresh acceptance sent including interest)				

NOTE : It should be noted that there is no cash payment here, either towards the principal amount or interest.

Illustration - 13

Ravi Sastri draws upon Umrigar a Bill for Rs. 6,000 which Umrigar accepts and which he sends back to Ravi Sastri.
Before the due date Umrigar requests Ravi Sastri for renewal and Sastri agrees. Umrigar pays Rs. 3,000/- and accepts a fresh Bill for 3 months for the balance amount plus interest @ 12% p.a.

On the due date, the second Bill is duly paid. Journalise these transactions in the Books of Ravi Sastri and Umrigar.

In the Books of Ravi Sastri (drawer)

JOURNAL

1	Bills Receivable A/c	Dr.		6,000	
	To Umrigar's A/c				6,000
	(Being Umrigar's acceptance received)				
2	Umrigar's A/c	Dr.		6,000	
	To Bills Receivable A/c				6,000
	(Being cancellation of Umrigar's acceptance on renewal)				
3	Cash A/c	Dr.		3,000	
	To Umrigar's A/c				3,000
	(Being amount received)				
4.	Bills Receivable A/c	Dr.		3,090	
	To Umrigar's A/c				3,000
	To Interest A/c				90
	(Being fresh acceptance received including Rs. 90/- towards interest)				
5.	**On the Due Date of the Second Bill :**				
	Cash A/c	Dr.		3,090	
	To Bills Receivable A/c				3,090
	(Being Umrigar's Acceptance due this day honoured)				

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In the Books of Umrigar (Drawee)

JOURNAL

1	Ravi Sastri's A/c Dr. To Bills Payable A/c (Being our acceptance sent)			6,000	6,000
2.	Bills Payable A/c Dr. To Ravi Sastri's A/c (Being cancellations of our acceptance on renewal)			6,000	6,000
3.	Ravi Sastri's A/c Dr. To Cash A/c (Being amount paid)			3,000	3,000
4.	Ravi Sastri A/c. Dr. Interest A/c. Dr, To Bills Payable A/c. (Being fresh acceptance sent for the balance plus interest)			3,000 90	3,090
	On the Due date of the Second Bill				
5.	Bills Payable A/c Dr. To Cash A/c (Being our acceptance due this date duly met)			3,090	3,090

Some more illustrations of Renewal

Illustration - 14

Gulam Ali who owed Rs. 10,800/- to Ravi Shankar settled his account by accepting two Bills. one for Rs. 4,500/- and the other for Rs. 6,300/- for 3 months and 5 months respectively.

Ravi Shankar immediately discounted the first Bill for Rs. 4,350/- . The second Bill was endorsed to Bapuji.

Before the due date of the first Bill Gulam Ali being unable to arrange funds requested Ravi Shankar to cancel the Bill and draw a fresh Bill for 3 more months for that amount plus Rs. 200/- towards interest. Accordingly, a fresh Bill was drawn and accepted.

Once again, before the due date of the second Bill Gulam Ali found himself in a difficult financial position. He requested Ravi shankar to accept Rs. 3,000 in part payment and draw a fresh Bill for the balance due and interest @ 12% p.a. for a further period of 4 months. Ravi Shankar having agreed to the proposal, the transactions were carried out accordingly. However, Bapuji is not willing to wait further for collecting his debt. Therefore, Ravi Shankar had to pay him on the due date.

Both the renewed Bills were met on their respective due dates.

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Journalise these transactions in the books of Ravi Shankar and Gulam Ali.

Solution

In the Books of Ravi Shankar (Drawee)

JOURNAL

1	Bills Receivable A/c (No.1)	Dr.		4,500	
	To Gulam Ali's A/c				4,500
	(Being Gulam's acceptance received for the first bill)				
2.	Bills Receivable A/c (No.2)	Dr.		6,300	
	To Gulam Ali's A/c				6,300
	(Being Gulam Ali's Acceptance received for the II Bill)				
3.	Bank A/c	Dr.		4,350	
	Discount A/c	Dr.		150	
	To Bills Receivable A/c (No.1)				4,500
	(Being Gulam Ali's first acceptance discounted)				
4.	Bapuji's A/c	Dr.		6,300	
	To Bills Receivable A/c (N0.2)				6,300
	(Being Gulam Ali's Second acceptance endorsed)				
5.	Gulam Ali's A/c	Dr.		4,500	
	To Bank A/c				4,500
	(Being amount paid to bank on renewal of Ali's First acceptance)				
	Note : As the Bill was discounted Ravi Shankar had to pay the bank.				
6.	Bills Receivable A/c (No.3)	Dr.		4,700	
	To Gulam Ali's A/c				4,500
	To Interest A/c				200
	(Being fresh bill drawn on renewal including interest)				
7.	Gulam Ali's A/c	Dr.		6,300	
	To Bapuji's A/c				6.300
	(Being cancellation of Bill No.2 which was endorsed on renewal)				
8.	Bapuji's A/c	Dr.		6,300	
	To Cash A/c				6,300
	(Being amount of the Bill paid to Bapuji on renewal)				

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9.	Cash A/c To Gulam Ali's A/c (Being part payment received from Gulam Ali)	Dr.		3,000	3,000
10.	Bills Receivable A/c (No.4) To Gulam Ali's A/c To Interest A/c (Being fresh acceptance received including interest)	Dr.		3,432	3,300 132
11.	Cash A/c To Bill Receivable A/c (No.3) (Being amount realised on Bill (No.3) on the due date)	Dr.		4,700	4,700
12.	Cash A/c To Bills Receivable A/c (No.4) (Being amount realised on Bill No.4 on the due date)	Dr.		3,432	3,432

NOTE : When there are multiple Bills, it is better to provide them with serial numbers. Thus the bills are numbered 1,2,3 and 4.

In the Books of Gulam Ali (Drawee)

JOURNAL

1	Ravi Shankar A/c To Bills Payable (No.1)A/c (Being our acceptance sent)	Dr.		4,500	4,500
2.	Ravi Shankar A/c To Bills Payable (No.2) A/c (Being our acceptance sent)	Dr.		6,300	6,300
3.	Bills Payable (No.1) A/c To Ravi Shankar A/c (Being our acceptance cancelled on renewal)	Dr.		4,500	4,500
4.	Ravi Shankar's A/c Interest A/c To Bills Payable (No.3) A/c (Being fresh acceptance sent including interest)	Dr. Dr.		4,500 200	4,700
5.	Bills Payable (No.2) A/c To Ravi Shankar's A/c (Being cancellation of our acceptance on renewal)	Dr.		6,300	6,300

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6.	Ravi Shankar's A/c Dr. To Cash A/c (Being part payment made)			3,000	3,000
7.	Ravi Shankar's A/c Dr. Interest A/c Dr. To Bills Payable (N0.4) A/c (Being our acceptance sent for balance due and interest)			3,300 132	3,432
8.	Bills Payable (No.3) A/c Dr. To cash A/c (Being our acceptance due this date duly met)			4,700	4,700
9.	Bills Payable (No.4) A/c Dr. To Cash A/c (Being our acceptance due this date duly met)			3,432	3,432

Illustration - 15

On the 1st of January Viswanath supplied goods to Sunil of the value of Rs. 9,000/- He received three Bills of exchange for Rs.3,000/- each due respectively after two, three and four months from Sunil in settlement. A week later, Viswanath discounted the first Bill with his bank at a discount of Rs. 60/- and held the other Bills.

The first two Bills were paid at maturity. On the date of maturity of the third one Sunil arranged to retire the Bill paying Rs. 1,000/- in cash and giving Viswanath a fresh Bill for four months to cover the balance with interest at the rate of 6% per annum.

Viswanath discounted this Bill for Rs. 1,920/-
Set forth the journal entries in the books of Viswanath.

Solution

In the Books of Viswanath
JOURNAL

				Rs.	Rs.
1989 Jan. 1	Sunil's A/c Dr. To Sales A/c (Being Sale of goods)			9,000	9,000
1989 Jan. 1	Bills Receivable A/c Dr. To Sunil's A/c (Being Sunil's acceptance received for Bills No. 1,2 & 3 of Rs. 3000 each)			9,000	9,000
1989 Jan. 8	Bank A/c Dr. Discount A/c Dr. To Bills Receivable (No. 1) A/c (Being the first Bill discounted)			2,940 60	3,000

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1989 April 4	Bank A/c To Bills Receivable (No. 2) A/c (Being payment for the II Bill duly received on the due date i.e. 3 months plus 3 days of grace)	Dr.	3,000	3,000
1989 May. 4	Sunil A/c To Bills Receivable (No. 3) A/c (Being cancellation of III Bill on renewal)	Dr.	3,000	3,000
1989 May. 4	Bank A/c To Sunil's A/c (Being amount received)	Dr.	1,000	1,000
1989 May. 4	Bills Receivable (No. 4) A/c To Sunil's A/c To Interest A/c (Being fresh acceptance including interest)	Dr.	2,040	2,000 40
1989 May. 4	Bank A/c Discount A/c To Bills Receivable (No. 3) A/c (Being the new Bill discounted)	Dr.	1,920 120	2,040

9.9 INSOLVENCY OF DEBTOR/ACCEPTOR

Sometimes the drawee/acceptor becomes insolvent before the due date of the Bill. An insovent is a person whose assets are insufficient to pay his liabilities. An insolvent's estate might realise some amount on sale of asets which might not be enough to pay the creditors in full in which case the amount available would be distributed pro-rate among all the unsecured creditors. Each creditor may get 20 paise or 30 paise. or such other amount in every rupee due to him depending on the amount available and the total amount due to creditors by the insolvent. This part payment made finally is called the full and final dividend.

In the Bill transactions, when the drawee becomes insolvent we pass the entry for dishonour. Whatever amount is received from the estate of the insolvent will be debited to cash a/c and the balance treated as bad debts.

Following are the entaies on renewal in different circumstances in the books of the Drawer and the Drawee/ Acceptor.

Illustration :16

On 5th January, 1989 Dilawar purchased goods from Murthy for Rs.5,000/- and accepted a Bill for three months for an identical amount. Before the due date, being unable to find sufficient funds to discharge the Bill, Dilawar requested Murthy to accept Rs. 1,500/- and draw a fresh Bill for the balance due plus interest of Rs. 150/- for a further period of 4 months. Accordingly, a fresh Bill was drawn and accepted on the due date of the first Bill.

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Before the due date of the Second Bill Dilawar requested once again for renewal. Murthy drew a fresh Bill again for two months including the interest of Rs.125/-. Before the due date of this Bill Dilawar became insolvent and only 25 paise in rupee was received as first and final dividend.

Journalise the above transactions in the books of Murthy and Dilwar.

Solution

In the Books of Murthy
JOURNAL

1989 Jan. 5	Dilwar's A/c To Sales A/c (Being sale of good)	Dr.		5,000	5,000
1989 Jan. 5	Bills Receivable A/c To Dilawar's A/c (Being Bill received after acceptance)	Dr.		5,000	5,000
1989 Apl. 8	Dilawar's A/c To Bills Receivable A/c (Being cancellation of the bill for renewal)	Dr.		5,000	5,000
1989 Apl. 8	Cash A/c To Dilwar's A/c (Being part payment received)	Dr.		1,500	1,500
1989 Apl. 8	Bills Receivable A/c To Interest A/c To Dilawar's A/c (Being fresh acceptance received from Dilawar including interest)	Dr.		3,650	150 3,500
1989 Aug.11	Dilawar's A/c To Bills Receivable A/c (Being cancellation of the second Bill for renewal)	Dr.		3,650	3,650
1989 Jan.11	Bills Receivable A/c To Interest A/c To Dilawar's A/c (Being fresh acceptance received including interest)	Dr.		3,775	125 3,650
1989 Oct. 14 or before	Dilawar's A/c To Bills Receivable A/c (Being the dishonour of the Bill on insolvency)	Dr.		3,775	3,775
1989 Oct.14	Cash A/c Bad Debts A/c To Dilawar's A/c (Being 0.25 paise per rupee received from the estate of Dilawar on his becoming insolvent)	Dr. Dr..		943.75 2,831.25	3,775

BRAOU

In the Books of Dilawar

JOURNAL

1989 Jan. 5	Purchases A/c	Dr.		5,000	
	To Murthy's A/c				5,000
	(Being credit purchases)				
1989 Jan. 5	Murthy's A/c	Dr.		5,000	
	To Bills Payable A/c				5,000
	(Being our acceptance sent)				
1989 Apl. 8	Bills Payable A/c	Dr.		5,000	
	To Murthy's A/c				5,000
	(Being cancellation of our acceptance on renewal)				
1989 Apl.8	Murthy's A/c	Dr.		1,500	
	To Cash A/c				1,500
	(Being part payment made)				
1989 Apl.8	Murthy's A/c	Dr.		3,500	
	Interest A/c	Dr.		150	
	To Bills Payable A/c				3,650
	(Being fresh acceptance for the balance plus Interest sent)				
1989 Apl .11	Bills Payable A/c	Dr.		3,650	
	To Murthy's A/c				3,650
	(Being cancellation of our second acceptance on renewal)				
1989 Apl.11	Murthy's A/c	Dr.		3,650	
	Interest A/c	Dr.		125	
	To Bills Payable A/c				3,775
	(Being fresh acceptance including interest sent)				
1989 Oct.14	Bills Payable A/c	Dr.		3,775	
	To Murthy's A/c				3,775
	(Being dishonour of our III acceptance)				
1989 Oct 14	Murthy's A/c	Dr.		3,775	
	To Cash A/c				943.75
	To Profit & Loss A/c *				2,831.25
	(Being 0.25 paise in a rupee paid & amount transferred to Profit & Loss A/c)				

* This amount can also be credited to Deficiency Account opened in the books of insolvent.

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9.10 SUMMING UP

A Bill of Exchange is a negotiable instrument. It may be a Bill made by the drawer or a Promissory Note made by the drawee. The need for Bills of Exchange arises out of credit sale transactions. The Bill or the Promissory-Note may be dealt with by the drawer in any of the following four ways :

a) It may be retained with the drawer himself ;
b) It may be discounted ;
c) It may be endorsed; or
d) It may be sent to Bank for collection.

On the due date or date of maturity the Bill under each of the above cases may be honoured or dishonoured, i.e., the drawee may make the payment or may fail to pay. A Bill may be paid off before the due date in which case the drawee is given some rebate. This is called the "retirement of Bill under rebate".

When the drawee is unable to arrange payment of the Bill, he may request the drawer to grant him extension in time for which some interest is offered. Part payment may or may not be made. In such a case the old Bill is cancelled and a fresh Bill is drawn giving the drawee some more time. This is known as 'Renewal of Bills'. A renewed Bill may be honoured or dishonoured on due date or further renewal may be sought. The drawee may also become insolvent.

9.11 ANSWERS TO CHECK YOUR PROGRESS

1) i) a) Drawer, b) Drawee and c) Payee

2) i) Some times the 'drawee' is willing to make the payment, before the date of maturity, for which, it is normal practice to allow him some discount. This is known as 'Retiring the Bill, under rebate'.

3) i) When the drawer agrees to the proposal of the drawee, that the old Bill is cancelled and a fresh Bill is drawn for a fresh period. This is known as "Renewal of the Bill".

9.12 MODEL EXMINATION QUESTIONS

A. Short Answer Questions

1. Define Bill of Exchange.
2. Distinguish between Bill of Exchange and Promissory Note.
3. What is Bill of Exchange ? Who are parties to the Bill ?
4. Explain days of grace and days of maturity.
5. Explain the following.
   a) Indian Bill and Foreign Bill.
   b) Endorsement of a Bill.
6. What do you understand by :
   a) Discounting of a Bill
   b) Honour and dishonour of a Bill
7. What are the advantages of a Bill?
8. Explain the following
   a) Noting and Protesting
   b) Acceptance of a Bill.

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B. Essay Answer Questions.

9. Explain the following:
   a) Retirement under rebate.
   b) Renewal of Bill.
   c) Endorsement of Bill.
   d) Days of grace and term of the Bill.

10. Distinguish between a Promissory Note and a Bill of Exchange and bring out their importance.
11. Explain different types of renewals with the help of journal entries.
12. What are the circumstances in which a Bill is retired under rebate and when is interest added to the Bill amount ? Write specimen journal entries wherever necessary.
13. Make out a specimen each of a Promissory Note and a Bill and show who the various parties to the Bill are with their help.

PROBLEMS

1. X drew a Bill on Y for Rs.10,000 for three months, Show what entries would appear in the books of X and Y in each of the following cases, assuming that the Bill was met on the date of maturity.
   (a) If X retained the Bill till the date of maturity.
   (b) If he discounted it for Rs.9,750/-
   (c) If he endorsed it in favour of his creditors Rao & Co.
   (d) If the Bill was sent to the Bank for collection.

2. What differences in the entries it would have made if the Bill was dishonoured in each of the above mentioned cases ?

3. Devilal who had owed Rs. 8,500/- to Ramakrishna discharged his debt by accepting on 2nd January, 1989 two Bills for Rs. 4,000/- and Rs. 4,500/- for 3 months and 4 months respectively.

   Ramakrishna discounted both the bills on the same day at a discount of 9% per annum. The first Bill was duly met on the date of maturity. Before the due date of the second Bill Devilal approached Ramakrishna to cancel the Bill and draw on him a fresh Bill for Rs.4,800 for a further period of three months, Ramakrishna, accordingly, drew a fresh Bill on the due date of the second Bill. The third Bill was endorsed to Raghuram. Devilal could not meet this Bill. Raghuram incurred noting charges of Rs. 50/-
   Journalise the transactions in the books of Ramakrishna, Devilal and Raghuram.
   (Devilal's A/c(Dr.) Rs. 4,850. Raghuram's A/c (Cr.) Rs. 4,850)

4. For goods supplied on the 1st of January, 1990 Ganesh drew a Bill on Dinesh for Rs.3,100 due three months after date. The Bill was endorsed to Mahesh who discounted it at 5% per annum. On the due date the Bill was dishonoured and Ganesh took it up paying noting charges of Rs. 10/- journalise the above transactions in the books of Ganesh, Dinesh and Mahesh.
   (Dinesh A/c Rs. 3,110/- Dr. Balance)

5. Journalise the following transactions :
   a) Retired our acceptance in favour of Javed for Rs. 2,600/- at a rebate of Rs. 150/-
   b) Ram Rajesh's Promissory Note endorsed in favour of Raj Narain Rs. 3,000 wasdishonoured.Raj Narain paid Rs.40/- as Noting charges.
      We paid Raj Narain by cheque and received from Ram Rajesh another Bill for the amount due plus interest of Rs. 100/-
   c) Our own acceptance to Lalit Mishra for Rs. 750/- dishonoured due to absence of necessary instructions to the bank in time. We had to pay Rs. 780/- by cheque to Lalit Mishra including his expenses.
   d) Raju's acceptance for Rs. 4,500/- renewed for 3 months at 12% per annum interest.
   e) Our acceptance to Mehta for Rs. 1,200/- was discharged by Shouries acceptance to us for a similar amount.

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(Bills Payable A/c Dr. to Bills Receivable A/c.)

f) Megreger's acceptance for Rs. 2,800/- sent to the bank for collection was dishonoured and bank paid Rs. 50/- as noting charges.

g) Srikant's acceptance to us for Rs. 2,000/- due this date was dishonoured, owing to his insolvency. 25 paise in a rupee was received from the estate of Srikanth.

6. On the 1st January, 1989 Satyanarayana supplied goods to David of the value of Rs. 9,000/- and settled the account by means of three Bills of Exchange for Rs. 3,000 each due respectively after two, three and four months. A week later, Satyanarayana discounted the first Bill with this bank at a discount of Rs. 60/- he held the other bills.
The first two bills were paid at maturity. On the date of maturity of the third one David arranged to retire the Bill paying Rs. 1,000 in cash and giving Satyanarayana a fresh bill for four months to cover the balance with interest @ 6%p.a This Bill was discounted for Rs. 1,920/-

Set forth the journal entries in the books of Satyanarayana
(Interest Rs.40, New Bill Rs.2,040, Discount Rs. 80, David's A/c is closed).

7. On the 1st of April, 1989 Y owed to X Rs. 2,400/- for which the latter drew three Bills No. 1 for Rs. 700 at one month, No. 2 for Rs. 800 at two months, and No. 3 for Rs.900 at three months. Y accepted and returned these bills to X
X endorsed on the 20th of April the first Bill to his creditor, Z, in full settlement of his account of Rs. 710/- discounted on the 22nd of April the second Bill at his Bank Rs.792/- and retained the third Bill.
The first Bill was met at maturity. The Second Bill was dishonoured on the due date, Rs. 10/- being paid for noting charges x changed Rs.15/- as interest and drew a fresh Bill for Rs.825/- at three months. The third nd fourth bills were duly honoured on their due dates. Pass necessary journal entries in the books of X.
(X receives a discount of Rs. 10 on endorsement of first bill to Z)

9.14 GLOSSARY

1. Acceptance	Consent of the drawee to the order of the drawer of a Bill.
2. Acceptor	Person who accepts the Bill (very often the drawee himself)
3. Bill of Exchange	An instrument in writing containing an unconditional order, signed by the maker directing a certain person to pay a certain sum of money only to or to the order of a certain person or the bearer of an instrument.
4. Bill Receivable	A Bill of exchange on which money is receivable by the businessman.
5. Bill Payable	A Bill of Exchange on which money is payable by the businessman.
6. Bills For Collection	Bills Receivable sent by the businessman to his banker to be collected on his behalf on the due date.
7. Drawer	The maker of a Bill
8. Drawee	The person on whom a Bill is drawn.
9. Due Date or Date of Maturity	The date on which a Bill becomes payable.

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10. Days of Grace	Three days are added to the term of the Bill to fix the due date as per business convention. These days are called 'days of grace'
11. Discounting	Act of endorsing the Bill in favour of the banker to obtain money before its due date.
12. Dishonour	Drawee failing to pay the amount on the due date.
13. Endorsement	Transferring a Bill Receivable in favour of a third person by signing on the reverse side of the instrument.
14. Endorser	The party endorsing the instrument.
15. Endorsee	The party in whose favour an instrument (B/E) is endorsed.
16. Foreign Bill	A Bill drawn outside India but payable in India or drawn in India but payable outside.
17. Honouring the Bill	The drawee making payment on the due date.
18. Hundi	An instrument when drawn in vernacular is called 'hundi'(for example, in Hindi or Telugu).
19. Insolvent	When a person's assets are insufficient to meet his liabilities, he is called an Insolvent. An Insolvent will not be able to meet the Bill.
20. Inland Bill	A Bill drawn and payable within the country.
21. Meeting the Bill	The drawee making payment on the due date.
22. Note	Promissory Note. An instrument in writing containing an unconditional undertaking signed by the maker to pay a certain sum of money to or to the order of a certain person or bearer of the Instrument.
23. Noting And Protesting	Getting the fact of dishonour of a Bill noted by a Notary public and obtaining a certificate to that effect.
24. Promisor	The maker of the Promissory Note who undertakes to pay.
25. Promisee	The person in whose favour the Promissory Note is made.
26. Payee	The person named in the instrument to whom money (of the Bill) is payable.
27. Renewal	The act of cancelling the old Bill and drawing a fresh Bill.
28. Retiring A Bill Under Rebate.	The drawee paying the Bill before the due date in which case the drawer usually gives him some rebate.
29. Trade Bill	A Trade Bill is drawn and accepted to settle indebtedness arising out of commercial transactions.

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30. Term or Tenor of The Bill — The period after which the Bill becomes payable.

31. Via — Copies of a foreign Bill.

Writer : Sri P. Diwakar Rao

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UNIT - 10 : ACCOMMODATION BILLS

Contents

10.0 Aims and Objectives
10.1 Introduction
10.2 Different Methods of Accommodation
10.3 Summing Up
10.4 Model Examination Questions
10.5 Recommended Books
10.6 Glossary

10.0 AIMS AND OBJECTIVES

The aims of this unit are to discuss 1) the accounting aspects of the Bills of Exchange used as a means of providing short-term financial accommodation to one or more parties, and
2) the different methods adopted to achieve this end.

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

- understand the accounting aspects of the Bills of Exchange used as a means of providing short term financial accommodation to one or more parties.
- solve the problems.

10.1 INTRODUCTION

The Bill transactions which we have so far discussed have arisen out of the indebtedness on the part of one of the parties to the Bill who gives acceptance to the Bill in discharge of his trade debt. Usually he owes that money to the drawer of the Bill for the goods he has earlier purchased from him on credit. Accommodation Bills are entirely different from others although the drawing of the Bill and its acceptance are much the same. An accommodation Bill, as the name itself indicates, is drawn and accepted for the financial accommodation of the parties to the Bill. There is no indebtedness on the part of the acceptor of the Bill of accommodation before he actually accepts it. The acceptor accepts the Bill in this case merely to enable the drawer to discount it at the bank and receive cash immediately. As these Bills are used for the purpose of securing short-term financial accommodation they are called 'Accommodation Bills' as distinguished from the Trade or Commercial Bills discussed earlier in Unit -9 . The Accommodation Bills are also called 'Kites' or Finance Bills'

There is no difference between Trade and Accommodation Bills in so far as the accounting treatment is concerned. The same entries for acceptance, honour and dishonour are made in this case also. But the Accommodation Bills are distinct in the sense that they are drawn and 'accepted without consideration. The proceeds obtained by discounting an Accommodation Bill may be utilised for the term of the Bill by one party only or by both the parties., i.,e., the drawer as well as the Acceptor in some agreed ratio. The banker who discounts the Bill does not know whether it is a trade Bill or accommodation Bill. He provides the discounting facility depending on the credit-worthiness and integrity of the drawer and drawee.

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10.2 DIFFERENT METHODS OF ACCOMMODATION

All Accommodation Bills are made for the purpose of securing short-term financial accommodation through discounting. In practice the parties to the Bill may follow different methods depending upon the need and convenience. Usually, the following three methods are followed.

1. The acceptor accepts a Bill to help the drawer discount it and utilise the funds till the due date. The acceptor does not owe any thing. He merely helps his friend (the drawer) to obtain funds. On the due date the drawer remits the full amount of the Bill to the Drawee or Acceptor to enable him to meet it at the bank.

2. After 'discounting the Bill the Drawer and the Acceptor share the proceeds in agreed proportions. They also share the discount in the same proportions. On the due date the drawer remits his portion of the amount of the Bill to the Acceptor. The latter adds the amount utilised by him and meets the Bill. Thus, the Bill is used by both the parties to accommodate each other.

3. Instead of the drawer and drawee sharing the proceeds as in the above mentioned case each party draws a Bill upon the other and each party discounts his own Bill and utilises the proceeds. This means that there will be two accommodation Bills. Thus the inconvenience of sharing the proceeds of the single Bill and remittance before the due date is avoided. The two Bills may be drawn for identical sums or different sums. If they are made for different sums the person utilising more funds will have to send the excess to the other by the due date.

For example, 'A' draws on 'B' a Bill for Rs. 3,000. B sends his acceptance and at the same time 'B' draws upon A for Rs.5,000/- which A accepts. Both discount the Bills. Here B's Bill is for a higher amount than A's i.,e., Rs. 2,000/- more. So B will have to remit this amount i.c., Rs. 2,000/- to A by the due date.

As stated earlier, the entries to be made are the same for Accommodation Bill transactions and Commercial Bill Transactions, and the same principles apply. The only difference is in respect of cash remittances sent by the drawer of the Bill to the drawee in accordance with their agreement to share fund utilisation for which the usual entries are made as follows:

Debiting cash account when cash is coming in and Crediting the personal account of the 'Giver'; and Crediting cash account when it is going out and debiting the personal account of the 'Receiver'.
The following illustrations make the position clear.

Illustration -1

For the accommodation of Sivaram, Ashwini accepts a Bill drawn upon him by the former for Rs. 4,000/- for 3 months. The Bill is discounted by Sivaram @ 9%.

On the due date Sivaram remits the amount to Ashwini who meets the Bill.

Record the above transactions in the books of both the parties

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Solution

In the Books of Sivaram

JOURNAL

	Bills Receivable A/c Dr			4,000	
	To Ashwini's A/c				4,000
	(Being ashwini's Acceptance received)				
	Bank A/c Dr.			3,910	
	Discount A/c Dr.			90	
	To Bills Receivable A/c				4,000
	(Being discounting of the Bill)				
	On Due Date				
	Ashwini's A/c Dr.			4,000	
	To Cash A/c				4,000
	(Being amount sent to Ashwini to enable him to meet the Bill)				

LEDGER ACCOUNTS

Dr. ASHWINI'S ACCOUNT Cr.

		Rs.			Rs.
	To Cash A/c	4,000		By Bills Receivable A/c	4,000

Dr. BILLS RECEIVABLE ACCOUNT Cr.

		Rs.			Rs.
	To Ashwini's A/c	4,000		By Bank A/c	3,910
				By Discount A/c	90
		4,000			4,000

NOTE : Even though it is not specified that the discount rate is per annum, it is always to be taken that the rate of discount is per annum unless otherwise stated and accordingly, the proportionate discount for three months is calculated.

PRAOU

In the Books of Ashwini

JOURNAL

			Rs.	Rs.
	Sivaram's A/c Dr		4,000	
	To Bills Payable A/c			4,000
	(Being our Acceptance sent for accommodation of Sivaram)			
	On Due Date			
	Cash A/c Dr.		4,000	
	To Sivaram's A/c			4,000
	(Being amount received)			
	Bills Payable A/c Dr.		4,000	
	To Cash A/c			4,000
	(Being Sivaram's Bill due this date duly met)			

LEDGER ACCOUNTS

Dr. SHIVARAM'S ACCOUNT Cr.

		Rs.			Rs.
	To Bills Payable A/c	4,000		By Cash A/c	4,000

Dr. BILLS PAYABLE ACCOUNT Cr.

		Rs.			Rs.
	To Cash A/c	4,000		By Sivaram's A/c	4,000

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Illustration -2

On the 1st of January, 1985 Murali drew a Bill for Rs. 15,000 on Ramesh for 4 months, payable at Bank of India, Bangalore. The Bill was discounted by Murali after acceptance @ 9%. 1/3 of the proceeds was remitted to Ramesh. On the due date Murali sent the necessary amount to Ramesh who met the Bill duly. Journalise in the books of both the parties.

Solution

In the Books of Ashwini

JOURNAL

			Rs.	Rs.
1985				
Jan.1	Bills Receivable A/c	Dr	15,000	
	To Ramesh's A/c			15,000
	(Being Ramesh's acceptance received)			
	Cash A/c	Dr.	14,550	
	Discount A/c	Dr.	450	
	To Bills Receivable A/c			15,000
	(Being Ramesh's Acceptance Discounted)			
	Ramesh's A/c	Dr.	5,000	
	To Cash A/c			4,850
	To Discount A/c			150
	(Being 1/3rd amount sent and 1/3rd of discount debited to Ramesh)			
May.4	Ramesh A/c	Dr.	10,000	
	To Cash A/c			10,000
	(Being 2/3rd amount utilised by us sent to Ramesh to meet the Bill)			

NOTE : As Ramesh had received 1/3rd amount he must also bear 1/3rd of discount (450 × 1/3) As Murali retained 2/3 of the amount, he had to send on the 2/3 of the Bill amount on the due date so that Ramesh could add his 1/3 to it and meet the Bill.

In the Books of Ramesh

JOURNAL

			Rs.	Rs.
1985				
Jan.1	Murali's A/c	Dr	15,000	
	To Bills Payable A/c			15,000
	(Being our acceptance sent)			
	Cash A/c	Dr.	4,850	
	Discount A/c	Dr.	150	
	To Murali's A/c			5,000
	(Being 1/3rd proceeds received and 1/3rd discount borne by us)			

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May. 4	Cash A/c To Murali's A/c (Being 2/3rd of bill amount being Ramesh's share received on the due date)	Dr.		10,000	10,000
	Bills Payable A/c To Cash A/c (Being our acceptance due this date duly met)	Dr.		15,000	15,000

NOTE : Ramesh adds his share of the Bill amount utilised by him (including the discount) Rs. 5,000 to the amount received from Murali which is 2/3rd of it and meets the Bill.

Illustration - 3

On the 1st of April, 1989 Saxena and Somayajulu agreed to draw on each other a Bill of exchange at 4 months for Rs. 3,000 and to discount the other Bill, each meeting his own acceptance as it would become due. Both Bills were accepted and discounted at 5 per cent per annum. Saxena met his own acceptance on maturity, but Somayajulu's acceptance was dishonoured and the drawer was called upon to take it up. Expenses charged by the bank on the dishonoured Bill amounted to Rs. 50/- Somayajulu accepted a new Bill drawn by Saxena at 4 months for the amount due to the latter plus interest at 6 percent. This Bill was met by Somayajulu on Maturity.

Write up the Journal Entries in the books of both the parties.

Solution

In the Books of Saxena

JOURNAL

				Rs.	Rs.
1989 Apr.1	Bills Receivable A/c To Somayajulu's A/c (Being Somayajulu's acceptance received at 4 months)	Dr		3,000	3,000
	Bank A/c Discount A/c To Bills Receivable A/c (Being Somayajulu's acceptance discounted)	Dr. Dr.		2,950 50	3,000
	Somayajulu's A/c To Bills Payable A/c (Being our acceptance sent)	Dr.		3,000	3,000

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Aug. 4	Bills Payable A/c To Cash A/c (Being our acceptance due this date duly met)	Dr.		3,000	3,000
	Somayajulu's A/c To Bank A/c (Being amount paid on dishonour by Somayajulu including Rs.50/- for charges)	Dr.		3,050	3,050
	Bills Receivable A/c To Interest A/c To Somayajulu's A/c (Being fresh acceptance received from Somayajulu including interest and charges 3,000 +50+61)	Dr.		3,111	61 3,050
Dec.7	Cash A/c To Bills Receivable A/c (Being Somayajulu's acceptance due this date met by him)	Dr.		3,111	3,111

In the Books of Somayajulu

JOURNAL

				Rs.	Rs.
1989					
	Saxena's A/c To Bills Payable A/c (Being our acceptance sent)	Dr		3,000	3,000
	Bills Receivable A/c To Saxena's A/c (Being Saxena's acceptance received for an identical amount)	Dr.		3,000	3,000
	Bank A/c Discount A/c To Bills Receivable A/c (Being Saxena's acceptance discounted at bank at 5%)	Dr. Dr.		2,950 50	3,000
Aug.4	Bills Payable A/c To Saxena's A/c (Being our acceptance due this date dishonoured)	Dr.		3,000	3,000

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	Noting charges A/c Dr. To Saxena's A/c (Being noting charges due to Saxena on our dishonoured Bill)			50	50
	Saxena's A/c Dr. Interest A/c Dr. To Bills Payable A/c (Being fresh acceptance sent for the Original amount of the Bill plus noting charges plus interest)			3,050 61	3,111
Dec.7	Bills Payable A/c Dr. To Cash A/c (Being our second acceptance due this day duly met)			3,111	3,111

Note : The Student is advised to prepare ledger accounts also and see for himself how the position is reflected by these accounts. The question set here however, does not require it.

Illustration -4.

Surender accepted a Bill drawn upon him by Kishore Sahu for Rs.24,000 at 3 months for mutual accommodation, to be shared equally. After acceptance, Kisohare Sahu discounted the Bill at 6% and remitted half of the proceeds to Surender as he had been agreed upon

On the due date of the Bill Kishore Sahu remitted his half share in cash to Surender. But Surender failed to meet the Bill and Kishore Sahu had to take it up.

Surender accepted another Bill for the total amount due from him plus interest of Rs.540/- for three months. The second Bill was duly met.

Journalise the above transactions in the books of both the parties and also show how Surender's A/c and Kishore Sahu's A/c appear in each other's books.

Solution

In the Books of Kishore Sahu

JOURNAL

			Rs.	Rs.
1	Bills Receivable A/c Dr To Surender's A/c (Being Surender's acceptance received.)		24,000	24,000
2	Bank A/c Dr. Discount A/c Dr. To Bills Receivable A/c (Being the Bill discounted at 6%)		23,640 360	24,000

3	Surender's A/c Dr. To Cash A/c To Discount A/c (Being half the amount remitted and half of discount debited to Surender)		12,000	 11,820 180
	On the due date			
4.	Surender's A/c Dr. To Cash A/c (Being half the amount of the Bill sent towards our share)		12,000	 12,000
5	Surender's A/c Dr. To Bank A/c (Being amount paid on dishonour of Surender's acceptance)		24,000	 24,000
6	Bills Receivable A/c (No.2) Dr. To Surender's A/c To Interest A/c (Being fresh acceptance received including interest)		24,540	 24,000 540
	On the due date of the Second Bill			
7	Cash A/c Dr. To Bills Receivable A/c (No.2) (Being amount realised)		24,540	 24,540

Dr. SURENDER'S ACCOUNT Cr.

	Rs.		Rs.
To Cash A/c	11,820	By B/Receivable A/c	24,000
To Discount A/c	180	By B/R A/c (No.2)	24,000
To Cash A/c	12,000		
To Bank A/c	24,000		
	48,000		48,000

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In the Books of Surender

JOURNAL

				Rs.	Rs.
1	Kishore Sahu's A/c	Dr		24,000	
	To Bills Payable A/c				24,000
	(Being Bills sent after acceptance)				
2	Cash A/c	Dr.		11,820	
	Discount A/c	Dr.		180	
	To Kishore Sahu's A/c				12,000
	(Being amount received and discount borne)				
	On the due date				
3	Cash A/c	Dr.		12,000	
	To Kishore Sahu's A/c				12,000
	(Being amount received being his share of the Bill amount)				
4.	Bills Payable A/c	Dr.		24,000	
	To Kishore Sahu's A/c				24,000
	(Being dishonour of our acceptance)				
5	Kishore Sahu's A/c	Dr.		24,000	
	Interest A/c	Dr.		540	
	To Bills Payable A/c (No.2)				24,540
	(Being fresh acceptance including interest sent)				
	On the due date of the Second Bill				
6	Bills Payable A/c (No.2)	Dr.		24,540	
	To Bank A/c (or Cash)				24,540
	(Being our acceptance due this date discharged)				

Dr. KISHORE SAHU'S ACCOUNT Cr.

	Rs.		Rs.
To Bills Payable A/c	24,000	By Cash A/c	11,820
To Bills Payable A/c(No.2)	24,000	By Discount A/c	180
		By Cash A/c	12,000
		By Bills Payable A/c	24,000
	48,000		48,000

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Illustration - 5

For the purpose of mutual accommodation of Chandrashakhar and Umesh the former drew a Bill on the latter for Rs. 9,000/- for 4 months. After acceptance, the Bill was discounted by Chandrasekhar at 9% p.a ., and immediately One Third of the proceeds was remitted to Umesh as they had agreed to share in the ratio of Two Third and One Third.

Before the due date, Chandrasekhar could not arrange to pay the Two Third of the amount utilised by him Umesh drew another Bill for Rs.12,500 in order to provide funds needed to meet the first Bill. The second Bill was discounted for Rs.12,150/- and the first Bill was met, Rs. 2,100 was remitted to Chandrasekhar. Before the due date of the second Bill . Chandrasekhar became insolvent. Umesh received a first and final discount of 50 paise per rupee from the insolvent's estate.

Pass the necessary Journal Entries in the books of Chandrasekhar and Umesh. Also show Chandrasekhar's A/c in Umesh's ledger.

Solution

In the Books of Chandrasekhar

JOURNAL

				Rs.	Rs.
1	Bills Receivable A/c To Umesh A/c (Being Umesh's acceptance received.)	Dr		9,000	9,000
2	Bank A/c Discount A/c To Bills Receivable A/c (Being the Bill discounted at 9%)	Dr. Dr.		8,730 270	9,000
3	Umesh A/c To Cash A/c To Discount A/c (Being One Third of the proceeds remitted and One Third of discount debited to Umesh)	Dr.		3,000	2,910 90
4.	Umesh A/c To Bills Payable A/c (Being our acceptance sent)	Dr.		12,500	12,500
5	Cash A/c Discount A/c * To Umesh (Being amount received and discount proportionately borne)	Dr. Dr.		2,100 233*	2,333
6	Bills Payable A/c To Umesh's A/c (Being dishonour of our acceptance on insolvency)	Dr.		12,500	12,500
7	Umesh A/c To Cash A/c To Profit and Loss A/c (or Unpaid A/c) (Being 50 paise per rupee paid and the rest written off to P&L A/c)	Dr.		8,333	4,166-50 4,166-50

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*Discount Calculation:

Amount Due on the first Bill by Chandrasekhar		Rs.6,000-00
Amount received from Umesh out of the proceeds of the Second Bill		Rs.2,100-00
	Total amount	Rs.8,100-00
Total amount of Second Bill		Rs. 12,500-00
Cash Proceeds of Second Bill		Rs. 12,150-00
	Discount	Rs. 350-00
Proportionate Discount to be borne by Chandrasekhar for Rs.8,100/- due from him	350 x 8,100 + 12,150=233	

In the Books of Umesh

JOURNAL

				Rs.	Rs.
1	Chandrasekhar's A/c	Dr		9,000	
	To Bills Payable A/c				9,000
	(Being our acceptance sent)				
2.	Cash A/c	Dr.		2,910	
	Discount A/c	Dr.		90	
	To Chandrasekhar's A/c				3,000
	(Being 1/3 of Proceeds received and 1/3 of the discount borne)				
3.	Bills Receivable A/c	Dr.		12,500	
	To Chandrasekhar's A/c				12,500
	(Being Chandrasekhar's Acceptance received)				
4.	Bank A/c	Dr.		12,150	
	Discount A/c	Dr.		350	
	To Bills Receivable A/c				12,500
	(Being Chandrasekhar's acceptance discounted)				
5.	Bills Payable A/c	Dr.		9.000	
	To Bank A/c				9,000
	(Being our acceptance duly met)				
6.	Chandrasekar's A/c	Dr.		2,333	
	To Cash A/c				2,100
	To Discount A/c				233
	(Being amount sent and proportionate discount debited)				

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	On the due date of II Bill			
7.	Chandrasekhar's A/c Dr. To Bank A/c (Being amount paid to the bank on the dishonour of the Bill due to the insolvency of Chandrasekhar)		12,500	12,500
8.	Cash A/c Dr. Bad Debts A/c Dr. To Chandrasekhar's A/c (Being dividend @ 0.50 paise. received from Chandrasekhar's estate and the balance written off)		4,166-50 4,166-50	8,333-00

Dr. CHANDRASEKHAR'S ACCOUNT Cr.

	Rs.		Rs.
To Bills Payable A/c	9,000	By Cash A/c	2,910
To Cash A/c	2,100	By Discount A/c	90
To Discount A/c	233	By Bills Receivable A/c	12,500
To Bank A/c	12,500	By Cash A/c	4,166-50
		By Bad Debts A/c	4,166-50
	23,833		23,833-00

Illustration - 6

For the purpose of mutual accommodation Patel and Murthy drew Bills on each other. On January 2, 1988 Patel drew a Bill on Murthy for Rs.1,000 Payable at three months and on the 3rd of January, 1988 Murthy drew a Bill on Patel for Rs.500/- Payable at three months. As per their agreement both the Bills were immediately discounted at 5% per annum and the proceeds shared equally. On maturity of the first Bill Murthy became insolvent and was unable to honour the Bill. A divdend of 50% however, was realised from his estate on June 30,1988.

Show the relevant account in the books of Patel, who closed his books on June 30, 1988.

Solution

Although the question requires the writing up of ledger accounts only in the books of Patel, Journal entries are also recorded to guide the student. The student should, however, practice to prepare ledger accounts without first passing journal entries.

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In the Books of Patel

JOURNAL

			Rs.	Rs.
1988				
Jan.2	Bills Receivable A/c	Dr	1,000	
	To Murthy's A/c			1,000
	(Being Murthy's acceptance received)			
	Cash A/c	Dr.	987-50	
	Discount A/c	Dr.	12-50	
	To Bills Receivable A/c			1,000
	(Being discounting of the Bill)			
	Murthy's A/c	Dr.	500	
	To Cash A/c			493-75
	To Discount A/c			6-25
	(Being half of the proceeds remitted)			
June.3	Murthy's A/c	Dr.	500	
	To Bills Payable A/c			500
	(Being our acceptance sent)			
	Cash A/c	Dr.	246-88	
	Discount A/c	Dr.	3-12	
	To Murthy's A/c			250
	(Being amount received and discount shared)			
April.5	Murthy's A/c	Dr.	1,000	
	To Cash A/c			1,000
	(Being Murthy's acceptance due this date taken up by us on dishonour due to insolvency)			
April.6	Bills Payable A/c	Dr.	500	
	To Cash A/c			500
	(Being our acceptance due this date dishonoured)			
June.30	Cash A/c	Dr.	375	
	Bad Debts A/c	Dr.	375	
	To Murthy's A/c			750
	(Being 50% dividend realised and the balance written off as irrecoverable)			

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LEDGER ACCOUNTS

Dr. BILLS RECEIVABLE ACCOUNT Cr.

	Rs.		Rs.
To Murthy's A/c	1,000	By Cash A/c	987-50
		By Discount A/c	12-50
	1,000		1,00-50

Dr. MURTHY'S ACCOUNT Cr.

To Cash A/c	493-75	By Bills Receivable A/c	1,000-00
To Discount A/c	6-25	By Cash A/c	246-88
To Bills Payable A/c	500-00	By Discount A/c	3-12
To Bank A/c	1,000-00	By Bad Debts A/c.	375-00
		By Cash A/c.	375-00
	2,000-00		2,000-00

Dr. BILLS PAYABLE ACCOUNT Cr.

	Rs.		Rs.
To Cash A/c	500	By Murthy's A/c	500

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10.3 SUMMING UP

When the Bills are drawn for mutual financial accommodation or for the accommodation of the drawer, they are called 'Accommodation Bills'. Financial accomodation is obtained by discounting the Bill. Only one Bill may be drawn and the proceeds are shared in an agreed proportion, that is, sharing the discounting charges in the same proportion, or each party may draw on the other and each discounts his own bill. The possibilities for renewal, honour, dishonour and insolvency on the due date and the accounting entries are the same as in the case of commercial bills.

10.4 MODEL EXAMINATION QUESTIONS

A. **Short Answer Questions**

1. What do you understand by 'Accommodation Bills'?
2. In what way Accomodation Bills are distinct fromCommercial Bills?
3. What are the distinct features ofAccommodaton Bills?

B. Essay Anwer Questions

4. Why are Accommodation Bills so called?
   For whole and what type of accommodation are they made?
5. Explain the distinct features of an Accommodation Bill and distinguish it from other Bills?

PROBLEMS

1. For the mutual accommodation of Madanlal and Dilip, they drew on each other one Bill each for Rs. 5,000. Both the Bills were discounted at Rs. 4,800/- each.
   On the due date both the Bills were duly met. Jounalise these transactions in the books of both the parties and show how Madanlal's A/c, in Dilip's ledger and Dilip's A/c in Madanlal's ledger appear.

2. On the 15th of September, 1984 Farooq drew a Bill for Rs. 9,000 on Mohsin for three months for their mutual accommodation. The Bill was duly accepted and returned by Mohsin. Farooq discounted the Bill at 6% and remitted 1/3 of the proceeds to Mohsin. Before the due date Farooq sent him the balance. But Mohsin dishonoured the Bill on the due date and Farooq had to pay his bankers the amount of the Bill along with noting charges of Rs. 30. Mohsin accepted a fresh Bill for the amount due including an interest of Rs. 150 and noting charges payable after two months.

   Pass the necessary journal entries in the books of Farooq and Mohsin.

   (Answer: Mohsin's A/c. (Dr) Balance Rs. 9,180)

3. Avinash accepted a Bill drawn by Rakesh for Rs.10,000 for three months for accommodating Rakesh, Rakesh discounted the Bill immediately at a discount of Rs.350/-.

   On the due date Rakesh could not send the money to Avinash, Avinash, therefore, had to pay from his pocket and discharge the acceptance. Rakesh accepted two Bills drawn upon him by Avinash for Rs. 5,000/- and Rs. 5,600/- for three months and four months respectively.

   Both the Bills were duly honoured by Rakesh on their respective due dates. Pass Journal entries in the Books of Avinash and write up Avinash Account in Rakesh's ledger

   (Answer :No balances remain in personal accounts or Bills Receivable account or Bills Payable A/c, Interest Rs. 600)

4. Nitin draws a Bill on Bose for Rs. 1,500 which Bose accepts for the sales of mutual accommodation in the ratio of 2:1, i.e., Nitin 2/3 and Bose 1/3. Nitin discounts the Bill for Rs. 1,410 and remits 1/3 of the proceeds to Bose. Before the due date Bose draws another Bill for Rs. 2,100 on Nitin in order to provide funds needed to meet the first Bill. The second Bill is discounted for Rs. 2,040 with the help of which the first Bill is met and Rs. 360/- is remitted to Nitin. Before the due date of second Bill Nitin becomes insolvent and Bose receives a dividend of 50 paise in the rupee in full satisfaction. Pass entries in the books of both the parties

   (Answer :Discount to be borne by Nitin in the second Bill is Rs.40/- i.e.,

   $$(2/3)\ 60\times \frac{1,000+360}{2,040}$$ Bad Debts Rs. 7000/– Dividend Rs: 700)

5. Girish for the purpose of mutual accommodation of himself and Sirish drew upon the latter

a Bill for 3 months for Rs. 800/- 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. 400/-. 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.
(Answer : Bad Debts Rs. 450)

6. On the 1st of October, 1989 M drew a Bill on N for Rs. 500 and N drew a Bill on M for a similar amount, each for a term of 3 months. Both the Bills were discounted. The bank charged Rs. 8/- for discounting each Bill. On the due date N met his bill. M however, informed N of his inability to meet the Bill and N, therefore, had to take it up. M paid N Rs. 200/- on the 3rd of January, 1990 and accepted another Bill drawn by N at two months for Rs. 307/- including interest. This acceptance was met by M on the due date.
Pass Journal entries in the books of both the parties.
(Answer : Interest included in the 3rd of January. Bill Rs. 7/- the personal accounts, the B/R and B/P Accounts will be closed)

7. Shiromany drew a Bill for Rs. 9,000/- on Shivcharan Sing on January 2, 1989 for 3 months. Shiromany got it discounted with the State Bank of India for Rs. 8,820/- and on January 3, 1989 remitted one third of the amount to Singh which he received on January 5th. On the due date Shiromany failed to remit the amount due to Singh, but he accepted a Bill for Rs. 12,600/- for three months which Singh discounted for Rs. 12,330/- and remitted Rs. 2,220/- to Shiromany.

Before the maturity of the renewed Bill Shiromany became insolvent and only 50% was realised from his estate on July 10th.

Pass the necessary journal entries in the books of Shiromany and Shivcharan Singh

(Answer : Discount to be borne by Shiromany on his acceptance

Rs. 180/- being 2/3= $270 \times \frac{6,000+2,220}{12,330}$; Bad Debts Rs.4,200/–)

8. On the 1st of March, 1989. Abraham drew a Bill on Bimal at 3 months for Rs. 1,600/- Abraham discounted it immediately with his banker at 6% and sent half the proceeds to Bimal.
Bimal for a similar purpose and at the same time drew a Bill at 3 months on Abraham for Rs. 800/- which he discounted at 6% and sent half the proceeds to Abraham. Abraham honoured his own acceptance on the due date. Bimal became insolvent on the 31st of May and a first and final dividend of 25 paise in the rupee was paid out of his estate on the 31st of August.

Pass journal entries and open parties accounts in the books of both the parties

(Answer : Bad Debts Rs. 900/-)

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10.5 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)

10.6 GLOSSARY

1. **Accommodation Bill** : Bill drawn and accepted for mutual accommodation.

Writer : Sri. P. Diwakar Rao

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UNIT - 11 TRIAL BALANCE

Contents

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11.0 AIMS AND OBJECTIVES

The aims of this unit are i) to explain the meaning, purpose and importance of Trial Balance,
ii) to show how the Trial Balance is prepared,
iii) to enable the student to appreciate the importance of the arithmetical accuracy of the books of account and to get to know what types of errors arise in this regard.

After going through this unit you will be able to :

- prepare the Trial Balance
- know the errors disclosed by Trial Balance and not disclosed by Trial Balance
- identify the procedure for locating the errors which cause the disagreement of Trial Balance.

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11.1 INTRODUCTION

We have so far seen the method of recording the various types of transactions that usually take place in a business. These transactions are passed through a book of original entry, i.e., any one of the sub-divisions of the Journal or the Journal Proper itself and then the two aspects of it (debit and credit) are posted into the concerned accounts in the ledger. We have also seen that these accounts are periodically balanced and while some acccounts may get closed, the other accounts will show a debit balance or a credit balance. We have discussed earlier the significance of a balance in an account, i.e., it reveals whether it has got more than it has received or vice versa. Having recorded the transaction in the manner outlined above, i.e, journalising, ledger posting and balancing of accounts, a businessman is interested in verifying the arithmetical accuracy of books of account before he proceeds to prepare the Final Accounts. For this purpose, a Trial Balance is prepared containing the balances of all ledger accounts, whether debit balances or credit balances. It is important to ensure arithmetical accuracy through verification because if the Final Accounts are prepared without verification, the conclusion drawn may be inaccurate.

'Arithmetical accuracy' means,verifying whether the principle of doble entry has been strictly adhered to or not. We know that for every debit there must be a corresponding credit as the benefit received

by an account exactly tallies with the benefit given by one or more accounts. Thus, the total debits given to various accounts in respect of any number of transactions must exactly equal the total credits given to various accounts. As the principle of double entry will apply to each and every transaction, it would be equally valid for all the transactions, i.e., as each debit has a corresponding credit, the total debits have equal and corresponding total credits, it stands to reason that the total debit balances of various accounts must tally with the total credit balances of various accounts whatever be the number of accounts on postings. It is necessary to ensure arithmetical accuracy before a businessman proceeds to prepare his Final Accounts. The arithmetical accuracy is known by preparing a statement of all the balances on various accounts known as 'Trial Balance.' However, it is important to note that the tallying of a Trial Balance is not the sole and conclusive proof of the correctness of the books . It serves the limited purpose of ensuring that every debit has its corresponding credit.

11.2 IMPORTANCE OF TRIAL BALANCE

When the Trial Balance tallies, it provides prima facie evidence that the transactions have been recorded as per the principle of double entry. When it does not tally it reveals the presence of errors. It is necessary to note that even when it does tally, it does not conclusively prove that there are no errors. Thus though it does not disclose all the errors it serves the purpose of detecting certain types of errors. Further, the Trial Balance will facilitate the preparation of Final Accounts as all the balances of personal, real and nominal accounts available in one statement.

11.3 PREPARATION OF TRIAL BALANCE

The Trial Balance is a statement and that is why no journal entries are passed to prepare it.

All the ledger accounts, wherever they appear, i.e., in one book or in many books are balanced and included in the Trial Balance. Thus all the personal, real and nominal accounts will appear in the Trial Balance provided they have some balance. i.e, either a debit balance or a credit balance. Earlier, we have seen that in addition to the Cash Book (which must be regarded as cash account and thus considered a part of the ledger) a general ledger is maintained with all personal, real and nominal accounts; or that the general ledger is sub-divided into debtors ledger, creditors ledger and general ledger. A list of all accounts of customers appearing in the debtors ledger and showing debit balances will be prepared and totalled. This total will be referred to as 'Sundry Debtors'. Similarly, the total of credit balances apearing in various suppliers accounts in the creditors ledger will be called 'Sundry Creditors'. Cash and Bank accounts, contained in the Cash Book, will be balanced and included in Trial Balance . Other personal accounts like capital account of the properietor, drawings account and various real and nominal accounts contained in the general ledger will also be balanced and included in the Trial balance.Thus any account, wherever it might appear, will be included in the Trial Balance, provided it shows some balance.

A Trial Balance is prepared in the following proforma.

TRIAL BALANCE AS ON ----------

Name of Account	LF	Dr. Balance Amount	Cr. Balance Amount
		Rs.	Rs.

Balances in various accounts will be shown in the appropriate column and the two amount columns will be totalled. When the two totals tally, i.,e.,when the total of debit balances equals the total of credit balances, it is proved that a debit exists for every credit and that it can reasonably be said that the ledger's arithmetical accuracy is established. However, it does not conclusively prove that the postings are accurate in all respects, as there are certain types of errors which could take place in the ledger inspite of the agreement of the Trial Balance.

The following illustration will make the process of preparation of a Trial Balance clear:

Illustration - 1

From the following balances from Gupta's ledger, prepare a Trial Balance on the 31st December, 1989:

Building	15,000
Capital	84,950
Purchases	1,00,000
Sales	1,20,000
Insurance	600
Sundry Debtors	25,000
Bills Receivable	7,800
Bills Payable	5,200
Investments	8,000
Printing and, Stationery	1,500
Cash in hand	7,000
Plant and Machinery	25,000
Drawings	9,000
Loan	12,000
Returns inward	9,000
Stock	35,000
Salary	1,250
Rent	1,200
Salary Payable	200
Sundry Creditors	17,000
Commission (Cr.)	1,600
Interest receivable	600
Carriage	3,200
Advertisement	1,800
Returns outward	10,000

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Solution

Trial Balance of Gupta as on the 31st of December, 1989.

Name of Account	LF	Dr. Balance	Dr. Balance
		Rs.	Rs.
Building		15,000	...
Plant & Machinery		25,000	....
Capital		....	84,950
Drawings		9,000	....
Purchases		1,00,000	....
Loan		....	12,000
Sales			1,20,000

Returns inward		9,000	....
Returns outward		....	10,000
Stock		35,000	....
Salary		1,250	....
Rent		1,200	....
Insurance		600	...
Salary Payable		....	200
Sundry Debtors		25,000	....
Sundry Creditors			17,000
Commission		....	1,600
Bills Payable		....	5,200
Interest receivable		600	.....
Investments		8,000	....
Carriage		3,200	...
Printing and Stationery		1,500	...
Advertisement		1,800	...
Cash in hand		7,000	...
Bills Receivable		7,800	..
		2,50,950	2,50,950

Note : It is important to note the method of determining whether an account shows a debit balance or credit balance. This is done on the basis of the nature of account, i.,e., whether it is personal, real or nominal and the corresponding rule of debit and credit applied to it. Accounts which represent assets or expenses will show a debit balance and accounts which represent liabilities or incomes will show credit balances.

11.4 DISAGREEMENT OF TRIAL BALANCE

In the illustration given above the two amount columns tally. However, when they do not tally it means that there are some errors in book keeping work. The following are some of the errors that cause the disagreement of Trial Balance :

i Errors in totalling subsidiary books, ledger accounts.
ii. Errors in balancing ledger accounts.
iii. Posting of wrong amount to the concerned ledger account.
iv. Posting a correct amount (even wrong amount) but on the wrong side of a ledger account
v. Omission to post an entry from a subsidiary book or from a Journal proper.
vi. Posting one effect of an entry twice, either to the same account or to some other account.
vii. Omission to include the balance of an existing account in the Trial Balance or including it in the wrong column of Trial Balance.
viii. Errors in adding up the two columns of the Trial Balance.

11.5 LOCATION OF ERRORS

When a Trial Balance does not tally it is vident that there are errors. These errors must be detected and corrected so that the Trial Balance agrees. The correction of errors is the subject matter of Unit 19 and hence only the procedure for locating the errors will be outlined here :

1. Verifying the totals of the two columns of Trial Balance once again.
2. Going through the accounts listed to verify whether the balances have been correctly entered in the appropriate column or not.

If no error is found at this stage or the errors found have been corrected and if the revised Trial Balance does not agree, it means that there are certain undetected errors remaining in the books. In such a case the following steps are required to be taken:

3. Check whether the balances of all ledger accounts have been included in the Trial Balance to see that no account is omitted. Compare the current year's Trial Balance with the previous year's Trial Balance to see whether all accounts have been included or not.
4. Check the balances of various ledger accounts and see whether they are correct.
5. Check the periodical totals of subsidiary journals and verify whether they have been posted correctly or not to the proper sides of concerned ledger accounts. Verify the details of the subsidiary Journals, i.e, whether all individual items are correctly posted and whether there are any omissions or wrong entries.
6. See whether the ledger folio column is marked against each individual item as evidence of posting. If there is any omission, check up whether the amount is posted.
7. Verify whether all the opening balances have been correctly brought forward from the previous year.

The steps outlined above will reveal the errors and a revised Trial Balance can then be prepared. If there are no more errors the revised Trial Balance would tally. However, it is possible that even the revised Trial Balance may also not tally which points to the presence of few more errors. Such a situation may arise when the businessman, being in a hurry to prepare the Final Accounts, cannot wait to repeat the process once again and detect the remaining errors. Then the difference between the two amount columns of Trial Balance will be put in a suspense account and the Trial Balance is made to tally temporarily. The 'Suspense Account' will be discussed in Unit 20. It is important to note that even when the Trial Balance tallies, it does not guarantee absolute accuracy of all ledger work because there are certain types of errors which do not effect the agreement of Trial Balance. Now we shall discuss these errors which remain undiscovered even though the Trial Balance tallies.

11.6 TRIAL BALANCE AND UNDISCLOSED ERRORS

As stated earlier, certain types of errors remain undisclosed in spite of the agreement of Trial Balance. Errors of this type can be classified as follows:

1. *Errors of Principle*: When a transaction is recorded ignoring or wrongly applying any principle of Book-keeping, it is called an 'error of principle'. Example: Purchase of office furniture is passed through Purchases Journal. Such errors do not affect the agreement of the Trial Balance, as debit/credit correspondence exists.

2. *Errors of Omission*: When a transaction is completely omitted to be entered, it is called an 'error of omission'. Example: Goods were sold to a customer on credit but the sales invoice was not prepared by oversight. As invoice was not prepared the sales journal will have no record of this transaction, and as neither debit nor credit exists in respect of this transaction the agreement of Trial Balance will not be affected.

3. *Compensating Errors*: When the wrong effect of one error is exactly compensated by the wrong effect of one or of more other errors, such sets of errors are called 'Compensating errors'. Example: Rs.100 received from Rama, though recorded correctly, in the Cash Book was posted to the credit of Rama's account as Rs.10, resulting in a short credit of Rs.90. In another transaction when Rs.10. was received from Krishna, though recorded correctly in

the Cash Book, was posted to the credit of Krishn's account as Rs.100, resulting in an excess credit of Rs.90. Thus the wrong effect of short credit of Rs.90 of the first transaction exactly compensates for and cancels the wrong effect of the excess credit of Rs.90 of the other transaction. As the effect of one error is cancelled by that of another error the agreement of the Trial Balance is not affected.

4. Certain other clerical errors also do not affect the agreement of the Trial Balance which are called 'errors of commission'. Example : Rs.100 received from a party was wrongly recorded as Rs.10 in the Cash Book itself and consequently the party's account was also credited with Rs.10 . As per wrong debit of Rs. 10 has a equal and corresponding credit of Rs.10, the agreement of Trial Balance is not affected. Similarly, posting to wrong Heads of accounts also will have no effect on the agreement of the Trial Balance.

Errors of the four types explained above also have to be detected and rectified before preparing the Final Accounts. Rectification of errors is the subject matter of unit - 19.

Illustration - 2

From the following list of balances extracted from the Books of Ravish prepare a Trial Balance as on 31st July, 1989.

	Rs.		Rs.
Capital	24,405	Salaries	2,000
Drawings	1,500	Bank Loan	2,400
Freehold Premises	5,800	Sales	22,500
Sundry Debtors	6,750	Stock 1st Aug. 1988	10,000
Purchases	11,500	Bills Payable	3,425
Sundry Creditors	4,250	Carriage on Purchases	150
Furniture and Fittings	2,500	Wages	7,535
General Expenses	1,625	Bank Charges	150
Returns Inward	450	Carriage on Sales	175
Postage and Stationery	125	Discount Received	140
Discount Allowed	420	Cash in Hand	240
Cash at Bank	1,200		
Bills Receivable	5,000		

Solution

The Trial Balance of Ravish as on 31st July, 1989

Name of Account	LF	Dr.Amount	Cr. Amount
		Rs.	Rs.
Capital		.....	24,405
Drawings		1,500	.....
Salaries		2,000	.....
Bank Loan		.....	2,400
Freehold Premises		5,800	.....
Sundry Debtors		6,750	.....
Purchases		11,500	.....
Sales		.....	22,500
Returns inward		450	.....

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Stock	10,000	.....
Bank charges	150	.....
Sundry Creditors	.....	4,250
Bills payable	.....	3,425
Furniture and Fittings	2,500	.....
Carriage on Purchases	150	.....
General Expenses	1,625	.....
Wages	7,535	.....
Postage and Stationery	125	.....
Carriage on Sales	175	.....
Discount allowed	420	.....
Discount received	.....	140
Cash at Bank	1,200	.....
Cash in Hand	240	.....
Bills Receivable	5,000	.....
	57,120	57,120

Check Your Progress - 1

List out the errors that are not disclosed by trial balance

11.7 SUMMING UP

The Trial Balance is prepared as a preparatory step at the time of the preparation of final accounts. It serves the purpose of verifying the arithmetical accuracy, i.e., whether every debit has got its corresponding credit recorded in the books of account or not. When a trial balance tallies, it proves the arithmetical accuracy of entries, it is not to be taken as a conclusive proof of the correctness of the books. This is so becuase there are certain types of errors which do not affect the agreement of Trial Balance.

When a Trial Balance does not tally, a number of steps have to be taken to ensure that errors are located and rectified. Errors which do not affect the agreement of a Trial Balance can be broadly classified as i) Errors of principle ; ii) Errors of omission ; iii) Compensating errors ; iv) Certain other clerical errors.

Errors of principle refer to those errors which arise when a transaction is recorded ignoring or misapplying any principle of book-keeping. Errors of omission refer to the total omission of the recording in respect of a transaction. And 'compensating error' is the term used when the wrong effect of an error is exactly compensated for, by the wrong effect of one or more other errors.

11.8 MODEL ANSWERS TO CHECK YOUR PROGRESS

1. i) a) Errors of principle
   b) Errors of omission.
   c) Compensating errors.
   d) Clerical errors.

11.9 MODEL EXAMINATION QUESTIONS

A. Short Answer Questions

1. What is a Trial Balance ?
2. What do you mean by the error of omission ?
3. Why is Trial Balance prepared ?
4. State the types of errors which a Trial Balance may not reveal.
5. State the types of errors which affect the agreement of a Trial Balance.

B. Essay Answer Questions

6. What is a Trial Balance ? Why is it prepared ? Is the agreement of Trial Balance a conclusive proof of the accuracy of accounts ?
7. Draw a Trial Balance using imaginary accounts and figures.

PROBLEMS

1. From the following details prepare a Trial Balance :

	Rs.
Opening Stock	80,000
Purchases	8,20,000
Sales	8,58,000
Purchases Returns	2,500
Sales Returns	5,000
Carriage Inwards	3,000
Carriage Outwards	5,000
Bank Overdraft	42,000
Cash	8,000
Capital	2,55,500
Drawings	20,000
Wages	14,600
Salaries	22,000
Outstanding Expenses	2,000
Prepaid Expenses	1,500
Postage, Telegrams & Telephones	1,800
Discount Received	750
Discount Allowed	2,000
Bad debts	1,500
Sundry Debtors	2,00,000
Sundry Creditors	75,000
Loan	82,750
Investments	20,000
Accrued Income	1,200
Interest	7,000
Interest Income	600
Reserve for Bad debts	3,500
Furniture & Fixtures	15,000
Machinery	95,000

(Answer : Total of Trial Balance : Rs. 13,22,600)

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2. A Book-keeper extracted the following Trial Balance as on 30th June, 1989.

	Dr. Rs.	Cr. Rs.
Furniture	400	.....
Capital	.....	4,000
Debtors	4,000	.....
Stock (1st July 1988)	2,080	.....
Creditors	.....	1,600
Trade Expenses	1,000	.....
Sales	.....	17,160
Wages	600	.....
Machinery	1,960	.....
Leasehold Premises	...	1,000
Purchases	12,500	...
Discount Allowed	...	80
Drawings made by the Proprietor	...	900
Motor Van	1,200	...
Proprietor's Loan to the Business	1,000	...
	24,740	24,740

You are required to redraft the Trial Balance correctly
(Answer : Total of the correct Trial Balance : Rs.23,760)

3. Draw a Trial Balance from the following:

	Rs.
Opening Stock	18,000
Purchases	1,80,000
Sales	3,40,000
Salary	12,000
Returns Outward	1,500
Sales Returns	1,000
Sundry Debtors	60,000
Sundry Creditors	52,000
Furniture & Fixtures	22,000
Plant & Machinery	86,000
Wages	18,000
Rates & Taxes	2,000
Carriage Inwards	2,200
Carriage Outwards	3,000
Loan	28,000
Investments	20,000
Capital	3,29,700
Drawings	8,000
Outstanding Expenses	1,800
Prepaid Expenses	1,200
Bank	10,000
Cash	2,025
Closing Stock	28,000
Travelling and Conveyance	1,500
Printing and Stationery	2,000
Postage	575
Telephone	1,000
Miscellaneous Expenses	2,500

(Answer :Total of Trial Balance : Rs. 7,53,000)

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4. From the following Trial Balance, prepare a correct Trial Balance.

	Dr. Rs.	Cr. Rs.
Purchases	45,000	...
Reserve Fund	15,000	...
Sales	...	75,000
Purchase Returns	750	...
Sales Returns	...	1,000
Opening Stock	22,500	...
Closing Stock	...	30,000
Expenses	...	15,000
Outstanding Expenses	1,500	...
Bank balance	3,750	...
Assets	37,500	...
Debtors	....	60,000
Creditor's	...	22,500
Capital	78,500	...
Suspense account being difference in books ...	7,500	...
	2,04,000	2,04,000

(Answer: Total of Trial Balance Rs. 1,92,750)

11.10 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).

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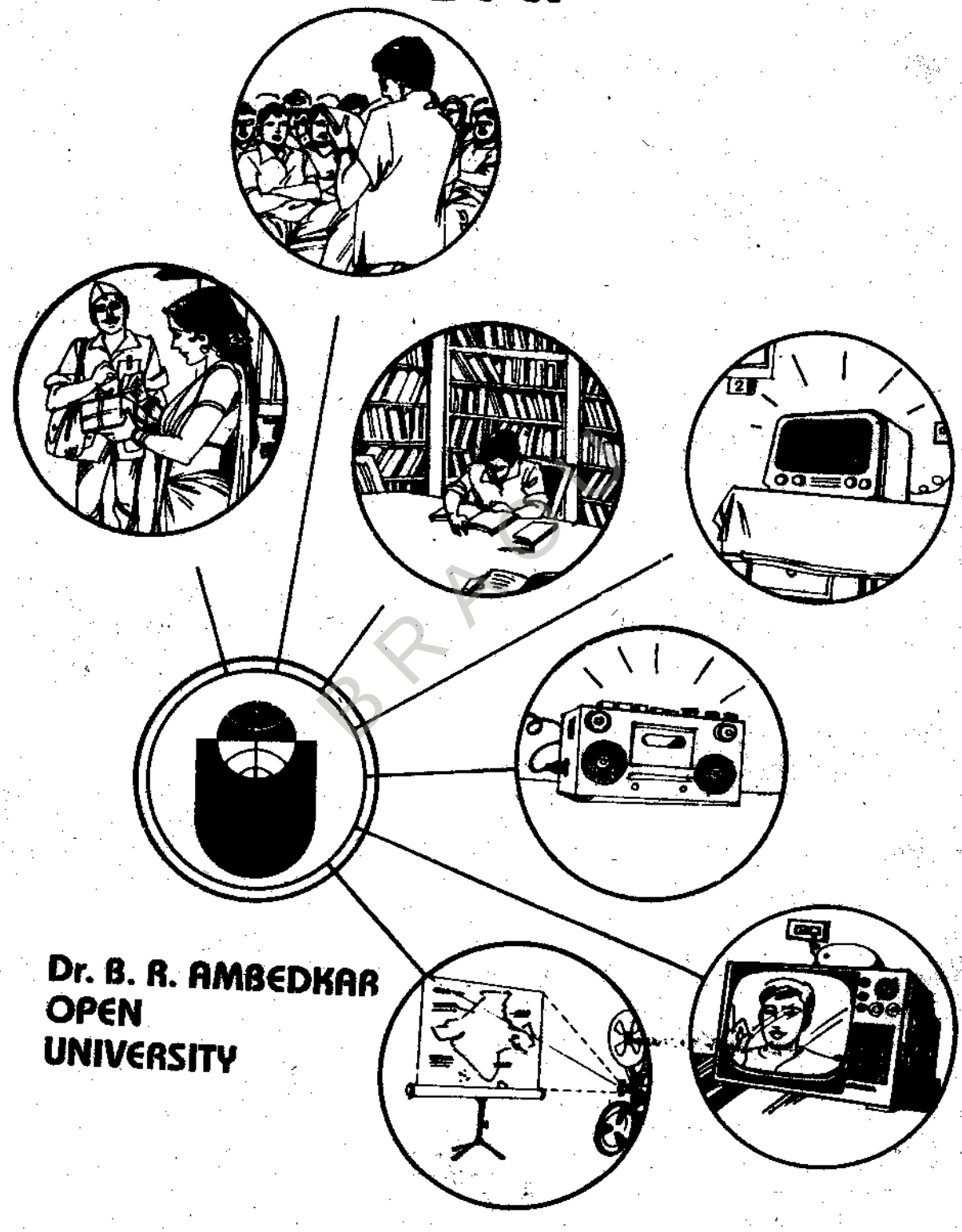
11.11 GLOSSARY

1. **Compensating Error** — is the term used when the wrong effect of an error is exactly compensated for by the wrong effect of one or more other errors.
2. **Error of Omission** — refers to a complete omission of the recording in respect of a transaction.
3. **Error of Principle** — refers to those errors which arise when a transaction is recorded ignoring or misapplying any principle of book-keeping.
4. **Trial Balance** — is the statement of balances of all the accounts in the ledger prepared to prove the arithmetical accuracy of the books of accounts.

Writer : Prof. V. Viswanadham

UNIVERSITY AT YOUR DOOR STEP



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C2 - A2

ACCOUNTANCY

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ACCOUNTANCY
PAPER - II

BLOCKS : III - IV

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Dr. B.R. AMBEDKAR OPEN UNIVERSITY
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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

Contents

2.0 Aims and Objectives
2.1 Introduction
2.2 Capital and Revenue
2.3 Capital Expenditure
2.4 Revenue Expenditure
Expenditure and Payment
Deferred Revenue Expenditure
Capital Receipts
Revenue Receipts
Summing Up
Answers to Check Your Progress
Model Examination Questions
Glossary

AIMS AND OBJECTIVES

ims of this unit are to explain the difference between capital and revenue items and their ance in ascertaining the profit and preparation of final accounts.
g studied this unit you will be able to:

lain the distinction between capital and revenue
inguish between capital expenditure and revenue expenditure
inguish between expenditure and payment
cribe the deferred revenue expenditure
tinguish between capital receipts and revenue receipts.

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2.1 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.

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 incurred for maintaining fixed assets for their efficient working, e.g., repairs and renewals of buildings, machinery, etc., This expenditure does not add to the earning capacity but helps in maintaining it.
3. Costs incurred towards the purchase of goods for resale and cost of raw material acquired for consumption in the course of manufacturing, to the extent they are sold or used up during the year, should also be treated as revenue expenditure. The value of unsold goods or unused material will be treated as asset.
4. Depreciation (reduction in value) of fixed assets and interest on loans borrowed for business 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 full amount incurred, whether paid or not; whareas payment is the amount actually paid. Suppose furniture is purchased from Z& Co. for Rs.30,000 by paying Rs.15,000 in cash and promising to pay the balance 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 which yields benefit beyond that year. It is called deferred revenue expenditure thus, heavy advertisement expenditure incurred when a new product is introduced into the market, expenses on shifting of business premises fall under Deferred Revenue expenditure, etc. It is customary to spread such expenditure 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 the businessman or on account of loans taken are called capital receipts. Such receipts are not frequent and are usually repayable.

12.8 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:

1. Freight paid on goods purchased Rs. 2,500
2. Cost of pulling down an old building preparatory for constructing a new one Rs. 2,000
3. Repairs to second hand machinery purchased, Rs. 3,000
4. Legal expenses incurred in defending a suit for breach of contract to supply goods Rs.1,500
5. Rs.50,000 spent on the construction of railway siding.

Answer

1. Rs.2,500 paid towards freight, is revenue expenditure as it has been incurred in connection with the purchase of goods meant for resale.
2. 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.
3. 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.
4. 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.
5. The amount of Rs.50,000 spent is capital expenditure, as it is the cost of acquiring a fixed asset, viz Railway siding.

12.9 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.

12.10 ANSWERS TO CHECK YOUR PROGRESS

1) 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.
2) i) Expenses incurred in the normal course of business, eg., administration expenses, selling expenses etc.

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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.

Writer : Sri. M. Satyanarayana

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UNIT - 13 : TRADING ACCOUNT AND MANUFACTURING ACCOUNT

Contents

13.0 Aims and Objectives
13.1 Introduction
13.2 Trading Account
13.3 Cost of Goods Sold
13.4 Form of Trading Account of Trading Concern
13.5 Explanation of the Trading Account Items

- 13.5.1 Opening Stock
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- 13.5.3 Direct Expenses
- 13.5.4 Sales
- 13.5.5 Closing Stock
- 13.5.6 Adjusted Purchases
- 13.5.7 Gross Profit/Gross Loss.

13.6 Alternative Form of Trading Account
13.7 Manufacturing Account
13.8 Form of Manufacturing Account
13.9 Form of Trading Account of a Manufacturing Concern
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
13.15 Glossary

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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

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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)					
" Direct Expenses			" Closing Stock		
Gross Profit			Gross Loss if any		

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 so 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.

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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.

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 ----------

for the period ended ----------

Dr. 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	Rs.	Rs.		Rs.	Rs.	Cr.
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.

13.8 FORM OF MANUFACTURING ACCOUNT

The following is the form of Manufacturing Account:

MANUFACTURING ACCOUNT OF ----------

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

Particulars	Amount	Amount	Particulars	Amount	Amount
To Opening work in Progress			By Sale of Scrap		
" Materials consumed Opening Stock of Raw Materials			" Closing work-in-Progress		
" 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					
		---			---
		═══			═══

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 ----------
for the period ended----------

Dr. 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, conventionally 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.

BRAOU

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 Dec. 31	Purchases Returns Account Dr.		5,000	
	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

Contents

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14.10 Glossary

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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

loss. It is opened with gross profit or gross loss transferred from the Trading Account. The gross profit is shown on the credit side. In case 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 ----------

for the period ended----------

Dr. 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 the 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 c[illegible]rned with manufacturing work are called unproductive or non-productive wages. They should be take[illegible] 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.

PROOF

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 items '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 **Sample:** Generally, samples of goods dealt in are 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 Proft 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.		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

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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

Returns outwards 200
(Answer : Gross Profit Rs. 2542; 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.

BRAOU

Writer : Sri M. Satyanarayana.

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

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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.

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 orginal 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 :**

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.

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			Current Assets :		
Sundry Creditors (or creditors on open accounts)			Cash in hand		
Loans			Cash at Bank		
Reserve			Bills Receivable		
Capital :			Sundry Debtors (or Book Debts)		
Opening Balance			Closing Stock		
Add : Net Profit for the period			Fixed Assets :		
Less : Drawings			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 :		
			Office Furniture		3,500
Less : Drawings	12,000		Plant and Machinery		60,000
		1,88,910			
		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	3,800		
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

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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.

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

INTEREST ACCOUNT

Dr.							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

OUTSTANDING INTEREST ACCOUNT

Dr.							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.

PROFIT AND LOSS ACCOUNT

Dr.					Cr.
	Rs.	Rs.		Rs.	Rs.
			By Interest	300	
			Add : Outstanding	300	
				600	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			Rs.	Rs.
Dec.31	Prepaid insurance Account	Dr.	450	
	To Insurance Account			450
	(Being the adjustments of prepaid insurance)			

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 :

Dr. INSURANCE ACCOUNT Cr.

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

Dr. PREPAID INSURANCE ACCOUNT Cr.

1988 Dec.31	To Insurance A/c		Rs. 450	1988 Dec.31	By Balance c/d		Rs. 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 Dec.31	To Rent Received in Adv. A/c		Rs. 3,000	1989 Dec.31	By Cash A/c		Rs. 6,000
	" Profit & Loss A/c		3,000				
			6,000				6,000

Dr. RENT RECEIVED IN ADVANCE ACCOUNT Cr.

1989 Dec.31	To Balance c/d		Rs. 3,000	1989 Dec.31	By Rent A/c		Rs. 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 To Sundry Debtors Account (Being bad debts written off)	Dr.		400	400
"	Provision for Doubtful Debts A/c To Bad Debts Account (Being the transfer of bad debts to provision for D D)	Dr.		400	400
"	Provision for Doubtful Debts A/c To Profit and Loss Account (Being the transfer of surplus provision to Profit and Loss Account)	Dr.		300	300

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.	Rs.
			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 debtors 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 :

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 mentioned 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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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.
(Being the adjustment entry for provision for doubtful debts).

7. Debit - Profit and Loss A/c.
Credit - Provision for Discount on Debtors A/c.

8. i) Debit - Provision for Discount on Creditors A/c
Credit - Profit and Loss A/c.

ii) Personal Account - e,
Real Account - g, h, i.,
Nominal Account - a, b, c, d, f,

16.13 MODEL EXAMINATION QUESTIONS

A. Short Answer Questions

1) Write short notes on :
a) Outstanding expenses
b) Outstanding incomes

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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.45,000 and a 5% provision for doubtful debts was required to be kept. In 1989, the bad debts were Rs.750 and the debts at the end of the year were Rs.24,000 on which a 5% provision for doubtful debts, and a 2% provision for discount were required to be maintained.

   Show the Ledger Accounts and show also how these items will appear in the Profit and Loss 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 Profit and Loss Account Rs.2,150, in 1989 the debit Profit and Loss Account Rs.456 for Provision for Discount, the credit Profit and Loss Account Rs.300 for Provision for Doubtful Debts.)

16.14 GLOSSARY

1. Adjustment	:	Adjustment means putting this in order by suitable alterations.
2. Adjustment Entries	:	Adjustment Entries are the entries passed to make adjustments at the time of finalisation of accounts.
3. Bad Debts	:	Debts which are irrecoverable are called bad debts.
4. Doubtful Debts	:	Business man may find that the recovery of some debts is doubtful due to the fact that there is likely hood of a debtor becoming insolvent.

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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

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)

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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		.....

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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

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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)

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)

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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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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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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		Less: Provision for Doubtful Debts	23,000	
Less : Drawings	7,200			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	
					9,000
			Machinery	28,000	
			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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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

Dr. for the year ended 31st December, 1989 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

Dr. for the year ended 31st December, 1989 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

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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 doubtful debts	1,650	
Add: Int. on capital	6,425				64,350
Net Profit	50,785		Closing Stock		50,000
	1,85,710		Fixed Asets:		
Less: Drawings (including goods for domestic use) (12,000 + 3,000)	15,000	1,70,710	Office furniture	3,500	
			Less: Depn.at 10%	350	3,150
			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	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. Particulars	Rs.	Rs.	Cr. 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			By Net Profit b/d		18,600
General Reserve		930			
To Net Profit		17,670			
(Transferred to					
Capital Account)					
		18,600			18,600

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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 year's profit	930		Less: Bad Debts	500	
	---	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.

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	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

Dr. For the year ended 31 st December, 1989. 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

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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

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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.

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Solution

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

Dr. Cr.

Particulars	Rs.	Rs.	Particulars	Rs.	Rs.
ToOpening 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
ToSalaries		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

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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 Doubtful Debts	1,700	
Less: Provision for Disc.	640			32,300	
		31,360	Less: Provision for Disc.	646	
					31,654
General Reserve		30,000	Outstanding Commission		400
Capital:			Closing Stock		33,200
Balance on 1st April 1989	1,50,000				
Add: Net Profit	16,794		Fixed Assets:		
	1,66,794		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

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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.

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

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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)

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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).

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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 Accoutancy' (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

Contents

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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 ofTrial 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		

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.

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

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

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

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

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

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

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.

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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 Gill 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 account.

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

Contents

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20. 1 Introduction
20. 2 Suspense Account and Rectification of Errors
20.3 Effect of Rectifiction on the net profit
20. 4 Summing Up
20. 5 Answers to Check Your Progress
20. 6 Model Examination Questions
20. 7 Recommended Books

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. To Purchases Account (Being the rectification for overcasting in the Purchase Book)	1,000	1,000

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/-.

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(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. To Discount Allowed Account (Being the rectification of overcasting of discount column on the debit side of the cash book)		20	20
	(b) Rama's Account Dr. To Suspense Account (Being the rectification of wrong credit given to Rama)		2,000	2,000
	(c) Purchases Returns Account Dr. To Suspense Account (Being the rectification of overcast in the purchases Returns Book)		200	200
	(d) Narayana's Account Dr. To Suspense Account (Being the rectification of excess credit given to Narayana's A/c.)		624.60	624.60

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 /c Dr. To Suspense A/c (Being the omission of posting to Insurnce premium A/c now rectified)		120	120
	(b) Suspense Account Dr. To Salaries A/c (Being excess debit to salaries A/c now rectified)		2,250	2,250
	(c) Suspense A/c Dr. To Discount Allowed A/c (Being rectification of overcast in the discount allowed column of the Cash Book)		100	100
	(d) Suspense A/c Dr. To Sales A/c (Being the omission of posting to Sales A/c now rectified)		700	700

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

Recitify 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

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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. inal 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 Parmeshwar, 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.

BLOCK-IV : OTHER ACCOUNTING TOPICS

UNIT -21 : PROVISIONS AND RESERVES

Contents

21.0 Aims and Objectives
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21.2 Classification of Reserves and Funds
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21.8 Secret Reserves
21.9 Provision for Doubtful Debts
21.10 Provision for Discount on Debtors
21.11 Provision for Discount on Creditors
21.12 Provision for Repairs and Renewals
21.13 Summing Up
21.14 Answers to Check Your Progress
21.15 Model Examination Questions.
21.16 Glossary.

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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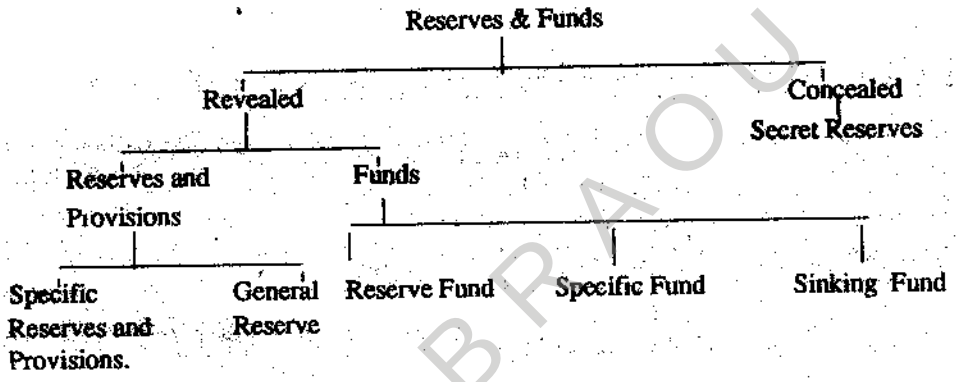
When a reserve is represented by some specific investment made outside the business, the word 'Fund' is added to denote the same. However, when no such outside investments are made, the account, is merely called a 'Reserve'

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 owners 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) Revenue 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 m ght not yet have been actually realised in cash and the profit figure represents 'profit earned' and nc. 'profit received or realised'. Further, it is possible that all the Sundry Debtors may not pay the amount: 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

JOURNAL

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.

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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

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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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JOURNAL

Date	Particulars	L.F.	Debit Rs.	Credit Rs.
1988 Dec. 31	Provision for Discount on Debtors A/c. Dr. To Discounts Allowed A/c. (Being the transfer of discounts allowed to the Provision A/c.)		5,000	5,000
Dec.31	Discounts Received A/c. Dr. To Provision for Discounts on Creditors A/c. (Being the transfer of discounts received to the Provision A/c.)		4,000	4,000
Dec.31	Profit & Loss A/c. Dr. To Provision for Discounts on Debtors A/c. (Being the amount required for meeting the new provision and the excess of discounts allowed over the Provision)		6,000	6,000
Dec.31	Provision for Discount on Creditors A/c. Dr. To Profit & Loss A/c. (Being the transfer of excess amount discounts received, over the provision along with the new provision)		4,400	4,400
1989 Dec.31	Provision for Discount on Debtors A/c. Dr. To Discounts Allowed A/c. (Being the transfer of discounts allowed to the Provision A/c.)		1,000	1,000
Dec.31	Discount Received A/c. Dr. To Provision for Discount on Creditors A/c. (Being the transfer of Discount received to the Provision A/c.)		800	800
Dec.31	Provision for Discount on Debtors A/c. Dr. To Profit & Loss A/c. (Being the transfer of excess provision to the Profit & Loss Account.)		1,000	1,000
Dec.31	Profit & Loss Acount. A/c. Dr. To Provision for Discount on Creditors A/c. (Being the transfer of excess provision to the Profit & Loss Acount		400	400

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.			Rs.
			1988	By Sundries	4,000
1988 Dec.31	To Provision for Discount on Creditors A/c.	4,000			
		4,000			4,000
			1989		
1989 Dec.31	To Provision for Discount on Creditors A/c	8 00		By Sundries	8 00
		8 00			8 00

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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

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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 Doubtful Debts A/c	6,000
Dec.31	" Debtors A/c		2,000			
			6,000			6,000
1989				1989		
?	To Debtors		1,600	Dec.31	By Provision for Doubtful Debts A/c	2,100
Dec.31	" Debtors		500			
			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.

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Date	Particulars		L.F	Dr.Rs.	Cr.Rs.
1st Year	Profit & Loss A/c To Provision for Repairs A/c (Being the creation of a provision for repairs)	Dr.		1,500	1,500
	Provision for Repairs A/c To Repairs A/c (Being the transfer of Repairs to Provision A/c)	Dr.		500	500
2nd Year	Profit & Loss A/c To Provision for Repairs A/c (Being the Provision for repairs)	Dr.		1,500	1,500
	Provision for Repairs A/c To Repairs A/c (Being the transfer of Repairs to Provision A/c)	Dr.		900	900
3rd Year	Profit & Loss A/c To Provision for Repairs A/c (Being the Provision for Repairs)	Dr.		1,500	1,500
	Provision for Repairs A/c To Repairs A/c (Being the transfer of Repairs to Provision A/c)	Dr.		2,000	2,000
4th Year	Profit & Loss A/c To Provision for Repairs A/c (Being the Provision for Repairs)	Dr.		1,500	1,500
	Provision for Repairs A/c To Repairs A/c (Being the transfer of Repairs to Provision A/c)	Dr.		2,600	2,600

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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 Rs.	1988 Rs.	1989 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 P & L Account		1988 P & L Account		1989 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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c) For the annual amount set aside:

	Profit & Loss Appropriation A/c To Sinking Fund A/c (Being the annual sum set apart)	Dr.			

d) When the annual instalment and the interest received together are invested in securities:

	Sinking Fund Investment A/c To Bank A/c (Being the amount invested)	Dr.			

At the end of the previous year, when the Debentures (or the Preference shares) were to be redeemed:

Entries (a), (b) and (c) given above will be passed but not the entry (d) becuase the investments are about to be sold and amount realised to facilitate redemption.

a) When amounts are realised on the sale of securities:

	Bank A/c To Sinking Fund Investment A/c (Being the amount realised on the sale of investments)	Dr.			

b) For Profit on sale of investment:

	Sinking Fund Investment A/c To Sinking Fund A/c (Being the transfer of Profit)	Dr.			

In case of loss on sale of investment :

	Sinking Fund A/c To Sinking Fund Investment A/c (Being the transfer of loss)	Dr.			

c) For payment of the amount to Debenture holders :

	Debentures A/c To Bank A/c (Being the redemption of Debentures)	Dr.			

Instead of a direct entry, two entries are also passed to record the payment:

	1) Debentures A/c To Debenture Holders A/c (Being the transfer of debentures for redemption)	Dr.			

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	2) Debenture Holders A/c Dr. To Bank A/c (Being the payment to debenture-holders)				

d) For balance on Sinking Fund transferred to Capital Redemption Reserve Fund:

	Sinking Fund A/c Dr. To Capital Redemption Reserve Fund A/c (Being the transfer of the balance of sinking fund a/c to to Capital Redemption Reserve Fund A/c on redmeption of Debentures)				

The following illustration will present the detailed accounting treatment in respect of a Sinking Fund:

Illustration - 1

On 1st January 1987, TDP, Ltd., issued debentures for Rs.1,00,000/- redeemable at par at the end of 3 years with a provision that a Sinking Fund be formed for this purpose and that the amounts be invested in Government securities.

Refenece to the Sinking Fund Tables reveal that Re.0.320349 invested at the end of each year at 4% compound interest will produce Re.1 at the end of 3 years.

Give journal entries and show how the Sinking Fund Account and the Sinking Fund Investments Account will appear in the Ledger, assuming that :

a) Interest was received annually and that it was re-invested immediately along with the annual instalment ;
b) that investments were made in multiples of thousands ; and
c) that the investments were sold at the end of the period at a profit of Rs.100 and that debentures were redeemed.

Solution

For getting one rupee at the end of three years at 4% interest the annual instalment required is Rc.0.320349.
For Rs.1,00,000 the annual instalment will be 0.320349 x 1,00,000 = Rs. 32,034.90
This is rounded off to Rs.32,035 (nearest rupee).

It would be useful to complete the necessary calculations before starting to give the journal entries and post them into the ledger accounts. For this purpose, the calculations made are presented in a tabular form :

Date	Instalment Amount	Interest Amount	Total amount available for investment	Amount actually invested	Balance Amount not invested	Cumulative total of investments made.
	Rs.	Rs.	Rs.	Rs.	Rs.	Rs.
31.12.87	32,035	----	32,035.00	32,000	35	32,000
31.12.88	32,035	1,281.40	35.00 33,31 .40	33,000	351.40	65,000
31.12.89	32,035	2,600.00	351.40 34,635.00	———	34,986.40	———

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	1,00,000	
	To Debentures A/c			1,00,000
	(Being the issue of Debentures)			
Dec.31	P&L Appropriation A/c	Dr	32,035	
	To Sinking Fund A/c			32,035
	(Being the annual amount set apart to provide for the redemption of Debentures)			
Dec.31	Sinking Fund Investment A/c	Dr	32,000	
	To Bank A/c			32,000
	(Being the investment of amount in multiples of thousands).			
1988				
Dec.31	Bank A/c	Dr	1,281.40	
	To Interest on S.F.Investment A/c			1,281.40
	(Being the receipt of interest on investment for Rs.32,000 @ 4% for one year)			
Dec.31	Interest on S.F.Investment A/c	Dr	1,281.40	
	To Sinking Fund A/c			1,281.40
	(Being the transfer of interest to Sinking Fund).			
Dec.31	P&L Appropriation A/c	Dr	32,035	
	To Sinking Fund A/c			32,035
	(Being the second annual instalment set apart).			
Dec.31	Sinking Fund Investment A/c	Dr	33,000	
	To Bank A/c			33,000
	(Being the investment of the annual instalment plus the interest in multiples of thousands).			
1989				
Dec.31	Bank A/c	Dr	2,600	
	To Interest on S.F.Investment A/c			2,600
	(Being the receipt of interest on investment for Rs.65,000 @ 4% for one year).			

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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

LEDGER

SINKING FUND ACCOUNT

Dr. Cr.

			Rs.				Rs.
1987 Dec.31	To Balance c/d		32,035.00	1987 Dec.31	By P & L App.A/c		32,035.00
			32,035.00				32,035.00
1988 Dec.31	To Balance c/d		65,351.40	1988 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 Dec.31	To Capital Redemption Reserve Fund A/c		1,00.086.40	1989 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

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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.

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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.10,02,990).

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.

Writer : Prof . V. Viswanadham.

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UNIT - 23 : DEPRECIATION

Contents

23.0 Aims and Objectives
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23.4 Depreciation and Related Concepts
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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.

L.C. Cropper difines 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 difined 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 referes 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 at others, 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

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physical depreciation of fixed assets(except in revaluation method). Depreciation is not directly connection with any real thing - cost 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

Deprecition 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.

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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, Amortization 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. Deprecition 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.

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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.

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

Contents

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24.12 Answers to Check Your Progress
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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.

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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: Safe Proceeds	850	
			150	
		Less: Loss Written off	150	—

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When 'Provision for Depreciation' method is followed :

PLANT ACCOUNT

Dr. 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

PROVISION FOR DEPRECIATION ACCOUNT

Dr. Cr.

		Rs.			Rs.
1986			1986		
Dec. 31	To Balance c/d	2,500	Dec. 31	By Depreciation A/c	2,500
		2,500			2,500
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 Jan.1	To Bank	10,500	1986 Dec.31	By Depreciation	3,667
	To Erection charges	500		By Balance c/d.	7,333
		11,000			11,000
1987 Jan.1	To Balance b/d	7,333	1987 Dec.31	By Depreciation A/c	2,444
			Dec.31	By Balance c/d	4,889
		7,333			7,333
1988 Jan.1	To Balance b/d	4,889	1988 Dec.31	By Depreciation A/c	1,630
			Dec.31	By Balance c/d	3,259
		4,889			4,889
1989 Jan.1	To Balance b/d	3,259	1989 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	

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.

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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 Jan.1	To Bank	10,500	1986 Dec.31	By Depreciation A/c	5,500
	To Erection charges	500		By Balance c/d.	5,500
		11,000			11,000
1987 Jan.1	To Balance b/d	5,500	1987 Dec.31	By Depreciation A/c	2,750
			Dec.31	By Balance c/d	2,750
		5,500			5,500
1988 Jan.1	To Balance b/d	2,750	1988 Dec.31	By Depreciation A/c	1,375
			Dec.31	By Balance c/d	1,375
		2,750			2,750
1989 Jan.1	To Balance b/d	1,375	1989 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 Jan.1	To Bank A/c	60,000	1986 Dec.31	By Depreciation A/c (10% on 60,000)	6,000
				By Balance c/d.	54,000
		60,000			60,000
1987 Jan.1	To Balance b/d	54,000	1987 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 Jan.1	To Balance b/d	48,600	1988 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 Jan.1	To Balance b/d	43,740	1989 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 Annunity 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 .

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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 Dr. To Bank A/c. (Being the entry for purchases of the machine)		10,000	10,000
1986 Dec. 31	Machine A/c Dr. To Interest A/c. (Being interest on the amount of investment in the machine)		500	500
Dec. 31	Depreciation A/c Dr. To Machine A/c (Being the depreciation on the machine written off)		2,310	2,310
1987 Dec. 31	Machine A/c Dr. To Interest A/c. (Being the interest on the balance of investment at the beginning of the year)		410	410
Dec.31	Depreciation A/c Dr. To Machine A/c (Being the depreciation written off)		2,310	2,310
1988 Dec. 31	Machine A/c Dr. To Interest A/c. (Being the interest on investment on the opening balance in the Machine account)		315	315
Dec. 31	Depreciation A/c Dr. To Machine A/c (Being the Depreciation on the machine written off)		2,310	2,310
1989 Dec. 31	Machine A/c Dr. To Interest A/c. (Being the interest on investment on the opening balance in the Machine account .)		215	215

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Dec. 31	Depreciation A/c Dr. To Machine A/c (Being the depreciation on the machine written off)			2,310	2,310
1990 Dec. 31	Machine A/c Dr. To Interest A/c. (Being the interest on Investment on the opening Balance Machine a/c of at the beginning of year)			110	110
Dec. 31	Depreciation A/c Dr. To Machine A/c (Being the depreciation on the machine written off)			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

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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.

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

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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)				

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)				

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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

Usually the securities are available in the market in 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.	39,940
				" P & L A/c. (Loss)	60
		40,000			40,000

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Dr. DEPRECIATION FUND ACCOUNT Cr.

		Rs.			Rs.
1986			1986		
Dec. 31	To Balance c/d.	7,239	Dec.31	By Depreciation A/c.	7,239
1987			1987		
Dec. 31	To Balance c/d	14,838	Jan. 1	By Balance b/d	7,239
			Dec. 31	" Bank (Interest)	360
			"	" Depreciation	7,239
		14,838			14,838
1988			1988		
Dec. 31	To Balance c/d	22,817	Jan. 1	By Balance b/d	14,838
			Dec. 31	" Bank (Interest)	740
			"	" Depreciation A/c	7,239
		22,817			22,817
1989			1989		
Dec. 31	To Balance c/d	31,196	Jan. 1	By Balance b/d	22,817
			Dec. 31	" Bank (Interest)	1,140
			"	" Depreciation	7,239
		31,196			31,196
1990			1990		
Dec. 31	To Depreciation fund Investment A/c	50	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			1986		
Dec. 31	To Bank A/c.	7,200	Dec.31	By Balance c/d	7,200
1987			1987		
Jan. 1	To Balance b/d	7,200	Dec.31	By Balance c/d	14,800
Dec. 31	To Bank A/c.	7,600			
		14,800			14,800
1988			1988		
Jan. 1	To Balance b/d	14,800	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. 31	To Bank A/c.	8,300	Dec. 1	By Balance c/d	31,100
		31,100			31,100
1990			1990		
Jan. 1	By Balance b/d	31,100	Dec. 1	By BankA/c	
			Dec. 31	(Sale Proceeds)	31,050
				"By Depreciation Fund A/c	50
		31,100			31,100

BRAOU

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)			

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During the last year
a)For payment of the premium:

Depreciation Fund Policy A/c To Bank A/c (Being the payment of premium on Depreciation Policy)	Dr.			

b) For charging depreciation:

Depreciation A/c To Depreciation Fund A/c (Being the Depreciation for the year on the asset)	Dr.			

* c) For receipt of amount on insurance policy.

Bank A/c To Depreciation Fund Policy A/c (Being amount received on the insurance policy)	Dr.			

d) For transferring the credit balance in the policy a/c

Depreciation Fund Policy A/c. To Depreciation Fund A/c. (Being the profit on the policy transferred)	Dr.			

e) For transferring the balance in the fund a/c to asset account :

Depreciation Fund A/c. To Asset A/c. (Being the transfer of depreciaton fund to the asset a/c)	Dr.			

f) For realisation of salvage value, if any, on the sale of asset:

BankA/c. To Asset A/c. (Being residual value realised on sale of asset)	Dr.			

g) (i) For transferring debit balance, if any, in the asset a/c

Profit and Loss A/c. To Asset A/c. (For transferring the loss in the asset a/c)	Dr.			

* Usually the money received on the policy will be more than the total amount of premium paid on the policy.

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OR

(ii) For transferring credit balance, if any, in the asset account:

	Asset A/c. Dr. To Profit and Loss A/c. (For the transfer of profit in the asset a/c)				

The following illustration will clarify how the accounts would appear when the Depreciation Fund Policy is taken :

Illustration - 6

On the 1st of January, 1986 'B' Purchased a three year lease of a building for Rs. 20,000 and it was decided to make provision for the replacement of the lease by means of an insurance policy for an equal sum, for an annual premium (Payable on January 1st every year) of Rs. 6,400. Show the necessary ledger accounts for three years.

Solution

Dr. LEASE ON OLD BUILDING A/C Cr.

			Rs.				Rs.
1986				1986			
Jan. 31	To Bank A/c.		20,000	Dec.31	By Balance c/d		20,000
1987				1987			
Jan. 1	To Balance b/d		20,000	Dec.31	By Balance c/d		20,000
1988				1988			
Jan. 1	To Balance b/d		20,000	Dec. 31	By Depreciation Fund A/c.		20,000

Dr. DEPRECIATION FUND A/C Cr.

			Rs.				Rs.
1986				1986			
Dec. 31	To Balance c/d.		6,400	Dec.31	By Depreciation A/c		6,400
1987				1987			
Dec. 31	To Banalce c/d		12,800	Jan. 1	By Balance b/d		6,400
				Dec.31	By Depreciation A/c		6,400
			12,800				12,800
1988				1988			
Dec. 31	To Leasehold Building A/c.		20,000	Jan. 1	By Balance b/d		12,800
				Dec. 31	" Depreciation A/c		6,400
				"	" Depreciation Fund Investment A/c		800
			20,000				20,000

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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, Bottles, 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 claritfy 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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				Rs.	Rs.
1989 Dec. 31	Depreciation A/c.	Dr.		2,500	
	To Loose Tools A/c.				2,500
	(Being the depreciation on revaluation of loose tools written off)				
Dec. 31	Profit and Loss A/c.	Dr.		2,500	
	To Depreciation A/c.				2,500
	(Being transfer of depreciation to P & L A/c.)				

Dr. LOOSE TOOLS A/C Cr.

			Rs.				Rs.
1989				1989			
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 year 1,000 units are obtained, the depletion value will be 1,000 units X Re. 1 = Rs. 1,000/- .The following illustration will clarify the position further.

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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.

$$\text{Depletion} = \frac{\text{Cost — Salvage Value}}{\text{Estimated Units}}$$

$$\text{Depletion per 1000 Board feet} = \frac{\text{Rs. } 7{,}500 + \text{Rs. } 1{,}500 - 500}{5{,}00{,}000} \times 1{,}000$$

$$= \frac{8{,}500}{500} = \text{Rs. } 17$$

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.

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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	To Profit & Loss A/c (Profit) (3)	1,268	July. 1 Dec. 31	By Depreciation A/c(2) By Depreciation A/c (4)	2,168 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
		Dec. 31		By Depreciation A/c (7)	3,469
		Dec. 31		By Balance c/d	19,656
		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		
	(40,000 – 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 23,125 (25,000 – 1,875)		3,469

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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.

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. Jack and Jill purchased a machine on the 1st of January, 1986 for Rs. 12,000 and spent Rs. 500 on its erection. 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

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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).

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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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25.0 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.	Grams : Hytraders
34, Station Road, Guntur.	HYDERABAD TRADERS M.G.Road, Hyderabad - 1.
	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
	For Hyderabad Traders Bhajanlal Managing Partner
E & O.E	

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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

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 following 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/-

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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 Dr
To Cash/Bank Account

---

iii) When any advance is given to the Consignor:

Consignor's Personal Account	Dr.	With the amount of the Bank Draft or with the amount of the Bill accepted
To Bank/Bills Payable Account		

---

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	

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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)			

BRAOU

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

BRAOU

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 To Profit & Loss Account (Being the Profit on consignment transferred to Profit & Loss A/c)	Dr.		53,800	53,800
Goods sent on Consignment Account To Trading Account (Being the goods sent on consignment a/c closed by transfer to Trading A/c)	Dr.		1,00,000	1,00,000

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 4,000 x 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. To Bank Account (Being the amount sent by cheque to Ali Brothers as advance)		50,000	50,000
	Bank Account Dr. Consignment Debtors Account Dr. To Ali Brothers Account (Being the sale proceeds of 60 cases for cash and 15 cases on credit)		1,20,000 32,000	1,52,000
	Ali Bros. Account Dr. To Commission Account (Being the commission earned 5% ordinary and 7 1/2% del credere)		19,000	19,000
	Ali Brothers Account Dr. To Bank Account (Being the expenses paid)		1,200	1,200
	Bank Account Dr. Bad Debts Account Dr. To Consignment Debtors A/c (Being the amount collected from debtors, Rs.750 which could not be collected debited to bad debts account)		31,250 750	32,000
	Commission Account Dr. To Bad Debts Account (Being the loss on account of bad debts set off against commission)		750	750
	Commission Account Dr. To Profit & Loss Account (Being net income on commission transferred to Profit & Loss A/c)		18,250	18,250
	Ali Brothers Account Dr. To Bank Account (Being the amount sent by draft to Ali Brothers of the amount due to them).		81,800	81,800

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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

BRAOU

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.

BRAOU

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

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 Maniklai 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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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

Dr. CONSIGNMENT TO MADRAS ACCOUNT Cr.

	Rs. P.s		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	
Selling Exps. 880		(37,000 x 100) / 980	3,775.50
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

BRAOU

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

$$\frac{\text{Total Cost}}{\text{Total quantity — Normal loss}} \times \text{Quantity in Stock}$$

$$= \frac{37,000}{1,000 - 20 \text{ kg.}} \times 100 \text{ Kg.} = \frac{37,000}{980 \text{ kg.}} \times 100 = \text{Rs.}3,775.50 \text{ (approx.)}$$

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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

B R O U

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 = $\frac{1,25,000}{500} \times 10$ =		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 = $\frac{1,22,500}{488} \times 68$

= Rs.17,069.67

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Books of Venkatesh Brothers

LEDGER

SURAJ OIL MILLS ACCOUNT

Dr.				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

COMMISSION ACCOUNT

Dr.				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.

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.

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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).

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. Kind & 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
26.3 Calculation of Loading
26.4 Summing Up
26.5 Model Examination Questions

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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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 $\frac{20}{100}$ =		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 x1/6 = 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	nil		
Expenses on 100 boxes	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

BRAOU

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

BRAOU

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 following:

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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CHANDMAL'S ACCOUNT

Dr.				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

STOCK ON CONSIGNMENT ACCOUNT

Dr.				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			

STOCK RESERVE ACCOUNT

Dr.				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			1989		
Jan. 1	To Goods sent on Consignment A/c	10,000	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 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 Bank A/c (Exps)	5,000		By Stock Reserve A/c (Loading — Opening Stock)	2,000
"	To Mukesh& Co.A/c (Selling Exps. and Disc.)	1,300	"	By Goods sent on Consignment A/c (Loading)	20,000
"	To Mukesh& Co.A/c (Comm.) Ordinary: 4,750 Del credere 500	5,250			
"	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

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?

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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.

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

Contents

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27. 3 Joint Venture and Partnership
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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.

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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

---

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 Account			2,500
	(Being architect's 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	
		Wages : 20,000	
			75,000
To Joint Venture Account (contract price received)	1,20,000	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		By Joint Bank Account (1/2 plant sold)	23,000
		1,60,000		
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 (architect's 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, Chandrasekhar'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				
Compensation paid	10,000		Less : brokerage @ 2 %	3,000	
Municipal taxes	2,000				
		2,87,000		1,47,000	
To Pankaj's Account :			ii) Sale of other plots	1,80,000	
Cost of fencing	3,000				
				3,27,000	
Stamp duty and Solicitor's fee	6,000		iii) Sale of timber	8,000	
		9,000			3,35,000
To Manoj's Account (Architects fees)		4,000	By Pankaj's Account (value of plots taken over)		15,000
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	
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 contributed)	1,50,000
To Joint Bank Account (final settlement)	1,74,000	By Joint Venture Account	
		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 accepted 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

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Dr. **DINESH'S ACCOUNT** **Cr.**

	Rs.		Rs.
To Joint Bank Account	1,78,000	By Joint Venture Account	1,78,000
	1,78,000		1,78,000

Dr. **BILLS RECEIVABLE ACCOUNT** **Cr.**

	Rs.		Rs.
To Uday's Account (Bill drawn)	2,15,000	By Joint Bank Account	2,13,000
		By Discount Account	2,000
	2,15,000		2,15,000

Dr. **DISCOUNT ACCOUNT** **Cr.**

	Rs.		Rs.
To Bills Receivable Account	2,000	By Joint Venture Account (transferred)	2,000
	2,000		2,000

Dr. **UDAY'S ACCOUNT** **Cr.**

	Rs.		Rs.
To Joint Venture Account (credit sales)	2,15,000	By Bills Receivable Account	2,15,000
	2,15,000		2,15,000

Dr. **AJAY'S ACCOUNT** **Cr.**

	Rs.		Rs.
To Joint Bank Account (final settlement)	1,00,600	By Joint Bank Account (amount contributed)	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

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.

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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	Dr.	Joint Venture Account	Dr.
To Cash Account/Bank Account		To A's Account	
or			
To Purchases Account (if goods belonging to A are supplied for the venture)			

2. When expenditure is incurred by B on account of Joint Venture :

Joint Venture Account	Dr.	Joint Venture Account	Dr.
To B's Account		To Cash Account/Bank Account	
		or	
		Purchases Account	
		(if goods are supplied by B)	

3. If advance is received from B, say, in the form of Bill of Exchange :

Bills Receivbale Account	Dr.	A's Account	Dr.
To B's Account		To Bills Payable Account	

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	Dr.	Joint Venture Account	Dr.
To Discount Account		To A's Account	

6. When money or income is received on account of joint venture by A :

Cash Account	Dr.	A's Account	Dr.
To Joint Venture Account		To Joint Venture Account	

7. When income on account of Joint Venture is received by B :

B's Account	Dr.	Cash Account/ Bank Account	Dr.
To Joint Venture Account		To Joint Venture Account	

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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

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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 the 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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Dr. JOINT VENTURE ACCOUNT Cr

		Rs.		Rs.
To A's Account: purchases	8,000		By Cash Sales	16,000
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	5,000	By Joint Venture Account :	16.000
Advance		Purchases 8,000	
To Bank Account final settlement	7,600	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 @ Rs. 12 per share	18,000
Advertising	1,500			
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 - Sale proceeds of 1,000 shares	12,000	By Joint Venture- A/c Rs.	
		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 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

SRAOU

In the Books of Shyam

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.

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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:

1. For receiving cash from other co-venturers as their share of investment:

Cash Account	Dr.	(with their respective
To Other co-venturers		contributions)
Personal Accounts		

---

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	
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 tranactions. 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.

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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).

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3. Guru Raj and Vasanth Kumar undertook the Costruction of a building for Sudarshan Engineering Co., Ltd., for a contract price of Rs.3,00,000 of which Rs.2,00,000 was payable by instalments in cash and Rs. 1,00,000 in shares of the company. Gururaj deposited Rs. 70,000 and Vasanth Kumar Rs.40,000 in a joint banking account opened for the purpose. They were to share profits and losses equally. The following amounts were spent from the joint bank account:

Wages : R. 60,000; Materials : Rs.1,60,000 and Plant : Rs. 40,000. Guru Raj paid the architect's fees amounting to Rs. 8,000 and Vasanth kumar supplied materials worth Rs. 10,000.

The contract was completed and the price duly received. The Joint Venture was closed by Guru Raj taking up all the shares at an agreed valuation of Rs. 90,000. Half of the plant was taken over by Vasanth Kumar for Rs. 18,000 and the other half was sold for Rs. 20,000. Vasanth Kumar also took over the unused stock of materials at a mutually agreed price of Rs. 6,000. Vasanth Kumar was to be paid Rs. 12,000 per annum towards establishment expenses to be charged to the joint venture account. The contract lasted 9 months. Prepare the necessary ledger accounts.

(Answer : Profit : Rs. 47,000; Final Payment to GuruRaj : Rs. 11,500 and to Vasanth Kumar : Rs. 58,500).

4. Ajay Sharma, Prajwal and Naveen entered into a joint venture and agreed to divide profits in the ratio of 6 : 3 : 1 respectively. They agreed to contribute the following amounts which were put in a joint banking account : Ajay Sharma : Rs.15,000 ; Prajwal : Rs.10,000 and Naveen : Rs.8,000.

They purchased goods worth Rs.30,000, the payment for which was made from the joint bank account. Some of the goods were sold for Rs.45,000 ; a part of the goods were spoiled and were taken away by Ajay Sharma for Rs.800. The following expenses were paid by the co-venturers ; Ajay Sharma : Rs.500 ; Prajwal : Rs.200 and Naveen : Rs.100.

You are required to open ledger accounts when a separate set of books is maintained for the joint venture

(Answer : Profit : Rs.15,000 ; Final payments to Ajay Sharma : Rs.23,700 ; Prajwal : Rs.14,700 and Naveen : Rs.9,600)

5. Sanjay Varma, Subhash and Suresh entered into a joint venture 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.90,000 Subhash Rs.80,000 and Suresh Rs.70,000, which amounts were banked in a joint account. They settled their accounts with Dinesh by cheque and paid for carriage and other expenses amounting to Rs.10,000. They sold goods worth Rs.2,40,000 for cash and to Rajesh on credit for Rs.90,000, who accepted a Bill payable after three months for the amount. The Bill was discounted with the bank for Rs.89,600. Sanjay Varma 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 :

(Answer : Profit : Rs.53,100 ; Final Settlement : Sanjay Varma : Rs.1,74,200 ; Subhash Rs. 97,700 and Suresh : Rs.87,700)

6. Kishore and Kiran entered into a joint venture sharing profits in the ratio of 3/5ths and 2/5ths. Kishore was to purchase goods at Bombay and forward them to Kiran in Dehradun. Kishore purchased good worth Rs.20,000 and paid Rs.2,000 as expenses. Kiran received the consignment and immediately accepted Kishore's draft for Rs.15,000. Kishore got it discounted for Rs.14,700. Kiran sold the goods for 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 Kiran.

(Answer : Profit : Rs.9,950 ; amount due from Kiran : Rs.13,270).

7. Pradeep and Prakash enter into a joint venture for guaranteeing the subscriptions at par of 5,00,000 shares of Re.1 each in Matrushi, Ltd. They agreed to share profits and losses equally. The terms of agreement with the company were that Pradeep and Prakash had to pay all expenses upto allotment in

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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 plan was got prepared at a cost of Rs.5,200 paid by Ravinder. In the said plan 1/6th of total area 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.70,000 ; Amount paid to Premchand : Rs.50,000).

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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 IS 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.

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Writer : Sri R.P. Trivedi.

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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
- Unit - 7 : Bank Reconciliation Statement - I
- Unit - 8 : Bank Reconciliation Statement - II
- Unit - 9 : Bills of Exchange
- Unit - 10 : Accommodation Bills
- Unit - 11 : Trial Balance

BLOCK - III 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
- Unit - 20 : 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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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 theory questions in about 30 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 31.12.1989	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.50
4) Cheques issued but not cashed, prior to 31st December 1989 amounted to Rs.15,000.
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 credited 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.

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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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UNDER GRADUATE COURSE
B.Com. II Year

SUBJECT : COMMERCE
COURSE: ACCOUNTANCY

ASSIGNMENT - II

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 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 Loss Account 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.

Dr. B.R. AMBEDKAR OPEN UNIVERSITY
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SUBJECT : COMMERCE
COURSE: ACCOUNTANCY

ASSIGNMENT - III

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 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 such 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 Contractors, 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.

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SECTION - B

Answer the theory question in about 15 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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