

B.COM-101

# FINANCIAL ACCOUNTING

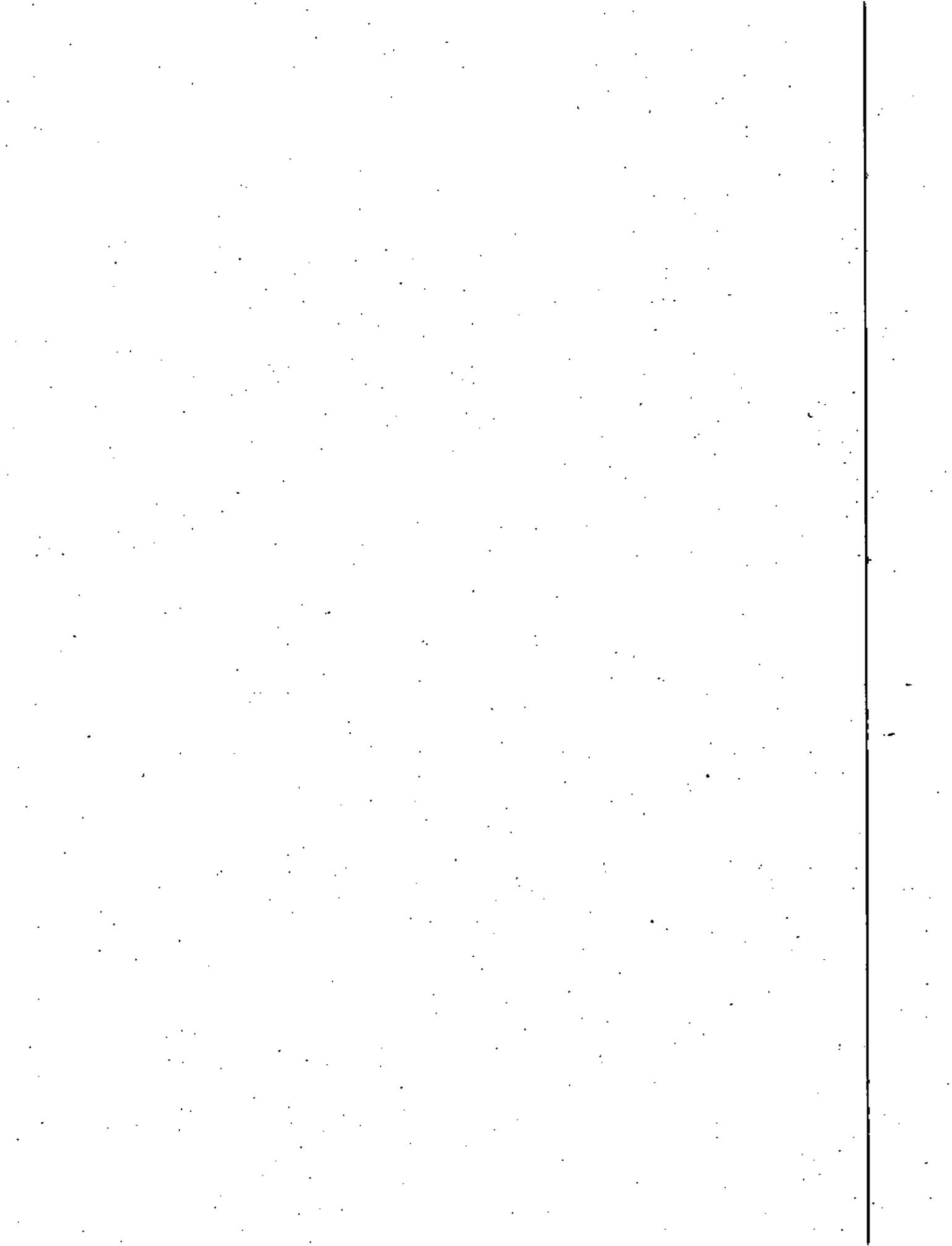


**DIRECTORATE OF DISTANCE EDUCATION**

**SWAMI VIVEKANAND**

**SUBHARTI UNIVERSITY**

Meerut (National Capital Region Delhi)



# FINANCIAL ACCOUNTING

B.Com-101

Self Learning Material



Directorate of Distance Education

**SWAMI VIVEKANAND**  
**SUBHARTI**  
**UNIVERSITY**  
Meerut  
UGC Approved

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MEERUT-250005

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# SYLLABUS

B.Com-I Semester I year

Financial Accounting

B.Com-101

<b>Course Code: B.Com-101</b>		
<b>Course Credit: 5</b>	<b>Lecture: 4</b>	<b>Tutorial: 1</b>
<b>Course Type:</b>	<b>Core Course</b>	
<b>Lectures delivered:</b>	<b>40L +10T</b>	

## End Semester Examination System

<b>Maximum Marks Allotted</b>	<b>Minimum Pass Marks</b>	<b>Time Allowed</b>
<b>70</b>	<b>28</b>	<b>3 Hours</b>

## Continuous Comprehensive Assessment (CCA) Pattern

<b>Tests</b>	<b>Assignment/ Tutorial/ Presentation/ class test</b>	<b>Attendance</b>	<b>Total</b>
<b>15</b>	<b>5</b>	<b>10</b>	<b>30</b>

**Course Objective:** This course aims to familiarize students with the Financial Accounting Principles and their application in the organizations. It will equip the students with understanding of Final Accounts, Inland Branches and Consignment Accounting. The course will use and focus on generally accepted accounting Principles and cases.

<b>UNIT</b>	<b>Course Content</b>	<b>Hours</b>
I	Financial Accounting: Nature and scope, Limitations of Financial Accounting. Basic Concepts and Conventions. Accounting Standards: Meaning, Significance, Generally Accepted Accounting Principles (GAAP). Accounting Process: From recording of transactions to preparation of final accounts	12
II	Depreciation Accounting: Meaning of Depreciation, causes, objects of providing depreciation, factors affecting depreciation, accounting treatment including provision for depreciation accounting. Methods of depreciation: straight line method, diminishing balance method, Change of method as per revised AS-6.	12
III	Final Accounts of Non profit Organization: From receipts and payments account with additional information and vice-versa Preparation of Balance Sheets (opening and closing) form receipts and payments account and income expenditure account and additional information.	12
IV	Consignment Accounting, .Accounting for joint venture in the same books of accounts.	7
V	Inland Branches: Dependent branches only and Ascertainment of Profit by Debtors method and Stock and Debtors method, Branch Accounting	7

**Course Outcomes:** After studying this course the student should be able to

CO 1: Understand the conceptual of Financial Accounting and their application in real world.

CO 2: Describe the Generally Accepted Accounting Principles and its contribution in preparation of Final Accounts of a company.

CO 3: Analyze and compare Financial Position of Different Companies.

CO 4: Assess the interlinking of Income and Expenditure of Non Profit Organization.

CO 5: Compare and Understand Consignment Accounting and Joint Venture Accounting. CO

CO 6: Understand Inland Accounting System.

#### **Text Books**

1. T.S. Grewal, Introduction to Accounting, S. Chand and Co., New Delhi, 2015, Edition
2. S.N. Maheshwari, Financial Accounting, Vikas Publication, New Delhi, 2018, Edition
3. P.C. Tulsian, Financial Accounting, Tata McGraw Hill, New Delhi, 2018, Edition

#### **Reference Books**

1. J.R. Monga, Basic Financial Accounting, Mayur Paper backs, Darya Gang New Delhi, 2016 Edition
2. Anthony, R.N. Hawkins, and Merchant, Accounting: Text and Cases. McGraw-Hill Education, 2016 Edition
3. Bal Ranjan Kumar, Financial Accounting – S. Chand, N. Sethi 2015-2016 Edition
4. Bansal.K.M - Financial Accounting – Taxman Publication, 2016-2017 Edition
5. Deepak Sehgal, Financial Accounting – Vikash Publication, 2017-2018 Edition
6. Horngren, Introduction to Financial Accounting, Pearson Education, 2017-2018 Edition

#### **Weblinks:**

1. <https://www.zeroify.com/mod/resource/view.php?id=4542>
2. <https://targetstudy.com/courses/bcom-financial-accounting.html>
3. <https://sol.du.ac.in/course/view.php?id=149>
4. <https://www.youtube.com/watch?v=80QWVZCxbaA>
5. <https://www.studocu.com> › ... › Introduction to Financial Accounting

# 1. Meaning and Scope of Accounting

**Notes**

## Structure

- 1.1 Book-Keeping
- 1.2 Accounting
- 1.3 Development of Accounting
- 1.4 Objectives of Accounting
- 1.5 Advantages of Accounting
- 1.6 Types or Sub-Fields/Branches of Accounting Information
- 1.7 Persons/Parties Interested Accounting
- 1.8 Basic Accounting Terminology
- 1.9 Introduction: Accounting Principle
- 1.10 Meaning of GAAP
- 1.11 Basic Accounting Concepts
- 1.12 Introduction: Transactions and Source Documents
- 1.13 Source Documents
- 1.14 Vouchers
- 1.15 Contents of Accounting Vouchers
- 1.16 Accounting Equation/Cycle
- 1.17 Computation-Classification of Transactions
- 1.18 Summary
- 1.19 Review Questions

## 1.1 BOOK-KEEPING

### Meaning

*Book-keeping is the proper and systematic keeping or maintenance of the books of accounts.* Book-keeping starts from the identification of business transactions. These transactions must be supported by the documents and they must be financial in nature. For example, selling goods for cash is an accounting transaction, because cash is received and goods are going outside the business. The transaction will increase cash and reduce goods:

It will affect the finance of the business. There will also be documentary proof of the transaction because cash memo must have been issued for sale. The book-keeper after identification of the accounting transaction will record it in the proper books of accounts.

**Definition**

*Book-keeping may be defined as the science and art of identifying and recording accounting transactions systematically in the proper books of accounts.*

According to North Cott, "Book-keeping is the art of recording in the books of accounts the monetary aspect of commercial or financial transactions."

**Notes**

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

Book-keeping is concerned with the proper maintenance of the books of accounts i.e., journal, ledger, cash book and other subsidiary books. *It is not concerned with disclosing or interpreting the results of the business.* Book-keeping involves the following process:

**Process of Book-keeping**

1. **Identifying Accounting Transactions:** All business transactions which are financial in nature and have documentary proof are accounting transactions. Non-economic activities concerning emotions of love, patriotism and respect do not find place in Book-keeping.
2. **Initial Record of Accounting Transactions:** The identified accounting transactions are passed through subsidiary books, such as purchases book, sales book, returns inward book, returns outward book, bills receivable book, bills payable book, cash book and journal proper.
3. **Preparation of Ledger Accounts:** All the transactions relating to a particular person, party or item are put together at one place under one head, which is known as its ledger account. For example, information regarding sales to Ram, amount received from Ram, discount allowed to Ram and so further sales and receipt of the amount should be written in Ram's Ledger Account. This will enable us in understanding the actual position of Ram's dealings at a glance. With the help of subsidiary books and journal proper all ledger accounts are prepared.
4. **Balancing Ledger Accounts:** Ledger accounts are balanced, i.e., the difference between the debit and credit side of the ledger accounts are ascertained. Personal accounts show the amount payable to or receivable from them. Assets accounts show the value of assets on a particular date. Ledger accounts, thus, reveal the balances of expenses, revenue, liability, capital and assets.
5. **Preparation of Trial Balance:** Trial balance is prepared with the balances shown by the ledger accounts. While passing journal entries and preparing subsidiary books we take into consideration the dual aspect of every transaction, so the debit and credit balance of the trial balance must tally. Trial balance is prepared to check arithmetical accuracy. If the totals of the debit and credit side of the trial balance is not equal, there must be certain errors. These errors are located and rectified.

## 1.2 ACCOUNTING

Every business has profit motive. It has transactions of financial nature, such as, purchasing goods, selling goods, incurring expenses, receiving income, etc. These transactions are financial in nature and affect the profit of the business. Accounting transactions are both money transactions and money worth transactions. Credit transactions are known as money worth transactions. It means that accounting transactions may not be necessarily cash transactions.

Transactions are classified as assets, liabilities, capital, revenues and expenses. Income statements are prepared to ascertain profit or loss of the business. The position statement is prepared to assess the value of assets and liabilities of the business. Various statements are prepared and ratios are calculated to measure the actual performance of the business. Comparison of the actual performance is compared with previous performance or desired performance and effective plans for future is made. In this way, *accounting is an art of identifying, classifying, recording, summarising and interpreting business transactions of financial nature.* The process of maintaining accountancy records contains the following steps:

All financial transactions which have documentary evidence are identified as accounting transactions. The elements of the transactions are classified as assets, liabilities, capital, revenues and expenses. These transactions are recorded in the appropriate books of accounts. Income statements are prepared to ascertain profit or loss of the business during accounting period. Position statements are prepared to ascertain assets and liabilities of the business. Finally, result of the business transactions are communicated.

### Definition of Accounting

In the words of **Smith and Ashburne**, "*Accounting is a means of measuring and reporting the results of economic activities.*"

In the opinion of **Bierman and Derbin**. "*Accounting may be defined as the identifying, measuring, recording and communicating of financial information.*"

### Difference between Book-Keeping and Accounting

Points of difference	Book-keeping	Accounting
1. Objective	The objective of book-keeping is to prepare original books of accounts. It is restricted to journal, subsidiary books and ledger accounts only.	The objective of accounting is to record, analyse and interpret the business transactions.
2. Scope	It has limited scope and is concerned with the recording of business transactions.	It has wider scope as compared to book-keeping.

Notes

## Notes

3. Level of work	It is restricted to low level of work. Clerical work is involved in it.	It is concerned with low level, medium level and even top level management. Low level clerks prepare the accounts, medium level report it and top level interpret it.
4. Mutual dependence	Book-keeping is only the art of recording transactions, so it has to depend upon accounting which makes it more meaningful and purposeful.	Accounting is based upon book-keeping which is its initial and vital part. It depends upon book-keeping.
5. Results of the business	It does not show the net result of the financial position of business.	Accounting shows the net result of the business. It tells us about the profit earned and also about the assets and liabilities of the business.
6. Principles of Accounting	In book-keeping, accounting concepts and conventions are followed.	The methods of reporting and interpretation in accounting may vary from firm to firm.

### 1.3 DEVELOPMENT OF ACCOUNTING

The role of accounting has changed from that of a mere record keeping during the 1st decade of 20th century to the present stage, when it is accepted as **information system and decision-making activity**.

The term accounting is becoming gradually broader. It is evident from **definitions of accounting** arranged in historical order:

- (i) **1941:** The American Institute of Certified Public Accountants (AICPA) defined accounting as:

*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 result thereof.*

- (ii) **1966:** The American Accounting Association (AAA) defined accounting as:

*The process of identifying, measuring and communicating economic information to permit informed judgements and decisions by uses of the information.*

- (iii) **1970:** Accounting Principles Board (APB) and AICPA states:

*The function of Accounting is to provide quantitative information primarily financial in nature, about economic entities, that is intended to be useful in making economic decisions.*

The above statements about Accounting show that the role of Accounting is gradually widening.

The role of accounting at present is assumed:

- (i) To provide information for judging management ability to utilise resources effectively in achieving goals.
- (ii) To provide factual and interpretative information by disclosing underlying assumptions on matters, subject to interpretation, evaluation, prediction or estimation and
- (iii) To provide information or activities affecting society.

**Notes**

Accounting in this way, identifies business transactions, records them in proper subsidiary books and journal proper and prepares ledger accounts. Trial balance is prepared with the balance of ledger accounts and finally financial statements are prepared, reported and communicated to parties concerned.

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## 1.4 OBJECTIVES OF ACCOUNTING

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Followings are the objectives of accounting:

- 1. Maintaining Proper Record of Business Transaction:** The main purpose of accounting is to identify business transactions of financial nature and enter them into appropriate books of accounts. Business transactions are classified as, assets, liabilities, capital, revenues, expenses and accordingly passed through books. The accounting records should be made properly and systematically, so that requisite information may be obtained at a glance from the books of accounts.
- 2. Calculation of Profit or Loss:** One of the main object of accounting is to calculate the profit or loss of the business. Income statements are prepared with the help of trial balance (prepared with the balances of ledger accounts). At the end of accounting period, we prepare Trading Account and ascertain gross profit or gross loss. Afterwards Profit and Loss Account is prepared to calculate net profit or net loss. Accounting in this way, is the source to evaluate the performance of the business in terms of profit.
- 3. Depiction of the Financial Position:** At the end of accounting period, we prepare position statement. The value of assets and liabilities are depicted in the balance sheet, also known as position statement.

The assets side of the balance sheet shows the position of various assets such as cash in hand, cash at bank, sundry debtors, closing stock, building, machinery, furniture, etc. The liabilities side shows creditors' claim as creditors' for goods, bills payable, loans, outstanding expenses and proprietor's claim as capital, net profit and reserves. Balance Sheet is said to be a mirror, reflecting the true position of assets and liabilities on a particular date.

- 4. Providing Effective Control Over the Business:** Accounting reveals the actual performance of the business in terms of production, sales, profit, loss, cost of production and the book value of sundry assets. The actual performance can be compared with the planned or desired performance of the business. It can also be compared with the previous performance. Comparison reveals deviation in terms of weaknesses and plus points.

Notes

Causes responsible for the poor performance are identified and efforts are made to remove them. Causes responsible for better performance are reinforced. Accounting, in this way, enables the management to adopt effective control over the business.

5. **Making Information Available to Various Groups:** Business, these days is a social institution. In addition to the owners of the business various groups, such as, creditors, lenders, investors, researchers, government and even workers and consumers have an interest in the performance of business. Accounting makes information available to all these interested parties. Proprietors have interest in the profit or dividend, *debenture holders, lenders and investors are concerned with the safety of money advanced by them to the business and interest thereon.* Financial soundness of the business makes their loans secured. Employees have an interest in their increased wages and bonus. The object of the accounting is to provide meaningful information to all these interested groups.

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## 1.5 ADVANTAGES OF ACCOUNTING

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1. **Replacing Memory:** Business transactions are innumerable, varied and complex, as such it is quite impossible to memorise each and every transaction. Accounting records these transactions in writing and thus, it is not necessary that the businessman should memorise all the transactions.
2. **Assisting the Performance of the Business:** Accounting keeps proper and systematic record of all business transactions. Income statements are prepared with these records and we are able to know the profit earned and the loss suffered by the business. Trading Account is prepared to find out gross profit or loss of the enterprise. Net profit or net loss can be known by preparing Profit and Loss Account.
3. **Assessing the Financial Status of the Business:** Financial position of the business is displayed through position statement, *i.e.* Balance Sheet of the business. The statement is prepared at the end of the accounting year and reflects the true position of assets and liabilities of the business on *particular date.*
4. **Documentary Evidence:** Accounting records can also be used as an evidence in the court of substantiate the claim of the business. These records are based on documentary proof. Every entry is supported by authentic vouchers. That is why, the court accepts these records as evidence.
5. **Assisting in Realisation of Debts:** In 'Accounts' we prepare personal ledger accounts of all the parties. The personal account shows the exact amount due from the debtors. We can send the debtors their statement of accounts and thus enable them to verify entries and also to make early payment of the amount due. The account can also be used to prove the claim of the business against the debtors in the court.
6. **Facilitating the Sale of the Business:** The position statement of the business shows the value of assets and liabilities of the business. We can calculate the 'Net Worth' of the business on the basis of these statements.

Accounting facilitates in the calculation of the consideration for which the business should be sold.

7. **Preventing and Detecting Frauds:** The proper accounting system and effective arrangement of internal check prevents leakage of goods and cash. In case, cheating takes place, theft or embezzlement is made and fraud is committed, accounting helps in detection of these losses and also fixes responsibility for it. Proper accounting prevents employees from committing fraud.
8. **Helpful to Management:** Accounting is useful to the management in various ways. It enables the management to assess the achievements of its performance. Actual performance can be compared with the desired performance or with the performance of previous years. The weaknesses of the business can be identified and corrective measures can be applied to remove them. Various profitability, sales and liquidity ratios can be calculated, the actual performance can be evaluated and effective line of action can be decided for the future. Funds flow statement can also be prepared to understand the additional funds earned during the year and their application.

Notes

**Full Disclosure:** The concept is also known as convention of full disclosure. **Accounting must disclose all material information.** It should be honestly prepared, free from any bias, favour or prejudice. Figures should not be manipulated. It should be the sincere effort of the accountant to present facts, keeping in view the various accounting assumptions. No material information should be concealed. Material information means the information capable of changing the results of the business. Enterprises have their existence separate from their proprietors. In case of companies, there is a divorce between ownership and management. In this context, it becomes binding upon the management to disclose all material information in accounts to its owners and other interested parties.

Disclosure of material facts does not mean leaking out the business secrecy, but disclosing all information of proprietors' and investors' interest. Accounting to this principle, certain unimportant items are left and some of them are merged with other items. The intention is not to over burden Accounting with information but present facts without any malafide intention.

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## 1.6 TYPES OR SUB-FIELDS/BRANCHES OF ACCOUNTING INFORMATION

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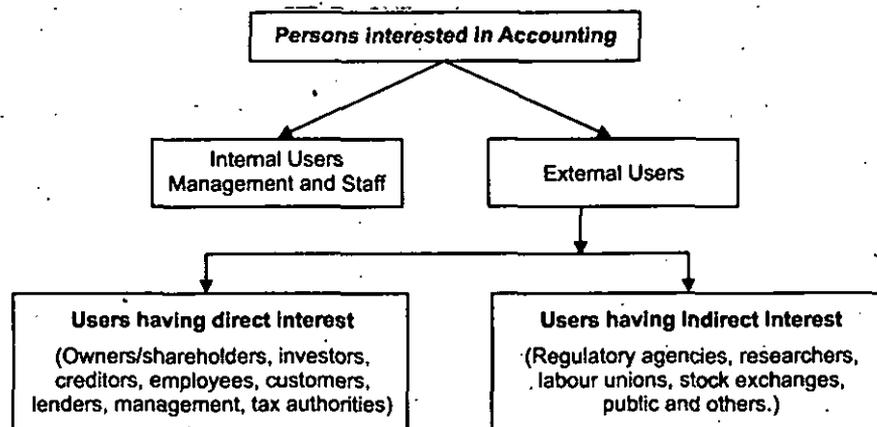
Accounting has at present three sub-fields or branches, mentioned as under:

1. **Financial Accounting:** Accounting is a wider and comprehensive concept. It is an art of identifying, classifying, recording, summarising and interpreting business transactions of financial nature. Accounting work involves low, medium and even top level employees. Accounting as such is book-keeping plus preparation of financial statements, reporting the results of the business and interpreting the accounting information in the forms of ratios, funds and cash flow statements, schedules, charts and diagrams.

Notes

2. **Cost Accounting:** It is that branch of accounting, which deals with cost of production and its various constituents. It is concerned with the classification, allocation, recording, summarising and reporting current and prospective costs. Cost accounting, like financial accounting serves the needs of proprietors, managers and interested outsiders. Cost accounting is the systematic process of determining unit cost at different levels of production.
3. **Management Accounting:** Management in the business is concerned with decision-making for the efficient working of the enterprise, so management accounting is a system to assemble and furnish the useful material and summarised accounting information to the management. Management accounting as such is the effective blending of financial and cost accounting together with financial management. The ultimate end of management is to maximise profit at the minimum cost and sacrifice. The management accounting serves as an effective tool for determining right line of action in future.

### 1.7 PERSONS/PARTIES INTERESTED ACCOUNTING



1. **Internal Users:** Top, middle and bottom level of management executives are the internal users of accounting information. They need it for making their decisions. These users are interested in the profitability, operational efficiency and financial soundness of the business. The top level management is concerned with accounting information relating to planning, the middle level is interested in planning and controlling and the lower level with operational affairs.
2. **External Users:** External users may have direct interest or indirect interest.
  - (i) *External users having direct financial interest:* The existing and the prospective creditors and investors have direct interest in the accounting information. The sources of information for external users are financial statements and reports of directors and auditors. Investors assess the financial worth of the business so that they may decide about buying, selling or holding investment in the business. Creditors, such as banks, lenders, debenture holders and financial institutions assess the risk involved in granting loans to the business.

- (ii) *External users having indirect interest:* These users, such as Department of Company Affairs, Registrar of Joint Stock Companies, sales tax and income tax authorities, labour unions, customers, stock exchanges, trade associations and others are also interested in the affairs of the business. They have to make their own decision on the basis of the financial reports of the business.

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## 1.8 BASIC ACCOUNTING TERMINOLOGY

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Every subject has got its own terminology. Accounting, as a subject has got its own terms. These terms have their specific meaning in Accounting and used to express financial nature of the business.

### 1. Business Transactions

*The economic event that relates to a business entity is called business transaction.*

Every business activity is not an accounting activity. That is why, every activity is not recorded in the books of accounting. We record only business transactions in Financial Accounting. The first step in the accounting process is the identification of business transaction. *Every activity of financial nature having documentary evidence, capable of being presented in numerical, monetary term causing effect on assets, liabilities, capital, revenue and expenses is termed as business transactions.*

**Special features of business transactions are as under:**

- (i) Business transactions must be financial in nature.
- (ii) Business transactions must be supported by documentary evidence.
- (iii) Business transactions must be presented in numerical monetary terms.
- (iv) Business transactions must cause an effect on assets, liabilities, capital, revenue and expenses.

Business transactions as such refer to business activities involving transfer of money or goods or services between two parties or two accounts. Purchase and sale of goods, receipts of income, etc. are business transactions. Business transactions may be both cash or credit.

### 2. Assets

*The valuable things owned by the business are known as assets.* These are the properties owned by the business. Assets are the economic resources of an enterprise which can be expressed in monetary terms. In the words of Prof. R.N. Anthony, "Assets are valuable resources owned by a business which were acquired at a measurable money cost." The most important assets are:

#### (a) Fixed Assets

These assets are acquired for long-term use in the business. They are not meant for sale. These assets increase the profit earning capacity of the business. Expenditure on these assets is not regular in nature. Land and building, plant and machinery, vehicles and furniture, etc. are some of the examples of fixed assets.

#### (b) Current Assets

*These assets, also known as circulating, fluctuating or floating assets. They change*

their values constantly. In the words of Institute of Certified Public Accountants, USA, "Current assets include cash and other assets or resources, commonly identified as those which are reasonably expected to be realised in cash, or sold or consumed during the normal operating circle of the business."

## Notes

It should be noted that certain assets, which are popularly known as fixed may prove to be current by virtue of their specific use such as:

- (i) **Land** will be current assets in the hands of land developers and property dealers.
- (ii) **Building** with the builders and property dealers.
- (iii) **Plant and Machinery** with the manufacturers and dealers of plant and machinery.
- (iv) **Furniture** with the furniture dealers and furnishers.
- (v) **Shares and Debentures** with the dealers in securities.

It should be taken care of that assets meant for regular purchase and sale are always current assets.

### (c) Fictitious Assets

*Fictitious assets are those assets, which do not have physical form. They do not have any real value. Actually, they are not the real assets but they are called assets on legal and technical ground.* These assets are the revenue expenditure of capital nature which are also termed as deferred revenue expenditure. The example of these assets are loss on issue of shares, advertising suspense and preliminary expenses, etc. Fictitious assets do not have real value, so they are written off in the future.

### (d) Tangible Assets

*Traditional View:* Assets having physical existence which can be seen and touched are known as tangible assets. These assets are land, building, plant, equipment, furniture, stock, etc.

*Alternative View:* In a court testimony in USA, it was argued that tangible assets should not be allowed to mean assets having physical construction only because there are certain assets, such as cash, cash equivalent and receivables which do not have physical construction but even then treated as tangible assets. It finally emerged that all assets where revenue generation is certain should be treated as tangible assets. The examples of these assets are building, plant, equipment, furniture, stock, receivable cash, cash equivalents such as treasury bills, commercial papers and money market funds.

On the other hand, in the case of assets like goodwill, patent or copyright the revenue generation is assumed to be uncertain. That is why they are put in the category of intangible assets.

### (e) Intangible Assets

These are the assets which are not normally purchased and sold in the open market such as goodwill and patents. It does not mean that these assets are never purchased and sold. They may be purchased and sold in special circumstances. Payment for patents can be made to reputed manufacturers of the country and abroad. Payments for patents is mostly made in case of medicines. While purchasing the business of other firms payment for goodwill is made. Goodwill may also be raised in case of

admission or retirement of partner. It is also preferable to write off goodwill and patents accounts and not to show in the balance sheet.

### (f) Wasting Assets

Assets, whose value goes on declining with the passage of time are known as wasting assets. Mines, patents and assets taken on lease are its examples.

### (g) Liquid Assets

Liquidity refers to convertibility in cash. Liquid assets, therefore are those assets, which can be converted into cash at short notice. The examples of liquid assets are cash in hand, cash at bank, debtors, bills receivable, etc. In other words, liquid assets are current assets less stock, *i.e.*

$$\text{Liquid Assets} = \text{Current Assets} - (\text{Stock} + \text{Prepaid Expenses})$$

## 3. Capital

It is that part of wealth which is used for further production and thus capital consists of all current assets and fixed assets. Cash in hand, cash at bank, building, plant and furniture, etc. are the capital of business. Capital need not necessarily be in cash. It may be in kind also. Capital may be classified as follows.

### (a) Fixed Capital

The amount invested in acquiring fixed assets is called fixed capital. The money is blocked in fixed assets and not available to meet the current liabilities. The amount spent on purchase or extension or addition to the fixed assets is fixed capital. Plant and machinery, vehicle, furniture and building, etc. are some of the examples of fixed capital.

### (b) Floating Capital

Assets purchased with the intention of sales, such as stock and investments are termed as floating capital.

### (c) Working Capital

The part of capital available with the firm for day-to-day working of the business is known as working capital. Sufficient funds are required for purchasing goods and incurring direct and indirect expenses. Operational expenses are met with working capital. Current assets and current liabilities constitute working capital. Current assets consist of cash in hand, cash at bank, bills receivable, debtors, stock in hand, etc. and creditors, bills payable, short-term loan, income received in advance and outstanding expenses are the current liabilities. Working capital can also be expressed as under:

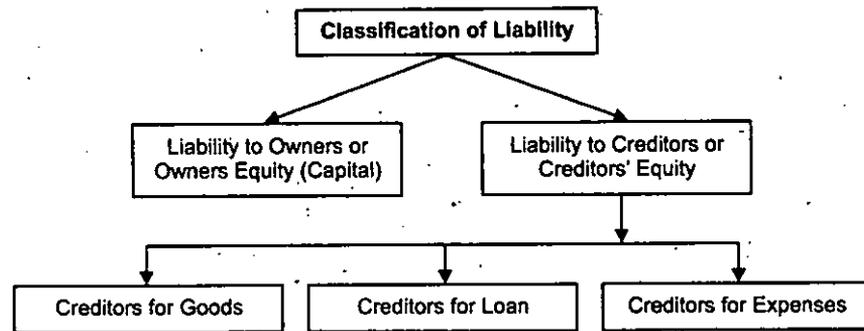
$$\text{Working Capital} = \text{Current Assets} - \text{Current Liabilities}$$

## 4. Equity or Liability

Liabilities are the obligations or debts payable by the enterprise in future in the form of money or goods. It is the proprietors' and creditors' claim against the assets of the business. Creditor may be classified as creditors for goods and creditors for expenses. The business should have sufficient current assets to meet its current liabilities and reasonable amount of fixed assets to meet its fixed liability. Liabilities can be classified as under:

Notes

## Notes



**Note:** Accountants in USA use the term equity to denote liabilities and capital.

(a) **Liability to Owners:** It is the owner's claim against the assets of the business, generally known as capital. It is technically known as *internal equity* or *shareholder's funds*. It may also be expressed as under:

$$\begin{aligned} \text{Owner's Equity or Internal Equity} &= \text{Capital} + \text{Profit Earned} + \text{Retained} \\ \text{(Shareholder's funds)} &\quad \text{Earning} + \text{Undistributed Profit} \\ &\quad + \text{Interest on Capital} - \text{Drawings} \\ &\quad - \text{Expenses.} \end{aligned}$$

(b) **Creditor's Equity:** It is creditors' claim against the assets of the business. These creditors may be creditors for goods and creditors for expenses:

(i) **Creditors for goods:** Business has to purchase goods on credit, so the suppliers of goods to the business on credit are known as creditors for goods. They may be called as creditors and bills payable.

(ii) **Creditors for loan:** These creditors are the parties, banks and other financial institutions. The liability is named as Bank loan, Bank overdraft, Loan from Industrial Finance Corporation, Industrial Development Bank of India and World Bank.

(iii) **Creditors for expenses:** Certain expenses may concern the accounting period but may remain unpaid. These expenses may be outstanding salaries, rent due and wages unpaid. It is the current liability of the business.

Liabilities can also be classified as fixed, current and contingent liabilities.

(a) **Fixed liability:** These liabilities are paid after a long period. Capital, loans, debentures, mortgage, etc. are its examples. These are not current liabilities.

(b) **Current liabilities:** Liabilities payable within a year are termed as current liabilities. The value of these liabilities goes on changing. Creditors, bills payable and outstanding expenses, etc. are current liabilities.

(c) **Contingent liabilities:** These are not the real liabilities. Future events can only decide whether it is really a liability or not. Due to their uncertainty, these liabilities are termed as contingent (doubtful) liabilities. Important examples of contingent liabilities are as under:

(i) Value of bills discounted.

(ii) Cases pending in the court of law.

(iii) Guarantees undertaken.

The value of contingent liabilities is not shown in the amount column at the liabilities side of balance sheet. It is clearly mentioned as a note inside/outside the balance sheet.

Liabilities are also classified as long-term liabilities and short-term liabilities:

- (a) *Long-term liabilities*: Liabilities payable after a period of one year such as term loans and debentures are long-term liabilities.
- (b) *Short-term liabilities*: Obligations payable within a period of one year, such as creditors, bills payable and overdraft, etc. are short-term liabilities.

**Notes**

## 5. Financial Statements/Final Accounts

Statements prepared by an enterprise at the end of accounting year to assess the status of income and assets is termed as Financial Statement/Final Accounts. It is categorised as Income Statement and Position Statement traditionally known as Profit and Loss Account and Balance Sheet.

## 6. Accounting Equation

Accounting rotate around three basic terms. These terms are Assets, Liabilities and Capital. The true inter-relationship between these terms is represented as Accounting Equations, i.e.,

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

## 7. Goods

Articles purchased for sale at profit or processing by the business or for use in the manufacture of certain other goods as raw material are known as goods. In other words, goods are the commodities, in which the business deals. Furniture will be goods for the firm dealing in furniture but it will be an asset for the firm dealing in stationery. *Americans use the term 'merchandise' for goods'.*

## 8. Cost

Expenditure incurred in acquiring, manufacturing and processing goods to make it sale worthy are termed as cost of goods. It includes purchases of tradeable goods, raw materials and direct expenses incurred in acquiring and manufacturing goods.

## 9. Purchases

In its routine business, the firm has to either purchase finished goods for sale or purchase of raw material for the manufacture of the article, being sold by the firm. The acquisition of these articles are purchases. The purchase of 10,000 metres of silk by Naro, a cloth merchant is termed as purchases in the business. In the same way, the purchases of ten fans by Kevi, a dealer in electrical appliances for use in the cooler being assembled in his factory will also be the purchases. It is immaterial whether goods have been purchased for cash or on credit. They may be purchased within the country or imported from abroad. *Purchases of assets, are not the purchases in accounting terminology as these assets are not meant for sale.*

Proper, complete and systematic record of the purchases is essential as the cost price of goods is based upon it. Purchases must be made at competitive rates.

## Notes

**10. Sales**

The ultimate end of the goods purchased or manufactured by the business is their sales. It includes both cash and credit sales. In accounting terminology, sales means the sale of goods, never the sale of assets, sales should have a regular feature. The sales of ten sofa sets by Amenla, a furniture is sales but sale of old furniture by Akho, a stationery dealer will not be a sale. Sales may be effected within the country or exported abroad.

The maintenance of proper and complete record of sales is necessary, because the profit or loss is associated with the amount of sales. It should be the sincere effort of every business to purchase goods at competitive rates and make sales at reasonably higher rates to earn more profit.

**11. Purchases Return or Return Outward**

It is that part of the purchases of goods, which is returned to the seller. This return may be due to unnecessary, excessive and defective supply of goods. It may also result, if the supplier violates the terms and conditions of the order and agreement. In order to calculate net purchases, purchases return is deducted from purchases. Purchases returns are also known as returns outward, because it is the return of goods outside the business.

**12. Sales Return or Returns Inward**

It is that part of sales of goods which is actually returned to us by purchasers. This return may also be due to excessive, unnecessary and defective supply of goods or violation of terms of agreement. Sales return, also known as returns inward is deducted from sales, in order to calculate net sales.

**13. Stock**

The goods available with the business for sale on a particular date is termed as stock. It varies, *i.e.*, increases or decreases and goes on changing. In accounting, we use the term stock widely as opening and closing stock. In case of business which is being carried on for the last so many years, the value of goods on the opening day of the accounting year is known as opening stock. In the same way, the value of goods on the closing day of the accounting year will be closing stock. For example, Avi and Sons started their business on Jan. 1, 2020 and decided to close their books on 31st December every year. The firm will not have any opening stock on Jan. 1, 2020, because the business did not exist before Jan. 1, 2020. If the firm has goods worth ₹ 50,000 on 31st December, 2020, it will be the closing stock on the date. On January 1, 2021, the closing stock of December 31, 2020 will be the opening stock of the year 2021. It should always be kept in mind that stock is valued at cost price or market price, whichever is lower.

In case of manufacturing enterprises stock is classified as under:

- (i) **Stock of Raw Material:** Raw material required for manufacturing of the product in which the business deals is known as stock of raw material. Cotton in case of cotton mill is its example.
- (ii) **Work in Progress:** It is the stock of partly finished or partly manufactured goods just as price of thread and unfinished cloth in case of cotton mill.

- (iii) **Stock of Finished Goods:** Manufactured and finished goods ready for sale are known as stock of finished goods. Finished cloth is its example.

## 14. Expenses

Expenses are cost incurred by the business in the process of earning revenues. Generating income is the foremost objective of every business. The firm has to use certain goods and services to produce articles, sold by it. Payment for these goods and services are called expenses. Cost of raw material for the manufacture of goods or the cost of goods purchased for sale, expenses incurred in manufacturing or acquiring goods, such as wages, carriage, freight and amount spent for selling and distributing goods such as salaries, rent, advertising and insurance, etc. are known as expenses in accounting terminology. According to **Finney and Miller**, "*Expense is the cost of use of things or services for the purpose of generating revenue. Expenses are voluntarily incurred to generate income*".

## Notes

## 15. Losses

Losses are unwanted burden which the business is forced to bear. Loss of goods due to theft or fire, or flood or storm or accidents are termed as losses in accounting. Losses are different from expenses in the sense that expenses are voluntarily incurred to generate income where losses are forced to bear.

Losses may be classified as normal and abnormal. Normal loss is due to the inherent weakness in the commodities, *i.e.* coal, cement, oil, ghee, ice, petrol. There will be shortage in their weight due to leakage, meltage, evaporation, spoilage and wastage during the journey. Abnormal loss on the other hand, is an extra ordinary loss due to earthquake, fire, flood, storm, theft and accidents.

Losses adversely affect the profit of the business, so it should be the sincere effort of every firm to adopt preventive measures to minimise losses.

## 16. Profit

Excess of revenue over expense is termed as profit. In other words excess of sale proceeds over cost of goods sold is income. Here, sales means net sales, *i.e.* sales less sales return. Cost of goods sold, also known as cost of sales is opening stock plus net purchases plus direct expenses less closing stock. Income must be regular in nature. It must concern routine activities of the business. It is always the part of revenue receipt. It must relate to the business of the current year. It is shown at the credit side of profit and loss A/c. Profit is generated through business activities.

## 17. Income

Increase in the net worth of the enterprise either from business activities or other activities is termed as income. Income is a wider term, which includes profit also. From accounting point of view, *income is the positive change in the wealth of the enterprise over a period of time.*

## 18. Debtors

The term 'debtors' represents the persons or parties who have purchased goods on credit from us and have not paid for the goods sold to them. They still owe to the business. For example, if goods worth ₹ 20,000 have been sold to Adi, he will continue to remain the debtor of the business so far as he does not make the full

payment. In case, he makes a payment of ₹ 16,000, he will remain to be debtor for ₹ 20,000 – ₹ 16,000 = ₹ 4,000.

In case, the firm is a service institution and the payment for service still remains to be realised, beneficiaries of the service will also be known as 'debtors'.

## Notes

### 19. Creditors

In addition, to cash purchases the firm has to make credit purchases also. The sellers of goods on credit to the firm are known as its creditors for goods. Creditors are the liability of the business. They will continue to remain the creditors of the firm so far the full payment is not made to them. Liability to creditors will reduce with the payment made to them.

Creditors may also be known as creditors for expenses. In case, certain expenses such as salaries, rent, repairs, etc. remain unpaid during the accounting period, it will be termed as outstanding expenses. Parties rendering these services will be our creditors. Creditors are current liability so the firm should have sufficient current assets to make their timely payment.

### 20. Receivables

Receivable means, what business has to receive from outside parties on revenue account. When we sell goods on credit, purchasers are known as debtors. Certain debtors accept bills drawn by us and become part of bills receivables. The total of Debtors and Bills Receivable is known as Receivables. These are current assets and realised within a year. Receivables are shown at the assets side of the Balance Sheet.

### 21. Payables

Payable means, what the business has to pay to outside parties. When we purchase goods on credit, sellers are known as creditors. We accept bills drawn by certain creditors, which becomes a part of Bills Payable. The total of Creditors and Bills Payable is termed as Payables. It is shown at the liabilities side of the Balance Sheet.

### 22. Proprietor

An individual or group of persons who undertake(s) the risk of the business are known as proprietor. They invest their funds into the business as capital. Proprietors are adventurous persons who make arrangement of land, labour, capital and organisation. They pay wages to labour, rent to land, interest to capital and salary to organisation. After meeting all the expenses of business. If there remains any surplus. It is known as profit. The proprietor is rewarded with profit for the risk undertaken by him if expenses exceed revenue the deficit is a loss to be borne by the proprietor.

In case of profit, proprietor's capital increases and in case of loss the capital decreases. Proprietor is an individual in case of sole trade, partners in case of partnership firms and shareholders in case of company.

### 23. Drawings

*Amount or goods withdrawn by the proprietor for his private or personal use is termed as drawing.* The cost of using business assets for private or domestic use is also drawing. Use of business car for domestic use or use of business premises for residential purpose is also drawing. Acquiring personal assets with business funds is also drawing. Certain examples of drawings are as under:

- (a) Amount withdrawn by proprietor for personal use.
- (b) Goods taken by the proprietor for domestic use.
- (c) Purchasing pocket transistor for proprietor's son.
- (d) Using business vehicles for domestic use.
- (e) Using business premises for residential purpose.

**Notes**

**24. Accounting Year**

Books of accounts are closed annually. From the balances of different ledger accounts we prepare income statement and position statement. Income statement shows gross and net income of the business. Position statement, traditionally known as Balance Sheet is a mirror, which reflects the true value of assets and liabilities on a particular date. There is no legal restriction about the accounting year of sole proprietorship and partnership firm. They may adopt the accounting year of their choice. It may be between January 1st to December 31st of the same year or July 1st of the year of June 30th of the next year or between two Diwalis or even financial year, i.e. April 1st to March 31st of the next year. The only restriction is that the accounting period must consist of 12 months.

Companies must adopt financial year as their accounting year.

**25. Entry**

An entry is the systematic record of business transactions in the books of accounts. While passing entries, the principle 'every debit has got its corresponding credit' is adopted. Different accounts are debited and credited in the entry with the same amount.

**26. Vouchers**

Accounting transactions must be supported by documents. These documentary proofs in support of the transactions are termed as vouchers. It may be a receipt, cash memo, invoice, wages bill, salaries bill, deeds or any document as an evidence of transaction having taken place. The contents of vouchers are date, amount paid, purpose of the payment, payment passed by competent authority, payment made and cancelled. Vouchers are the basis of accounting records. They facilitate accounting. Vouchers are also used for verification and auditing of business records. Vouchers may also be used for detecting embezzlement and frauds.

**27. Insolvent**

All business firms who have been suffering losses for the last many years and are not even capable of meeting their liabilities out of their assets are financially unsound. Only the court can declare the business firm as insolvent if it is satisfied that the continuation of the firm will be against the interest of the public or creditors. No firm can declare itself as insolvent. In case of solvency, the assets of the business are sold and liabilities paid with the funds realised from the sale of assets. If the funds realised fall short of the liabilities creditors are paid proportionately.

**28. Solvent**

Solvent are those persons and firms who are capable of meeting their liabilities out of their own resources. Solvent firms have sufficient funds and assets to meet proprietors' and creditors' claim. Solvency shows the financial soundness of the business.

**29. Gain**

Change in the net worth (equity) due to change in the form and place of goods and holding of assets for a long period, whether realised or unrealised is termed as gain. It may either be of capital nature or revenue nature or both.

**Notes****30. Expenditure**

Expenditure is the amount of resources consumed. It is long term in nature. It is the benefit to be derived in future. It is the amount spent for the purchase of assets. Expenditures can be made through cash, or exchanged for other assets or commodities or a promise to make the payment is made. Expenditures increase the profit earning capacity of the business and profit is expected from them in future. Expenditures are incurred to acquire assets of the business.

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## **1.9 INTRODUCTION: ACCOUNTING PRINCIPLE**

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The business today is large in size and complex in nature. There are various groups who are interested in the performance of the business such as shareholders, debenture holders, investors, employees and consumers, etc. Accounting, in this way, is required to report and present the facts of the business in such a way, which can meet the varied requirements of different groups. It is, therefore, necessary that the language and terminology of accounting may be standardised so that there may be uniformity in the presentation of accounts. The idea requires scientific study, analysis and presentation of Accounts.

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## **1.10 MEANING OF GAAP**

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Generally, Accepted Accounting Principles (GAAP) are the set of rules and practices that are followed while recording transactions and preparing the financial statements, GAAP build sound theoretical foundation of Accounting.

According to **American Institute of Certified Public Accountants (AICPA)**, GAAP have substantial authoritative support and general acceptability. GAAP must be relevant (meaningful), objective (reliable) and feasible (implemented without much cost and complexity).

Accounting is the systematised body of knowledge having cause and effect relationship. The subject has certain established concepts, conventions, standard language and terminology to enable the interested parties in the subject to understand it in the same sense as the accountant wants to communicate. These rules are usually called *Generally Accepted Accounting Principles (GAAP)*. Accounting assumptions, rule of recording and reporting business transactions are also known by terms like *concepts, principles, conventions, doctrines, tenets, axioms postulates, assumptions and modifying principles*.

The Principles of Accounting are not static in nature. These are constantly influenced by changes in legal, social and economic environment as well as the needs of the users. The various terms for principles are inter-changeably used by different authors. Generally, the term 'Basic Accounting Concepts' is used to refer all these terms.

## 1.11 BASIC ACCOUNTING CONCEPTS

The fundamental ideas or basic concepts underlying the theory and practice of financial accounting and broad working rules for all accounting activities, developed by professionals are listed and discussed below:

### Basic Accounting Concepts

1. Business Entity Concept
2. Money Measurement Concept
3. Going Concern Concept
4. Accounting Period Concept
5. Dual Aspect (or Duality) Concept

These concepts are the foundation of systematic and proper accounting. Every business enterprise must adopt these concepts, popularly known as pillars upon which the sound structure of accounting stands. Let us discuss these basic concepts:

### 1. Business Entity Concept

In accounts, we distinguish between the business and its proprietors. Business is assumed to have distinct entity, *i.e.* existence other than the existence of its proprietors and other business units. As an accountant, we are concerned with the business not the businessman. We have to record business transactions from firm's point of view and never from the viewpoint of proprietors. We record transactions in the books of shop, establishment, factory, firm, company and enterprise and never in the books of proprietor, partners and shareholders. While making decisions regarding asset, liability, capital, revenue and expense, business viewpoint is taken into consideration.

The capital introduced by the proprietor in its own business is considered liability from business point of view. It will not be a liability if proprietor's viewpoint is taken. The logic behind treatment of capital as liability is that the firm has borrowed funds from its own proprietors instead of borrowing it from outside parties. It would have been a liability if the funds would have been borrowed from outside agency, then why not, if it is being invested by the proprietor himself. We also allow interest on capital to the proprietors because capital is supposed to be a liability. Interest on capital is an expense of the business, therefore, it will reduce the profit of the firm. It is at the same time proprietor's claim against the business, so it will increase his capital. Amount withdrawn by the proprietor for personal use, known as drawings is assumed to be the assets of the business and at the same time a liability to the proprietor.

The business as a distinct entity records all business transaction into the books of accounts and reports the result to the proprietor in case of sole trade, partners in case of partnership firms and shareholders in case of company. There is a legal divorce between the ownership and management of a company. The company is owned by shareholders by managed by the elected representatives of the shareholders, *i.e.* directors. Accounts are prepared by the management and a copy of the financial statements is supplied to the shareholders, the owners of the company for information. Every accountant whether he is concerned with a petty shop or a firm or a company

Notes

or a big business house will have to compulsorily adopt the concept of business entity in his accounting operations.

*Legally, a sole proprietor or the partner of a partnership firm are not separate from their business units but in Accounting the business units are assumed to have distinct entity. Accounting entity is different from business entity. Accounting entity is wider term including business, clubs, institutions, public enterprises, local bodies and government, etc.*

## 2. Money Measurement Concept

In accounting, we identify and record only those business transactions which are financial in nature. Accounting transactions must have their monetary value. The worth of the transaction must be measured in terms of money. In all the accounting records, we have amount column showing rupees and paise. There is never any accounting record in metres, litres, kilograms and quintals. We evaluate the value of the commodities in terms of money and accordingly record them in the books of accounts. Recording transactions in monetary terms makes the information more meaningful. For example, statement that the business was started with ₹ 50,000 cash and 20,000 metres of silk is meaningless and fails to tell us the capital of the business. If the value of 20,000 metres of silk is estimated to be ₹ 5,00,000, we can safely say that the business was started with ₹ 50,000 + 5,00,000 = 5,50,000, which will be meaningful.

The concept of money measurement is not free from problems when we integrate the financial statements of an entity having operations in more than one nation.

## 3. Going Concern Concept

While recording business transactions in the books of accounts, we assume that the business will be carried on indefinitely. That is why, the business purchases fixed assets like land and building, plant and machinery, vehicles, furniture, etc. If the concept of going concern is not there, we would have hired these assets and not purchased. These assets have been acquired for use and not for sale, so we maintain individual assets account and charge necessary depreciation on it.

According to International Accounting Standard "The enterprise is normally viewed as a going concern, that is as continuing in operation for the foreseeable future". It is viewed that the enterprise has an intention to be carried on for longer period. The concept of assets, liabilities, capital, revenue and expenses used in the accounting operation prove that the firm has to last long. Planning, organising and personnel policies substantiate the fact that the business has been assumed to be going entity. It is binding upon every accountant to treat business activity as a continuing process and record transaction accordingly.

## 4. Accounting Period Concept

Strictly speaking, the result of the business can be estimated at the end of its life. If a firm was started with a capital of ₹ 50,000 and at the end of its life the capital was ₹ 5,00,000 we can say that the firm earned a profit of ₹ 4,50,000, i.e. 5,00,000 – 50,000 during its life. In this way, business as a going entity will continue indefinitely and we will have to wait for a very long period to estimate the financial result of the business. It will be too late to wait for the results, so the life span of accounting

should be split into shorter and convenient period. At present, accounting periods are regarded as twelve months. According to the Companies Act and Banking Regulation Act, accounting period should consist of twelve months. The period of twelve months is regarded as ideal and convenient period for accounting.

### 5. Dual Aspect (or Duality) Concept

Every business transaction has double effect. There are two sides of every transaction. This is evident when we study the accounting term, *i.e.* assets, capital and liabilities.

1. **Assets:** These are the valuable articles owned by the business. Expenditure incurred in acquiring valuable things for the firm is assets. Special features of assets are that they are meant for use in the business and will increase the profit earning capacity of the business. Cash in hand, cash at bank, land and buildings, furniture, vehicles, etc. are the assets of the firm. It has been an established fact that no business can be carried on without assets. Business as a separate entity and going concern must possess certain assets.
2. **Capital:** Capital is that part of wealth which is used for further production. In the context of dual aspect concept capital supplies necessary funds to the business to purchase certain assets. In the absence of capital, there will be no funds with the enterprise and thus, the question of acquiring assets does not arise. If we take it from business point of view, proprietor's capital is the liability of the business. Capital received in cash represents two accounts, capital and cash. Capital is the proprietor's claim against the assets of the business and the cash is the asset of the business itself. As the amount of the two accounts are the same, we can safely conclude that:

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

3. **Liabilities:** If the capital invested by the proprietor falls short the business has to borrow funds. Thus the loan on the one side is the liability of the firm and on the other side it will be in the form of cash or other assets. The amount represented by both loan and assets are equal. This transaction enables us to think about the two aspects so it is called dual aspect concept or double entry system. All the assets of the business are acquired by the funds contributed by proprietors and creditors, so it is always correct to conclude as under:

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

The relationship between assets, liabilities and capital is at present known as *Accounting Equation* which can also be expressed as under:

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

*or*

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

*or*

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

We record all the business transactions on the basis of dual aspect and call the system as *double entry system*.

### Notes

## 1.12 INTRODUCTION: TRANSACTION AND SOURCE DOCUMENT

### Notes

#### Origin of Transaction

We know that Accountancy is based upon verifiable objectives. The assumption explains that accounting deals with facts. There is no place for imaginations, expectations and possibilities in accounting.

We record Financial transactions in the books of accounts, when they actually happen and that too supported by documents. There must be certain written and authentic proof of the transaction, which has taken place. The written document is known as 'voucher', the source document upon which we base our accounting records.

#### Source Documents/Vouchers

*A document which becomes the basis for recording a transaction in the books of account is called source document.* These documents show the nature and amount of the transaction and named vouchers.

*Vouchers* are the receipts, bills, cash memos, invoices, salaries bills, wages bills, travelling allowance bills, counterfoils of cheques, registration deeds, and any other form of written proof that the transaction has actually taken place and can be verified from the documents. Whenever we sell goods, we prepare invoice for sending goods out of station, bills for credit sales, and cash memos for cash sales. The original copy is handed over or sent to the purchaser but the duplicate copy is kept as record in the business. These duplicate copies are the source documents for making record in our books of accounts. In the same way, while making purchase we receive original copy of invoices or bills or cash memos. These copies also work as source documents for recording purchase. Whenever we make payment we obtain receipt from the party receiving payment. While making payment of rent to landlord, a receipt for the rent is received. Workers and employees affix their signature on wages and salaries bills on receiving their wages and salaries. Insurance Company, Delhi Electric Supply Undertaking (DESU), Water Works issue receipts for having received the payment.

Buses, railways and airlines issue tickets on receiving payments. We receive receipts even for petty and insignificant payment. These receipts are the source documents for accounting records. The first step in accounting is to identify the origin of the transaction which is undoubtedly based upon documentary evidence known as source documents.

## 1.13 SOURCE DOCUMENTS

### Meaning

As we know Accounting deals in facts, which actually happen and can be verified by documentary evidence known as source documents.

It shows that source documents are real, visible, legible and meaningful records certifying the actual happening of the transactions of financial nature. In Accountancy, every journal entry must be supported by source documents popularly known as vouchers. Some important documents are discussed herewith:

**Notes**

1. **Cash Memo:** It is a document indicating the amount, date and details of cash purchases and cash sales. We receive cash memo on cash purchases and issue cash memo on sales. On the basis of these cash memos, cash purchases, cash sales and cash payments are recorded in the books.
2. **Invoices and Bills:** These documents, *i.e.* invoices and bills are used for credit purchases and credit sales. In case of credit sale of goods we issue invoices/bills, which indicate the date, amount and details of sale. We prepare three copies of invoice. The first copy is sent to the purchaser through post office or bank, the second copy is kept in the bundles, packets or cases of the goods, the third copy is retained with us. The third copy is used as source document for recording credit sale. In case of credit purchases of goods, we receive invoice or bills and record credit purchases on its basis.
3. **Receipt:** In case of receiving amount, we issue a receipt indicating the date and amount of payment, details of the payer and the purpose of payment. The counterfoil or the carbon copy of the receipt issued is used as source document for the receipt of the amount. In the same way, when we make the payment, we are issued receipts and record the payment in the books of Accounts.
4. **Pay-in-Slip:** In case of depositing cash and cheques in the Bank, we have to fill up Pay-in-Slip (Deposit slip). The main body of the Pay-in-Slip is retained by the bank and the counterfoil duly signed and stamped is returned to the customer. The counterfoil is used as the source document for recording the deposits.
5. **Cheques:** We issue cheques against different payments. The counterfoil of the cheque or notes on the cheque book containing details of the payment is used for recording the payment or withdrawal for self. Cheques received are deposited into the bank through Pay-in-Slip, which is used as source document.
6. **Debit Note:** In case of the return of goods purchased on credit we issue Debit Note to the seller, meaning that the Sellers' Account has been debited with the amount of purchases return. This debit note is used as source document for recording purchase return. A format of Debit Note is given as under:

Name of the Firm Issuing the Note		Address of the Firm
		Date of Issue
No.		
<b>DEBIT NOTE</b>		
Against: Supplier's Name		
Goods returned as per Delivery		Amount (₹)
Challan No.		
(Details of goods returned)		
(Rupees ..... Only)		
Signature of the Manager with date		

7. **Credit Note:** In case of sales return by our customers we issue Credit Note to them, meaning that the Customers Account is credited with the amount of sales return. The Credit Note is used as source document. A format of Credit Note is given as under:

**Notes**

Name of the Firm Issuing the Note		Address of the Firm
		Date of Issue
No.		
<b>CREDIT NOTE</b>		
Against: Customer's Name		
Goods returned by the customer	Amount (₹)	
Challan No.		
(Details of goods received)		
(Rupees ..... Only)		
Signature of the Manager with date		

8. **Miscellaneous:** Correspondence, registration deeds, wages, salaries, water, electricity, telephone bills, tickets, conveyance bills, counterfoils and receipts, etc. are also used as source documents.

### 1.14 VOUCHERS

#### Meaning

A voucher may be defined as a written document to be used in support of entry made in the books of accounts.

In the words of J.R. Batliboi, "A voucher may be defined as documentary evidence in support of an entry appearing in the books of accounts".

According to Ronald A. Irish, "A voucher may be a receipt, an invoice, an agreement, written requisition slip or in short any suitable written evidence, which confirms a written transaction."

<b>Transaction Voucher</b>	
Name of Firm	
Voucher No :	Date :
Debit account :	
Credit account :	
Amount (₹) :	
Narration :	
Authorised By :	Prepared By :

#### Special Features of Vouchers

- (i) Vouchers are documentary evidence,
- (ii) Vouchers are written document.

- (iii) Vouchers support the entry appearing in the books of accounts.
- (iv) Vouchers present full description of the transaction.
- (v) Vouchers substantiate the accuracy of entries in the books of accounts.

**Examples of Vouchers**

- (i) **Cash Receipts:** Various vouchers of cash receipts are counterfoils, carbon copies of receipts issued, carbon copies of contracts made, correspondence etc.
- (ii) **Cash Payment:** Various vouchers of cash payments are cash memos, wage sheets, salary register, copies of contracts, correspondence, etc.
- (iii) **Purchases:** Vouchers regarding purchases are invoices, copies of order sent, goods inward books, correspondence, etc.
- (iv) **Sales:** Copies of orders received, records of goods supplied, goods outward book, correspondence, etc.
- (v) **Purchases Return:** Goods outward book, letter of credit, correspondence, etc.

**Notes**

**Preparation of Vouchers:**

**Format of Accounting Vouchers**

RECEIVED from M/s LAXMI PUBLICATIONS PRIVATE LIMITED the sum of Rupees _____ on account of _____ By Cash/Cheque No. _____ Dated _____  Receiver's Signature <span style="border: 1px solid black; display: inline-block; width: 40px; height: 20px; vertical-align: middle;"></span>	<p><b>Laxmi Publications Private Limited</b></p> <p>113, GOLDEN HOUSE, DARYAGANJ, NEW DELHI-11002</p> <p>Voucher No. .... Dated ..... 20 .....</p> <table border="1" style="width: 100%; border-collapse: collapse;"> <thead> <tr> <th style="width: 80%;"></th> <th style="width: 10%; text-align: center;">₹</th> <th style="width: 10%; text-align: center;">P.</th> </tr> </thead> <tbody> <tr> <td>DEBIT _____</td> <td></td> <td></td> </tr> <tr> <td>_____</td> <td></td> <td></td> </tr> <tr> <td>_____</td> <td></td> <td></td> </tr> <tr> <td style="text-align: right;">TOTAL ₹</td> <td></td> <td></td> </tr> <tr> <td>CREDIT _____</td> <td></td> <td></td> </tr> <tr> <td>_____</td> <td></td> <td></td> </tr> <tr> <td>_____</td> <td></td> <td></td> </tr> <tr> <td style="text-align: right;">TOTAL ₹</td> <td></td> <td></td> </tr> </tbody> </table> <p>Accountant/Manager <span style="float: right;">M.D.</span></p>		₹	P.	DEBIT _____			_____			_____			TOTAL ₹			CREDIT _____			_____			_____			TOTAL ₹		
	₹	P.																										
DEBIT _____																												
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**1.15 CONTENTS OF ACCOUNTING VOUCHERS**

Voucher is a documentary evidence of the transaction, so it must be prepared carefully and cautiously. The voucher must be preferably printed. It should contain the following information about the transactions.

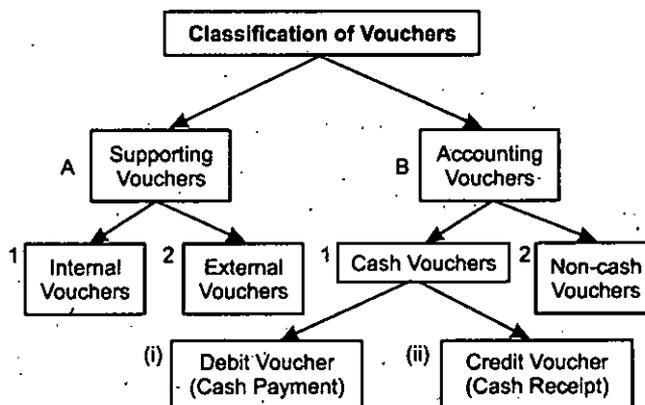
1. **Name and address of the firm:** Every voucher should bear the name and address of the firm at its top. It is generally printed at the top of the voucher.

Notes

2. **Voucher number:** Every voucher must bear its serial number, so that it can be easily identified, differentiated with other vouchers and referred in the books of accounts. Vouchers are serially numbered and their number is mentioned against the posting in the ledger, cash book and subsidiary books.
3. **Date:** The date of preparing the voucher must be written. It must bear the date, the month and the year of the transaction.
4. **Details of party to be debited:** It contains the name and address of the party, whom payment has been made. The purpose and the details of the payment is also recorded therein. In modern big business enterprises, voucher is prepared for every transaction. As such, in these enterprises the debit side may contain the name of the party to whom payment has been made. It may also contain the head of account against which the payment has been made. It may be Purchases Account, Assets Account and Expenses Account.
5. **Details of party to be credited:** The payment is made either through Cash or Cheque/Bank Draft, so we record Cash Account or Bank Account, with the number and date of issue of the cheque and bank draft. We may also use the account to be credited at the credit column.
6. **Proof of receiving the amount:** In case the payment is made through cash to someone, his signature is obtained with full details of the amount, the purpose and the date of payment received by him.  
In case payment is made through crossed Account Payee cheque, receivers signature is not necessary.
7. **Revenue Stamp:** Revenue stamp must be affixed on every payment of ₹ 500/-and more as per law, so that the document may be legalised. The signature of the receiver must touch certain part of the revenue stamp.
8. **Signature of the accountant and officer of the firm:** Voucher must be signed by the responsible person of the firm. He may be an accountant or manager. After verification and authentication it must be signed by the proprietor of the firm or any authorised officer of the enterprise.

**Types of Vouchers**

Vouchers may be classified as under:



## (A) Supporting Vouchers

These vouchers are prepared as documentary evidence in support of transaction having taken place. These vouchers are classified as internal and external vouchers.

1. **Internal Supporting Vouchers:** These vouchers are prepared by the organisation itself but authenticated and validated by third parties, such as counter foils of pay-in-slip and challan, etc.
2. **External Supporting Vouchers:** These vouchers are prepared by third parties and sent to us such as bills, cash memo and invoice received from supplier of goods. It may also be rent receipt received from land lord, debit note and credit note, etc.

Notes

## (B) Accounting Vouchers

The subsidiary or secondary vouchers prepared on the basis of supporting vouchers issued by third parties is called accounting vouchers. It is prepared by the Accountant and must be signed by the authorised signatory of the enterprise. Accounting vouchers are classified as cash vouchers and non-cash vouchers.

1. **Cash Vouchers:** The documentary evidence of cash payments and cash receipts is known as cash voucher. Cash vouchers are classified as debit (payments) voucher and credit (receipts) voucher.
  - (i) **Debit (Payment) Voucher:** The documentary evidence of cash payment is known as debit voucher such as cash payment of salaries, cash purchases of goods and assets, payment to creditors, employees and bank, etc. The debit voucher may be based on supporting voucher. In case supporting voucher is not available the Receipt portion of the voucher is filled in and used as supporting voucher.

It should be noted that if the payment is worth ₹ 500 or more, revenue stamp of ₹ 1 must be affixed.
  - (ii) **Credit (Receipt) Voucher:** The documentary evidence of cash receipt is known as credit voucher, such as cash receipt of interest, rent or any other income, cash sales of goods, assets and investments, amount withdrawn from bank, loans borrowed, collection from debtors, etc.

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## 1.16 ACCOUNTING EQUATION/CYCLE

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### Meaning

There has been a revolution in every field of knowledge. Scientific approach towards every subject has emerged as a basic consideration to decide its utility. Scientific studies were also made in accounting and result was discovery of 'Accounting Equation'. The study revealed that accounting rotates round the three terms, *i.e.* assets, liabilities and capital. The entire accounting structure is based upon these three terms. These terms are inter-related and inter-woven. Before explaining accounting equation let us discuss these terms:

### Analysis of Transactions

Assets, liabilities and capital are constituents of business transactions. Let us discuss these elements:

**Notes**

1. **Assets:** The acceptable meaning of assets is the valuable things owned by the firm. Expenditure for acquiring these valuable articles for use in the business is also termed as assets. The assets are acquired for constant future use. They are not meant for sale. These assets increase the profit earning capacity of the business. Some of the assets are listed as under:

- |                                    |                                 |
|------------------------------------|---------------------------------|
| (i) Cash in hand                   | (viii) Plant and machinery      |
| (ii) Cash at bank                  | (ix) Equipments and tools       |
| (iii) Sundry debtors or Book debts | (x) Furniture and fittings      |
| (iv) Bills receivables             | (xi) Patents, trade marks, etc. |
| (v) Investments                    | (xii) Goodwill                  |
| (vi) Closing stock                 | (xiii) Prepaid expenses         |
| (vii) Land and building            | (xiv) Accrued income            |

2. **Liabilities:** Creditors' and proprietors' claim against the assets of business is termed as its liability. Proprietor's claim is termed as capital, which we shall be discussing later on. Liabilities are also known as equities or claims. The term liability means the claim of outsiders against the business such as creditors for goods and expenses. Liability is the account for which the firm is indebted to outside parties. Certain external liabilities are mentioned as under:

- (i) Creditors for goods—sundry creditors and bills payable
- (ii) Creditors for expenses:
  - (a) Outstanding salaries
  - (b) Unpaid wages
  - (c) Rent due but not paid
- (iii) Other liabilities:
  - (a) Bank loan or overdraft
  - (b) Partner's loan
  - (c) Loan from Financial Institution, *i.e.*, IFC, IDBI, etc.
  - (d) Debentures
  - (e) Employees Provident Fund
  - (f) Workmen's Compensation Fund, etc.

Liabilities also go on changing. Their value either increases or decreases. In case of increase the business will have to pay more and in case of decrease the business will have to pay lesser.

7. **Capital:** It is the proprietor's claim against the assets of the business. In case of one man business the capital is contributed by the proprietor himself. In case of partnership, capital is contributed by partners and in case of companies, shareholders contribute for capital. Owners of the business are the contributor of the capital. Owners are the entrepreneurs of the business. They get profit of the business for the risk taken by them. If certain amount of profit remains undistributed or retained as reserve

and funds, it is also known as proprietor's claim. Proprietor's claim can be enumerated as under:

- (i) Capital
- (ii) Reserve, general reserve or reserve fund
- (iii) Profit or retained earning
- (iv) Interest on capital

**Notes**

**Explanation of Accounting Equation:** Business transaction are financial in nature and so every transaction affects the financial position of the business. These transactions increase or decrease the assets, liabilities or capital. Every business has certain assets. These assets are purchased with the funds supplied to the business by its proprietors or creditors. Proprietors' and creditors' funds, in whatever form they are, create assets. For example, if the business receives ₹ 1,00,000 as capital from the proprietor and retains that in the firm, it will create an asset, *i.e.*, cash in hand. If ₹ 80,000 are deposited into the bank, the total capital will be represented by two assets, *i.e.* cash ₹ 20,000 (due to deposit into the bank of ₹ 80,000 out of a cash balance of ₹ 1,00,000) and cash at bank ₹ 80,000. If furniture, worth ₹ 20,000 are purchased and payment is made out of bank deposit, the assets will now consist of cash in hand ₹ 20,000, cash at bank ₹ 60,000 (due to purchase of furniture, bank balance has reduced by ₹ 20,000) and furniture ₹ 20,000. **As such accounting equation is a statement of equality between debits and credits.** These above facts can also be presented in this way:

Capital	Assets
(i) ₹ 1,00,000 = Cash (₹ 1,00,000)	
(ii) ₹ 1,00,000 = Cash (₹ 20,000) + Bank balance (₹ 80,000)	
(iii) ₹ 1,00,000 = Cash (20,000) + Bank (60,000) + Furniture (20,000)	

The above facts are technically known as Accounting Equations in simple form and reveal that capital which is always equal to assets.

Increase in capital will, generally, result in the corresponding increase in the assets and in the same way, decrease in capital will result in the decrease of assets. If the proprietor introduces ₹ 40,000 as additional capital there will be corresponding increase in cash balance. As both capital and assets are increasing simultaneously with ₹ 40,000 the capital will remain equal to assets. Amount withdrawn by the proprietor for personal use will decrease capital and there will be decrease in the cash, an asset at the same time. If drawings are worth ₹ 10,000 both the capital and assets will decrease simultaneously with ₹ 10,000.

**Introduction of Creditors' Liability in Accounting Equations**

It has been accepted fact that business does not possess anything of its own. The business receives funds from proprietors and creditors and retains all of them in the form of various assets. This shows that capital + liabilities are always equal to assets. The fact can be presented in terms of accounting equation as under:

## Notes

<b>Equation.</b>	<b>Capital + Liabilities = Assets</b>	<b>or</b>	<b>C + L = A</b>
<b>or</b>	<b>Assets = Liabilities + Capital</b>	<b>or</b>	<b>A = L + C</b>
<b>or</b>	<b>Liabilities = Assets - Capital</b>	<b>or</b>	<b>L = A - C</b>
<b>or</b>	<b>Capital = Assets - Liabilities</b>	<b>or</b>	<b>C = A - L</b>
<b>or</b>	<b>Assets - Liabilities - Capital = Zero</b>	<b>or</b>	<b>A - L - C = Zero</b>

### 1.17 COMPUTATION—CLASSIFICATION OF TRANSACTIONS

Assets, liabilities and capital are the three basic elements of every business transaction. The relationship between these terms, as mentioned above in the form of Accounting Equation remains unchanged. It has been a mathematical truth. No business transaction can upset the relationship between these items. The inter-relationship of assets, liabilities and capital results into nine transactions. These transactions show that change in one element results in corresponding changes in the same item or in other element. These nine basic transactions are as under:

- (i) Increase in assets with corresponding increase in capital.
- (ii) Increase in assets with corresponding increase in liabilities.
- (iii) Increase and decrease in assets.
- (iv) Decrease in assets with corresponding decrease in liabilities.
- (v) Decrease in assets with corresponding decrease in capital.
- (vi) Increase and decrease in liabilities.
- (vii) Increase and decrease in capital.
- (viii) Increase in liabilities and decrease in capital.
- (ix) Increase in capital and decrease in liabilities.
- (i) **Increase in assets with corresponding increase in capital:** Commencement of business with ₹ 20,000 increases both the assets and capital of the firm. At the same time, it will affect the financial position of the business as under:

**Financial Position (Balance Sheet)**

Liabilities	Amount (₹)	Assets	Amount (₹)
Capital	20,000	Cash	20,000
Creditors	—		
	20,000		20,000

- (ii) **Increase in assets with corresponding increase in liabilities.** Purchase of goods on credit for ₹ 7,000 will increase stock of goods with ₹ 7,000 and also increase creditors' liabilities. The transaction will affect the financial position as under :

### Financial Position (Balance Sheet)

*Meaning and Scope of Accounting*

Liabilities	Amount (₹)	Assets	Amount (₹)
Capital	20,000	Cash	20,000
Creditors	7,000	Stock in trade	7,000
	27,000		27,000

**Notes**

The position can be presented alternatively as under :

$Assets = Liabilities + Capital$ $27,000 = 7,000 + 20,000$
--

- (iii) **Increase and decrease in assets:** Purchase of furniture worth ₹ 3,000 involves furniture and cash, the two assets. The transaction will increase furniture as an asset and decrease cash, also an asset. Increase and decrease in the assets with the same amount will not upset the equation. The transaction can be expressed as follows :

<i>Assets</i>			=	<i>Liabilities + Capital</i>	
Cash	+	Stock	+	Furniture	= Creditors + Capital
17,000	+	7,000	+	3,000	= 7,000 + 20,000

- (iv) **Decrease in assets with corresponding decrease in liabilities:** Payment of ₹ 2,000 to creditors will decrease creditors, the liabilities of the business and at the same time cash an asset will decrease. The decrease in assets and liabilities simultaneously with the same amount will hold the accounting Equation true. The transaction will effect the Accounting Equation as follows:

<i>Assets</i>			=	<i>Liabilities + Capital</i>	
Cash	+	Stock	+	Furniture	= Creditors + Capital
17,000	+	7,000	+	3,000	= 7,000 + 20,000
-2,000	+	0	+	0	= (-) 2,000 + 0
15,000	+	7,000	+	3,000	= 5,000 + 20,000

- (v) **Decrease in assets with corresponding decrease in capital:** ₹ 4,000 withdrawn by the proprietor for personal use will reduce capital and also cash, an asset simultaneously with ₹ 4,000. The transaction still proves the validity of accounting Equation as under :

<i>Assets</i>			=	<i>Liabilities + Capital</i>	
Cash	+	Stock	+	Furniture	= Creditors + Capital
15,000	+	7,000	+	3,000	= 5,000 + 20,000
-4,000	+	0	+	0	= 0 (-) 4,000
11,000	+	7,000	+	3,000	= 5,000 + 16,000

The financial position of the business up to 5th transaction will be as under:

## Financial Position (Balance Sheet)

Liabilities	Amount (₹)	Assets	Amount (₹)
Capital	16,000	Furniture	3,000
Creditors	5,000	Stock	7,000
		Cash	11,000
	21,000		21,000

## Notes

- (vi) **Increase and decrease in liabilities:** Creditors for goods sometimes draw a bill of exchange on us as per the arrangement of the payment. After acceptance of the bill, the payment becomes due for payment after the expiry of certain specified period. Acceptance of the bill reduces creditor's liability and creates another liability, known as bills payable, the bill whose payment has to be made. If we accept a bill for ₹ 1,500 creditors will be reduced to ₹ 5,000 – 1,500 = 3,500 and fresh liability known as Bills Payable will come into our records. The transaction will affect the financial position of the business as under:

## Financial Position (Balance Sheet)

Liabilities	Amount (₹)	Assets	Amount (₹)
Capital	16,000	Cash	11,000
Creditors	3,500	Stock in trade	7,000
Bills payable	1,500	Furniture	3,000
	21,000		21,000

The above position can alternatively be presented as under:

<i>Assets</i>	=	<i>Liabilities</i>	+ <i>Capital</i>
Cash + Stock + Furniture	=	Creditors + Bills payable	+ Capital
11,000 + 7,000 + 3,000	=	3,500 + 1,500	+ 16,000

- (vii) **Increase and decrease in capital:** Certain transactions involve capital only, Such as transfer of share of the Company from one shareholder to another shareholder. In this case, the capital of the company will increase and decrease with the same amount and this will remain unchanged. There will be change in the name of shareholder which will be recorded in the transfer register of the company. Interest on capital is another item affecting capital only. Proprietors capital will increase with the amount of interest allowed to him. Interest on capital is the expense of the business, so it will have to be borne by the proprietor and thus charged out of capital account. The net result will be an increase and decrease in capital simultaneously with the same figure and accounting equation will still prove to be true. Financial position of the business will remain unchanged.

Notes

(viii) **Increase in liabilities and decrease in capital:** In certain cases, capital may be converted into loan, as a liability. Such transactions may happen, when a partner retires from the firm and the capital refundable to him is transferred to his loan account. In this case, the firm will be showing partner's loan as a liability instead of partner's capital. In case of death of a partner amount payable to the legal inheritor of the deceased partner is transferred to partner's executor's loan account. This transaction will also decrease capital and increase liability. If ₹ 5,00 are transferred from capital account to loan account the financial position will be as under:

**Financial Position (Balance Sheet)**

Liabilities	Amount (₹)	Assets	Amount (₹)
Capital	11,000	Cash	11,000
Creditors	3,500	Stock in trade	7,000
Bills payable	1,500	Furniture	3,000
Loan	5,000		
	21,000		21,000

The above position can also be presented as under:

<i>Assets</i>			=	<i>Liabilities</i>			+	<i>Capital</i>				
Cash	+	Stock	+	Furniture	=	Creditors	+	Bills payable	+	Loan	+	Capital
11,000	+	7,000	+	3,000	=	3,500	+	1,500	+	5,000	+	11,000

(ix) **Increase in capital and decrease in liabilities:** Conversion of loan into capital reduces the liability of the business on one hand and increases capital on the other hand. Conversion of debentures into share capital is an example of such transaction. Creditors may also be converted into share capital. If creditors for ₹1,000 are allotted shares against their loan, the financial position will be affected as under:

**Financial Position (Balance Sheet)**

Liabilities	Amount (₹)	Assets	Amount (₹)
Capital	12,000	Cash	11,000
Creditors	2,500	Stock in trade	7,000
Bills payable	1,500	Furniture	3,000
Loan	5,000		
	21,000		21,000

The financial position shows that capital has increased by ₹ 1,000 and is now ₹ 11,000 + 1,000 = 12,000 and at the same time creditors have been reduced to ₹ 3,500 - 1,000 = 2,500.

The fact can alternatively be presented as under:

Notes

Assets			=	Liabilities			+ Capital
Cash	+ Stock	+ Furniture	=	Creditors	+ Bills payable	+ Loan	+ Capital
11,000	+ 7,000	+ 3,000	=	2,500	+ 1,500	+ 5,000	+ 12,000

The basic nine transactions discussed above are summarised through the following illustrations.

*Illustration 1: Develop accounting equation from the following transactions:*

	₹
(i) Adi commenced business with cash .....	50,000
(ii) Purchased goods for cash .....	30,000
(iii) Purchased goods on credit .....	20,000
(iv) Sold goods (cost ₹ 10,000) for .....	12,000
(v) Bought furniture on credit .....	2,000
(vi) Paid cash to a creditor .....	15,000

**Solution:**

**Accounting Equation**

Transactions	Assets			=	Liabilities + Capital	
	Cash +	Stock +	Furniture	=	Creditors +	Capital
(i) Adi commenced business with cash ₹ 50,000	50,000 +	0 +	0 =	0 +	50,000	
(ii) Purchased goods for cash ₹ 30,000	(-)30,000 +	30,000 +	0 =	0 +	0	
New Equation	20,000 +	30,000 +	0 =	0 +	50,000	
(iii) Purchased goods on credit ₹ 20,000	+ 20,000 +		0 =	20,000 +	0	
New Equation	20,000 +	50,000 +	0 =	20,000 +	50,000	
(iv) Sold goods (cost ₹ 10,000) for ₹ 12,000	+ 12,000 (-)	10,000 +	0 =	0 +	2,000	
New Equation	32,000 +	40,000 +	0 =	20,000 +	52,000	
(v) Bought furniture on credit ₹ 2,000	0 +	0 +	2,000 =	2,000 +	0	
New Equation	32,000 +	40,000 +	2,000 =	22,000 +	52,000	
(vi) Paid cash to a creditor ₹ 15,000	(-)15,000 +	0 +	0 =	(-)15,000 +	0	
New Equation	17,000 +	40,000 +	2,000 =	7,000 +	52,000	

**(a) Revenue Payments**

**Notes**

- (i) **Treatment of Expenses Paid:** The business had to pay certain expenses in its day-to-day operations, such as payment of salaries, rent, insurance premium, office expenses, wages, repairs, etc. These expenses are paid regularly. These business expenses are paid in cash, so cash will reduce and thus, payment of expenses are reduced from cash balance. These expenses will also reduce net income of the business. As the income is the reward paid to proprietor for the risk undertaken by him so expenses will reduce proprietor's reward. Proprietor is represented by Capital Account so the payment of expenses will decrease capital.
- (ii) **Treatment of Outstanding Expenses:** If expenses relate to accounting period and remain unpaid, they are termed as outstanding expenses. Outstanding salaries, rent unpaid, wages due, repairs due but not paid are its certain examples. As these expenses relate to the accounting period, so they will reduce capital of the proprietor. Both the case of expenses paid and expenses due are treated at par as regards decrease in the capital of the proprietor. They are different in the sense that expenses paid reduce cash balance but expenses outstanding do not reduce cash balance. As these expenses are still payable, it is a liability of the business and thus increase liability.
- (iii) **Treatment of Prepaid or Unexpired Expenses:** There may be certain cases where expense may have been paid in advance. In certain cases, expenses relating to the next accounting period may be paid during the current year. These expenses are prepaid or unexpired, i.e. insurance and rent paid in advance for the next following year. Prepaid expenses increase and decrease assets simultaneously. The payment has been made in cash, so cash will be reduced. As the expenses have been paid during the current year for the next year, it will be an asset for the current year because the amount has to be realised by the current year from the following year:

**Illustration 2:** Show the effect of following transactions on accounting equation and also prepare a Balance Sheet:

	₹
(i) Started business with cash amounting to ₹ 35,000 and goods.....	15,000
(ii) Salaries paid.....	2,000
(iii) Wages outstanding .....	200
(iv) Prepaid insurance .....	700
(v) Interest due but not paid.....	100
(vi) Rent paid in advance .....	150

## Accounting Equation

## Notes

Transactions	Assets			=	Liabilities + Capital	
	Cash +	Stock +	Prepaid expenses	=	Outstanding expenses	Capital
(i) Started business with cash ₹ 35,000 Goods ₹ 15,000	35,000 +	15,000 +	0 =		0 +	50,000
(ii) Salaries paid ₹ 2,000	(-) 2,000 +	0 +	0 =		0 (-)	2,000
New Equation	33,000 +	15,000 +	0 =		0 +	48,000
(iii) Wages outstanding ₹ 200	0 +	0 +	0 =		200 (-)	200
New Equation	33,000 +	15,000 +	0 =		200 +	47,800
(iv) Prepaid Insurance ₹ 700	(-) 700 +	0 +	700 =		0 +	
New Equation	32,300 +	15,000 +	700 =		200 +	47,800
(v) Interest due but not paid ₹ 100	0 +	0 +	0 =		100 (-)	100
New Equation	32,300 +	15,000 +	700 =		300 +	47,700
(vi) Rent paid in advance ₹ 150	(-) 150 +	0 +	150 =		0 +	0
New Equation	32,150 +	15,000	850 =		300 +	47,700

The accounting facts presented by the above accounting equation can also be verified by the following Balance Sheet:

## Balance Sheet

Liabilities	Amount (₹)	Assets	Amount (₹)
Outstanding wages	200	Cash	32,150
Outstanding interest	100	Stock in trade	15,000
Capital	47,700	Prepaid insurance	700
		Rent paid in advance	150
	48,000		48,000

## (b) Revenue Receipts

- (i) **Income Received:** The business receives certain income during its day-to-day operations. The income is received regularly. Rent received, commission earned and discount received, etc. are its examples. As the income is received in cash it increases cash balance on the one hand and also increases proprietor's capital. Proprietor's claim against the assets of business increases with every income, so the income earned is added to capital.
- (ii) **Income Due but not Received or Accrued Income:** The income has been earned during the year, so proprietors capital will increase but as income is accrued or still to be received it will be treated as assets. The income relates to the current year, so it will increase current year's income. The income has become due from other parties so the concerned party will be the debtor of the firm. Debtor's being assets, accrued income will also be an asset.

- (iii) **Unearned Income or Income Received in Advance:** It is just possible that we may have received certain income in advance. The income has been received during the current year, although it relates to the next year. As the income has been received in cash, it will increase cash balance. The income actually belongs to the next year but has been received by the current year, as such it will be a liability of the current year towards next year.

**Illustration 3:** Show the effect of the following transactions on assets, liabilities and capital using accounting equation. Also prepare Balance Sheet.

	₹
(i) Started business with cash .....	60,000
(ii) Rent received.....	2,000
(iii) Accrued interest .....	500
(iv) Commission received in advance .....	1,000

**Solution:**

**Accounting Equation**

Transactions	Assets		=	Liabilities + Capital	
	Cash +	Accrued Interest	=	Commission received in Advance	Capital
(i) Started business with cash ₹ 60,000	60,000 +	0 =		0 +	60,000
(ii) Rent received ₹ 2,000 New Equation	+ 2,000 +	0 =		0 +	2,000
(iii) Accrued interest ₹ 500 New Equation	0 +	500 =		0 +	500
(iv) Commission received in advance ₹ 1,000 New Equation	+ 1,000 +	0 =		1,000 +	0
	63,000 +	500 =		1,000 +	62,500

Accounting facts presented by the above accounting equation is also presented in the form of Balance Sheet.

**Balance Sheet**

Liabilities	Amount (₹)	Assets	Amount (₹)
Commission received in advance	1,000	Cash	63,000
Capital	62,500	Accrued interest	500
	63,500		63,500

**Treatment of Purchases and Sales**

**(a) Purchases**

- (i) **Cash Purchases:** Purchases of goods for cash affects assets only. It increases stock of goods with the business and at the same time decreases cash, because the payment for goods has been made in cash.

## Notes

(ii) **Credit Purchases:** The transaction increases stock of goods, an asset but also creates a liability. Payments to creditors have not been made so far, as such liability to creditors is still there. Credit purchases, therefore, increases both assets and liabilities at the same time.

Payment to creditors in cash will reduce cash, an asset and also creditors, a liability. If creditors draw a bill of exchange, the firm will accept the bill and thus a liability, as Bills Payable will be created in place of creditors. In this way, the transaction will decrease creditors and also create a liability as Bills Payable. In certain cases, if the payment to creditors is made immediately and creditors allow us discount, the transaction will reduce cash with actual amount paid increase capital with the amount of discount received and decrease creditors with the amount of actual payment plus discount. For example, if we purchase goods worth ₹ 1,000 from Anshu on credit and make a payment of ₹ 990 in full settlement. The payment will reduce creditors by ₹ 1,000, cash by ₹ 990 and also increase capital by ₹ 10.

**(b) Sales**

(i) **Cash Sales:** It is the sincere effort of every business to sell goods at a price more than its cost price. Excess of sales price over the cost price is profit and will increase capital. For example, if goods costing ₹ 1,740 are sold for ₹ 2,000, it will increase cash by ₹ 2,000, reduce stock of goods by ₹ 1,740 and the resultant profit *i.e.*,  $₹ 2,000 - 1,740 = 260$  will be added to capital.

(ii) **Credit Sales:** In case goods costing ₹ 2,700 are sold for ₹ 3,000 on credit, it will increase debtors, the assets of the firm by ₹ 3,000 reduce stock of goods by ₹ 2,700 and also increase capital with  $₹ 3,000 - 2,700 = ₹ 300$ . In this case, if full payment is received from debtors, it will increase cash and decrease debtors. Cash and debtors are both assets, so the effect of the transaction will be restricted to assets only. In the above case, if we receive ₹ 2,900 from debtors and allow them ₹ 100 as discount, the transaction will increase cash by ₹ 2,90, reduce capital with the amount of discount allowed, *i.e.* ₹ 100 and at the same time decrease debtors, by ₹ 3,000.

**Treatment of Miscellaneous Transactions**

(a) **Amount Withdrawn by the Proprietor:** If the proprietor withdraws ₹ 2,000 for personal use, the transaction will reduce cash by ₹ 2,000 and at the same time reduce proprietor's capital. In case the proprietor takes certain goods for domestic use, it will decrease his capital and the stock of goods.

(b) **Depreciation on Assets:** Depreciation is the wear and tear or loss in the value of assets due to its use, so it will reduce assets and capital at the same time. For example, if there is a depreciation of ₹ 2,000 on plant, the transaction will reduce plant by ₹ 2,000. As depreciation is a loss it will also reduce capital.

(c) **Interest on Capital:** Capital is the liability of the business. Interest on a

liability is an expense and thus, capital will be reduced. Interest on capital is credited to capital account, so capital will be increased. The transaction will increase and also decrease the capital.

- (d) **Interest on Drawings:** Drawings is the amount withdrawn by the proprietor from the business. In other words, it is the amount advanced by the firm to the proprietor and thus, interest on drawings will be received by the firm and capital will be increased. Interest on drawings will be charged on proprietor's capital, so the capital will be reduced. This transaction will also result in the increase and decrease of capital.

**Illustration 4:** Show the accounting equation on the basis of the following transactions :

	₹
(i) Ankita started business with cash .....	50,000
(ii) Purchased goods on credit .....	4,000
(iii) Purchased goods for Cash .....	1,000
(iv) Purchased furniture .....	500
(v) Paid rent .....	200
(vi) Withdrew for private use .....	700
(vii) Received interest .....	100
(viii) Sold goods on credit (cost ₹ 500) for .....	700
(ix) Paid to creditors .....	400
(x) Paid salaries .....	200

**Solution:**

**Accounting Equation**

Transactions	Assets				=	Liabilities + Capital	
	Cash +	Stock + of goods	Debtors +	Furniture	=	Creditors +	Capital
(i) Ankita started business with ₹ 50,000	50,000 +	0 +	0 +	0 =	0 +	50,000	
(ii) Purchased goods on credit ₹ 4,000	0 +	4,000 +	0 +	0 =	4,000 +	0	
New Equation	50,000 +	4,000 +	0 +	0 =	4,000 +	50,000	
(iii) Purchased goods for cash ₹ 1,000	(-) 1,000 +	1,000 +	0 +	0 =	0 +	0	
New Equation	49,000 +	5,000 +	0 +	0 =	4,000 +	50,000	
(iv) Purchased Furniture ₹ 500	(-) 500 +	0 +	0 +	500 =	0 +	0	
New Equation	48,500 +	5,000 +	0 +	500 =	4,000 +	50,000	
(v) Paid rent ₹ 200	(-) 200 +	0 +	0 +	0 =	0 (-)	200	
New Equation	48,300 +	5,000 +	0 +	500 =	4,000 +	49,800	

Notes

(vi) Withdrew for private use							
₹ 700	(-) 700 +	0 +	0 +	0 =	0 (-)	700	
New Equation	47,600 +	5,000 +	0 +	500 =	4,000 +	49,100	
(vii) Received interest ₹ 100	+ 100 +	0 +	0 +	0 =	0 +	100	
New Equation	47,700 +	5,000 +	0 +	500 =	4,000 +	49,200	
(viii) Sold goods on credit costing							
₹ 500 for ₹ 700	0 (-)	500 +	700 +	0 =	0 +	200	
New Equation	47,700 +	4,500 +	700 +	500 =	4,000 +	49,400	
(ix) Paid to creditors ₹ 400	(-) 400 +	0 +	0 +	0 =	(-) 400 +	0	
New Equation	47,300 +	4,500 +	700 +	500 =	3,600 +	49,400	
(x) Paid salaries ₹ 200	(-) 200 +	0 +	0 +	0 =	0 (-)	200	
New Equation	47,100 +	4,500 +	700 +	500 =	3,600 +	49,200	

The above fact can be presented by a Balance Sheet as under:

Balance Sheet

Liabilities	Amount (₹)	Assets	Amount (₹)
Creditors	3,600	Cash	47,100
Capital	49,200	Debtors	700
		Stock of goods	4,500
		Furniture	500
	52,800		52,800

Illustration 5: Show the effect of the following business transactions on assets, liabilities and capital through accounting equation:

	₹
(i) Commenced business with cash .....	20,000
(ii) Goods purchased on credit .....	7,000
(iii) Furniture purchased .....	3,000
(iv) Paid to creditors .....	2,000
(v) Amount withdrawn by the proprietor .....	4,000
(vi) Creditors accepted a bill for .....	1,500
(vii) Interest on capital .....	1,000
(viii) Transfer from capital to loan .....	5,000
(ix) Allotted shares to creditors .....	1,000

Solution: The inter-relationship of nine transactions may be summarised as under:

Transactions	Assets			=	Liabilities +			Capital
	Cash +	Stock +	Furniture	=	Creditors +	B/P +	Loan +	Capital
(i) Commenced business with cash ₹ 20,000	20,000 +	0 +	0 =	0 +	0 +	0 +	20,000	

Notes

(ii) Goods purchased on credit ₹ 7,000	0 +	7,000 +	0 =	7,000 +	0 +	0 +	0
New Equation	20,000 +	7,000 +	0 =	7,000 +	0 +	0 +	20,000
(iii) Furniture purchased ₹ 3,000	(-3,000 +	0 +	3,000 =	0 +	0 +	0 +	0
New Equation	17,000 +	7,000 +	3,000 =	7,000 +	0 +	0 +	20,000
(iv) Paid to creditors ₹ 2,000	(-)2,000 +	0 +	0 =	(-)2,000 +	0 +	0 +	0
New Equation	15,000 +	7,000 +	3,000 =	5,000 +	0 +	0 +	20,000
(v) Amount withdrawn by the proprietor ₹ 4,000	(-)4,000 +	0 +	0 =	0 +	0 +	0 +	(-)4,000
New Equation	11,000 +	7,000 +	3,000 =	5,000 +	0 +	0 +	16,000
(vi) Creditors accepted a bill for ₹ 1,500	0 +	0 +	0 =	(-)1,500 +	1,500 +	0 +	0
New Equation	11,000 +	7,000 +	3,000 =	3,500 +	1,500 +	0 +	16,000
						0 +	1,000
(vii) Interest on capital ₹ 1,000	0 +	0 +	0 =	0 +	0 +		(-) 1,000
New Equation	11,000 +	7,000 +	3,000 =	3,500 +	1,500 +	0 +	16,000
(viii) Transfer from capital to loan ₹ 5,000	0 +	0 +	0 =	0 +	0 +	5,000 +	(-)5,000
New Equation	11,000 +	7,000 +	3,000 =	3,500 +	1,500 +	5,000 +	11,000
(ix) Allotted shares to creditors ₹ 1,000	0 +	0 +	0 =	(-)1,000 +	0 +	0 +	1,000
New Equation	11,000 +	7,000 +	3,000 =	2,500 +	1,500 +	5,000 +	12,000

The above accounting equation proves that whatever the transaction, assets are always equal to capital and liabilities. The fact can also be verified by the Previous Financial Position (Balance Sheet).

**Illustration 6:** Prove that the accounting equation is satisfied in all the following transactions. Verify the result with Balance Sheet of the last new equation:

₹

(i) Rajesh started business with :	
Cash .....	20,000
Goods .....	12,000
Machine .....	8,000
(ii) He Purchased goods .....	5,000
(iii) Sold goods (Costing ₹ 2,000) for ₹ .....	2,500
(iv) Purchased goods on credit .....	7,000
(v) Payment made to creditors in full settlement .....	6,900
(vi) Sold goods on credit (Costing ₹ 5,400) .....	6,000
(vii) Payment received from debtors .....	5,800
Discount allowed .....	200
(viii) Salaries paid .....	4,000
(ix) Wages outstanding .....	400
(x) Prepaid Insurance .....	100
(xi) Rent received .....	300
(xii) Amount withdrawn .....	3,000

(xiii) Interest on drawing .....	200
(xiv) Depreciation on machinery .....	800
(xv) Purchased goods on credit .....	17,000

**Solution:**

**Accounting Equation**

Transactions	Assets					=	Liabilities		+	Capital
	Cash	Stock of Goods	Machine	Debtors	Prepaid Expenses	=	Creditors	Outstanding Expenses	+	Capital
(i) Started business with:										
Cash           ₹ 20,000										
Goods         ₹ 12,000										
Machine       ₹ 8,000	20,000 +	12,000 +	8,000 +	0 +	0 =	0 +		0 +		40,000
(ii) Purchased goods   ₹ 5,000	(-) 5,000 +	5,000 +	0 +	0 +	0 =	0 +		0 +		0
New Equation	15,000 +	17,000 +	8,000 +	0 +	0 =	0 +		0 +		40,000
(iii) Sold goods (Costing ₹ 2,000) for										
₹ 2,500	+ 2,500 +	(-) 2,000 +	0 +	0 +	0 =	0 +		0 +		500
New Equation	17,500 +	15,000 +	8,000 +	0 +	0 =	0 +		0 +		40,500
(iv) Purchased goods on credit										
₹ 7,000	0 +	7,000 +	0 +	0 +	0 =	7,000 +		0 +		0
New Equation	17,500 +	22,000 +	8,000 +	0 +	0 =	7,000 +		0 +		40,500
(v) Payment made to creditors in full settlement   ₹ 6,900	(-) 6,900 +	0 +	0 +	0 +	0 =	(-) 7,000 +		0 +		100
New Equation	10,600 +	22,000 +	8,000 +	0 +	0 =	0 +		0 +		40,600
(vi) Sold goods no credit (Costing ₹ 5,400) for ₹ 6,000										
₹ 6,000	0 +	(-) 5,400 +	0 +	6,000 +	0 =	0 +		0 +		600
New Equation	10,600 +	16,600 +	8,000 +	6,000 +	0 =	0 +		0 +		41,200
(vii) Payment received from Debtors             ₹ 5,800										
Discount allowed   ₹ 200	+ 5,800 +	0 +	0 +	(-) 6,000 +	0 =	0 +		0 +		(-) 200
New Equation	16,400 +	16,600 +	8,000 +	0 +	0 =	0 +		0 +		41,000
(viii) Salaries paid     ₹ 4,000	(-) 4,000 +	0 +	0 +	0 +	0 =	0 +				(-) 4,000
New Equation	12,400 +	16,600 +	8,000 +	0 +	0 =	0 +		0 +		37,000
(ix) Wages outstanding   ₹ 400	0 +	0 +	0 +	0 +	0 =	0 +		400 +		(-) 4,000
New Equation	12,300 +	16,600 +	8,000 +	0 +	0 =	0 +		400 +		36,600
(x) Prepaid Insurance    ₹ 100	(-) 100 +	0 +	0 +	0 +	100 =	0 +		0 +		0
New Equation	12,300 +	16,600 +	8,000 +	0 +	100 =	0 +		400 +		36,600
(xi) Rent received       ₹ 300	+ 300 +	0 +	0 +	0 +	0 =	0 +		0 +		300
New Equation	12,600 +	16,600 +	8,000 +	0 +	100 =	0 +		400 +		36,900
(xii) Amount withdrawn ₹ 3,000	(-) 3,000 +	0 +	0 +	0 +	0 =	0 +		0 +		(-) 3,000
New Equation	9,600 +	16,600 +	8,000 +	0 +	100 =	0 +		400 +		33,900
(xiii) Interest on drawings   ₹ 200	0 +	0 +	0 +	0 +	0 =	0 +		0 +		± 200
New Equation	9,600 +	16,600 +	8,000 +	0 +	100 =	0 +		400 +		33,900

(xiv) Depreciation on machinery									
₹ 800	0 +	0 +	(-) 800 +	0 +	0 =	0 +	0 +	(-) 800	
New Equation	9,600 +	16,600 +	7,200 +	0 +	100 =	0 +	400 +	33,100	
(xv) Purchased goods on credit									
₹ 17,000	0 +	17,000 +	0 +	0 +	0 =	17,000 +	0 +	0	
New Equation	9600 +	33,600 +	7,200 +	0 +	100 =	17,000 +	400 +	33,100	

### Balance Sheet

Liabilities	Amount (₹)	Assets	Amount (₹)
Creditors	17,000	Cash	9,600
Outstanding expenses	400	Stock in trade	33,600
Capital	33,100	Machine	7,200
		Prepaid expenses	100
	50,500		50,500

## 1.18 SUMMARY

- Book-keeping is the proper and systematic keeping or maintenance of the books of accounts. Book-keeping starts from the identification of business transactions.
- “Book-keeping is the art of recording in the books of accounts the monetary aspect of commercial or financial transactions.”
- Transactions are classified as assets, liabilities, capital, revenues and expenses.
- “Accounting is a means of measuring and reporting the results of economic activities.”
- Accounting is a wider and comprehensive concept. It is an art of identifying, classifying, recording, summarising and interpreting business transactions of financial nature.
- Every subject has got its own terminology. Accounting, as a subject has got its own terms. These terms have their specific meaning in Accounting and used to express financial nature of the business.
- “Assets are valuable resources owned by a business which were acquired at a measurable money cost.”
- Fictitious assets are those assets, which do not have physical form. They do not have any real value. Actually, they are not the real assets but they are called assets on legal and technical ground.
- Assets having physical existence which can be seen and touched are known as tangible assets.
- Intangible Assets are the assets which are not normally purchased and sold in the open market such as goodwill and patents.
- Cash in hand, cash at bank, building, plant and furniture, etc. are the capital of business.

Notes

- Statements prepared by an enterprise at the end of accounting year to assess the status of income and assets is termed as Financial Statement/Final Accounts.
- The ultimate end of the goods purchased or manufactured by the business is their sales. It includes both cash and credit sales.
- Losses are unwanted burden which the business is forced to bear.
- Excess of revenue over expense is termed as profit. In other words excess of sale proceeds over cost of goods sold is income.
- Generally, Accepted Accounting Principles (GAAP) are the set of rules and practices that are followed while recording transactions and preparing the financial statements, GAAP build sound theoretical foundation of Accounting.
- The relationship between assets, liabilities and capital is at present known as Accounting Equation which can also be expressed as under:

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### 1.19 REVIEW QUESTIONS

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1. Define accountancy.
2. What is the accounting year of the company?
3. Mention two advantages of accounting.
4. Name the document, which is used as a source document for recording business transactions.
5. State the meaning of Book-keeping.
6. Define Book-keeping.
7. Mention the objectives of Accounting in about 50 words.
8. Describe the steps in Book-keeping process.
9. What is accounting? Explain its objectives.
10. What is meant by Book-keeping? In what respects book-keeping is different from accounting?
11. Explain whether accounting is science or art or both.
12. Explain briefly the advantages and limitations of accountancy.
13. Give an example of a transaction which may be an expense for business and income for the businessman.
14. Name the concept responsible for the origin of 'Double Entry System'.
15. 'Business units last indefinitely'. Mention the concept on which the statement is based.
16. Explain Business Entity concepts.
17. Explain the concepts of money measurement.
18. Explain briefly the principle of Double Entry System.
19. Explain the following:
  - (a) Money measurement concept,
  - (b) Accounting period concept,
  - (c) Going concern concept,
  - (d) Dual aspect.

20. Explain the following with examples:
  - (a) Money measurement concept,
  - (b) Dual aspect,
  - (c) Accounting period.
21. If we receive ₹ 490 from our debtors in full settlement of a debt ₹ 500. What will be the accounting effect of ₹ 10 on assets, liabilities and capital?
22. If creditors worth ₹ 1000 are paid ₹ 980 in full settlement, what will be the accounting effect of ₹ 20?
23. How is income received in advance (unearned income) shown in the accounting equation?
24. If goods costing ₹ 9,500 are sold for ₹ 10,000, show how the capital will be affected?
25. Point out one transaction which will affect capital only.
26. Explain accounting equation in about 50 words.
27. What is meant by creditors for goods and creditors for expenses? How will these transactions affect assets, liabilities and capital?
28. Calculate total assets of the business if:  
Jacob starts business with ₹ 1,00,000. He earned a profit of ₹ 20,000. He has to pay his creditors for goods ₹ 7000 and outstanding salary amounts to ₹ 1000.
29. Explain the meaning of source documents with example.
30. Describe two basic purpose of source documents.
31. Describe the fundamental accounting equation. How are the revenue and expenses account related to it?
32. Discuss any seven basic transactions resulting from the relationship of assets, liabilities and capital.
33. Name the items affecting capital and explain them briefly.
34. How are the following items in accounting equation dealt with?
  - (a) Outstanding expenses
  - (b) Prepaid expenses
  - (c) Accrued income
  - (d) Unearned income.
35. Accounting equation remains intact under all circumstances. Justify the statement with the help of an example.

**Notes**

## 2. Depreciation, Provisions and Reserves

### Notes

#### Structure

- 2.1 Depreciation
- 2.2 Methods of Calculating Depreciation
- 2.3 Diminishing or Reducing or Written Down Value Method
- 2.4 By Creating/Maintaining Provision for Depreciation Account
- 2.5 Provisions AS-29
- 2.6 Reserves
- 2.7 Summary
- 2.8 Review Questions

### 2.1 DEPRECIATION

#### Meaning and Definition

Business is established for indefinite period. This is why, it acquires fixed assets for its use. These assets increase the profit earning capacity. Fixed assets are constantly used in the business. The assets lose their value gradually due to their constant use. Loss in the value and utility of assets due to their constant use and expiry of time is termed as depreciation. It has been our own experience that the furniture purchased for our own use in 2007 will lose a part of its value and lustre in 2011. Its value will further decrease in 2012 and so its effectiveness and value will go on decreasing with the passage of time. This 'wear and tear' is known as 'Depreciation' in accounting:

According to American Institute of Certified Public Accountants (AICPA), "Depreciation Accounting is a system of accounting which aims to distribute the cost or other basic value of tangible capital assets, less salvage value (if any) over the estimated useful life of the unit (which may a group of assets) in a systematic and rational manner. It is a process of allocation, not of valuation. Depreciation for the year is portion of the total charge under such a system that is allocated to the year."

#### Points to be Remembered

- Land and Building is never depreciated. It is always appreciated. (In case, if the value of Land and Building increases)
- Depreciation is charged every year whether the company is even suffering losses.

According to R.N. Carter, "Depreciation is gradual and permanent decrease in the value of an asset from any cause."

W. Pickles views, "Depreciation may be defined as permanent and continuing diminution in the quality, quantity or the value of an asset."

In the opinion of **Spicer and Peglar**, "Depreciation is the measure of exhaustion of the effective life of an asset from any cause during a given period."

According to **Accounting Standard-6**, "Depreciation is a measure of the wearing out, consumption or other loss of value of a depreciable asset arising from use, effluxion of time or obsolescence through technology and market changes."

According to **Institute of Cost and Management Accounting London (ICMA) terminology**. "The depreciation is the diminution in intrinsic value of the asset due to use and/or lapse of time."

According to Accounting Standard-6 issued by the Institute of Chartered Accountants of India (in November 1987) every company is liable to make provision for depreciation on its fixed assets.

## Notes

### Special Features of Depreciation

1. Depreciation is loss in the value of assets.
2. Loss should be gradual and constant.
3. Depreciation is the exhaustion of the effective life of business.
4. Depreciation is the normal feature.
5. Maintenance of assets is not depreciation.
6. It is continuing decrease in the value of assets.
7. It is the allocation of cost of assets to the period of its life.

Accountants have developed certain specific words to denote the loss in the value of particular assets, other than depreciation. These words are as under:

1. **Obsolescence:** Sometimes new inventions throw away the existing machines and equipments as obsolete (useless) although the old machines and equipments are not completely useless. The firm will have to replace the old machine and equipment with the latest, up-to-date and newly invented machine and equipment. Loss due to the obsolescence of the old machine and equipment is known as 'obsolescence'.
2. **Depletion:** The firm may possess certain mineral wealth such as coal, oil, iron ore etc. The more we extract mineral wealth from these mines the more mines are depleted. Decrease in mineral wealth of the mines is termed as depletion.
3. **Amortisation:** The word 'amortisation' is used to show loss in the value of intangible assets. These assets are goodwill, patents and preliminary expenses etc. These assets are written off over certain period.
4. **Fluctuation:** Increase and decrease in the market value of assets is known as fluctuation. As we record the value of these assets on historical basis, we do not pass any entry for the fluctuations in the market value of assets. In case of permanent fall in the value of investments fluctuation may be recorded.

### Causes for Depreciation

1. **By constant use:** The loss in the value, efficiency and utility of fixed assets due to its constant use is termed as depreciation.

Notes

- (ii) The number of shifts for which asset is to be used.
- (iii) Repair and maintenance policy of the business organisation.
- (iv) Technological obsolescence.
- (v) Innovation/Improvement in production method.
- (vi) Legal or other restrictions.

3. **Estimated scrap value:** It is the residual value, which is expected to be realised even if the asset becomes obsolete. We shall have to make provision of the amount which is the value of assets less its scrap value. Suppose we purchase a machine for ₹ 10,000, whose expected life is ten years. If the scrap value is ₹ 1,000, we will have to arrange ₹ 9,000, i.e.,  $10,000 - 1,000$  in ten years. Every year will bear a depreciation of ₹ 900, i.e.,  $9,000/10$ . If the scrap value in the above case is ₹ 2,000 depreciation to be charged will be ₹ 800 only.

- 4. **Chances to obsolescence:** If the asset acquired is expected to be obsolete within 5 years, we will have to split its value over 5 years. If it will be obsolete within four years the value will be split over four years. It shows that the amount of depreciation charged every year will decrease with comparatively remote chances of obsolescence.
- 5. **Addition to assets:** Depreciation should be charged on the additions to the assets also. If book value of furniture on Jan. 1, 2006 is ₹ 10,000 and additions worth ₹ 5,000 are made on July 1, 2006. Depreciation is to be charged @ 10%. We shall be calculating depreciation on ₹ 10,000 for the whole year and on 5,000 for six months.
- 6. **Legal provisions:** The rate and method of depreciation being used must be subjected to legal provisions. Companies have to honour the legal provision with regard to depreciation.

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## 2.2 METHODS OF CALCULATING DEPRECIATION

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There are various methods of calculating depreciation. Every method has got its own advantages and disadvantages. Different methods of providing depreciation are suitable for different assets. These methods are enumerated as under:

- 1. Fixed or Equal instalment method
- 2. Diminishing or reducing or written down value method
- 3. Annuity method
- 4. Depreciation fund method
- 5. Insurance policy method
- 6. Revaluation method
- 7. Depletion method
- 8. Machine hour rate method
- 9. Sum of years digit method
- 10. Replacement method.

**Note:** The first two methods are Prescribed in the syllabus for class XI, so we shall be discussing these two methods only.

The selection of an appropriate method depends upon the following:

- (i) Type of the Asset
- (ii) Nature of the use of such asset
- (iii) Circumstance prevailing in the business.

As per accounting standard 6, the selected depreciation method should be applied consistently from period to period. Change in the existing method of depreciation may be allowed only under special circumstances.

### 2.2.1 Fixed or Equal Instalment or Straight Line Method or Depreciation on Original Cost

It is the simplest method of charging depreciation. The original cost of the asset is divided by the estimated life period of the asset. For example, if the value of asset is ₹ 20,000 and its useful life is estimated to be 10 years, the amount of depreciation to be charged every year will be ₹ 2,000 i.e.,  $20,000/10$ . Depreciation to be charged every year will be ₹ 2,000 or in other words, it will be fixed at ₹ 2,000 for every year. If we draw a graph of depreciation of 10 years, we shall find it to be a straight line because depreciation every year is the same i.e., ₹ 2,000.

In certain cases, we are also given the scrap or residual value of the assets. The term residual or scrap value means the amount realised from the sale of obsolete asset.

In these cases, we use the following formula for the calculation of depreciation:

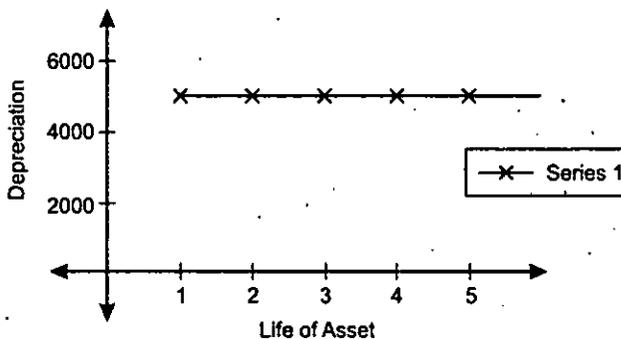
Annual depreciation =

$$\frac{\text{Scrap value or Residual Value or Breakup or salvage value}}{\text{Expected or Estimated life of asset}}$$

Under straight line method, depreciation may also be determined by applying a fixed rate to the original cost of the asset.

$$\text{Rate of Depreciation} = \frac{\text{Annual Depreciation}}{\text{Cost of Asset}} \times 100$$

Graphically it is represented as follows if annual depreciation is ₹ 4,500 for 5 years.



Notes

**Explanation of Formula:**

**Cost of the assets:** Cost of the assets means the original cost or the historical cost of the asset. The cost includes the purchase price and the expenses incurred in acquiring (carriage, cartage, freight on newly purchased asset), installation charge (in case of fixtures, plant and machinery) construction charges (in case of building).

**Scrap or residual or breakup or salvage value:** The asset being used will definitely become obsolete sooner or later. The asset can be disposed off, even if it is obsolete (useless) as a scrap. The amount fetched by scrapped asset is known as its residual value.

**Estimated life of the asset:** Whenever asset is acquired, the manufacturer generally mentions the estimated working life of the asset. It may be in years, months, days or hours (in case of machines and equipments) in tons (in case of coal mines) in kilometres (in case of truck) so on. If the estimated life is not mentioned by the manufacturer we can assume it on the basis of our past experience or any scientific method.

**Advantages of Straight Line Method**

Straight line method of providing depreciation has got the following advantages:

1. **Simplicity:** This is the simplest method of providing depreciation. This can be easily understood even by ordinary person. Calculation of depreciation according to this method is also very simple.
2. **Assets can be completely written off:** According to this method, assets can be written off to zero. The depreciation is calculated on the original cost of the asset at the specified rate, so the value of asset is fully split over the useful life of asset.
3. **Knowledge of total depreciation charged:** The amount of total depreciation charged can be easily known by multiplying the yearly amount of depreciation with number of years, the asset has been used.
4. **Suitable for small firms:** Straight line method is the most suitable method for small firms. These firms use this method, because it is easy, simple and suitable to the size of the firms.
5. **Suitable for firms having large number of old and new machines:** The weaknesses of this method are removed, if the firm has both old and new machines. More maintenance charges on old machines and lesser on the new machines balance each other.
6. **Useful for assets having lesser value:** This method is the most suitable for charging depreciation on assets of lesser value such as furniture, fixture and patents etc.

**Disadvantages or Limitations of Straight Line Method**

Straight line method suffers from the following weaknesses:

1. **Undue pressure on final years:** The final years of the life of the asset have to bear more repairs and maintenance charges and also the same amount of depreciation, whereas initial years have to suffer lesser repair charges.

2. **No provision for replacement:** The amount charged as depreciation is retained in the business and used in the routine affairs. The firm has to bother for making arrangement of funds for the replacement of assets although depreciation has been charged every year.
3. **Loss of interest:** The amount of depreciation charged every year is not invested outside the firm, so no interest is received. In certain methods of depreciation, the amount of depreciation is invested outside the business in securities and interest is received.
4. **Illogical method:** It seems illogical to charge depreciation on the original cost of the asset every year when the balance of the asset is declining year after year.
5. **Unsuitable for assets having long life and more value:** This method is not suitable for those assets which are subject to additions and extension from time to time, such as land and building and plant and machinery. It is not suitable for assets having more value also.

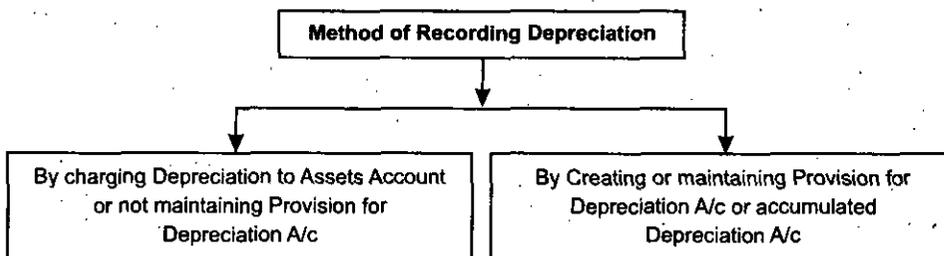
## Notes

### Uses of Straight Line Method

1. Straight line method is suitable for those assets, which require lesser expenses on repairs and maintenance.
2. The method is also useful for assets of lesser value such as patents, furniture etc.
3. This method is also useful for those big manufacturing concerns who have got a large number of machines. Some assets are very old and some of them are fresh.
4. The combined result of the depreciation on both the old and new machines and also repairs and maintenance charges balance each other. In case of old machines, maintenance charges are more but in case of new machines charges are lesser.
5. More maintenance charges on old machines and lesser repairs on new balance each other.
6. The method is very simple, so most appropriate for small firms and assets of small value.

### 2.2.2 Methods of Recording Depreciation

Depreciation is recorded in the books of accounts under the following two methods:



### 2.2.3 By Charging Depreciation to Assets

According to this method following journal entries are passed:

Notes:

**1. For purchase of assets**

Assets A/c Dr.  
     To Bank or Cash A/c

**2. For depreciation on assets**

Depreciation A/c Dr.  
     To Assets A/c

**3. For sale of assets**

Bank or Cash A/c Dr.  
     To Assets A/c

**4. For loss on sale of assets**

P/L A/c Dr.  
     To Assets A/c

The third and fourth entry regarding sale of asset or loss can be combined together:

Bank or Cash A/c Dr.  
 Loss on Sale of Assets A/c Dr.  
     To Assets A/c

Loss on sale of assets account will be closed by transfer to profit and loss account:

**5. For profit on sale of assets**

Assets A/c Dr.  
     To P/L A/c

**6. For closing of Depreciation Account**

P/L A/c Dr.  
     To Depreciation A/c

*Illustration 1. (Straight Line Method: When rate is given). The purchase of furniture amounted to ₹ 4,000 and it is decided to write off 5 per cent on the original cost as depreciation at the end of each year. Show the ledger account as it will appear during the first four years. Pass journal entries also.*

**Solution: Journal Entries**

Date	Particulars	L.F.	Amount	
			Debit (₹)	Credit (₹)
1st year	Furniture A/c <span style="float:right">Dr.</span>		4,000	
Jan. 1	To Bank A/c (Being purchase of furniture)			4,000
Dec. 31	Depreciation A/c <span style="float:right">Dr.</span>		200	
	To Furniture A/c			200

Notes

	(Being depreciation on furniture @ 5% on ₹ 4,000)			
2nd year				
Dec. 31	Depreciation A/c To Furniture A/c (Being depreciation charged on furniture @ 5% on ₹ 4,000)	Dr.	200	200
3rd year				
Dec. 31	Depreciation A/c To Furniture A/c (Being depreciation charged on furniture @ 5% on ₹ 4,000)	Dr.	200	200
4th year				
Dec. 31	Depreciation A/c To Furniture A/c (Being depreciation charged on furniture @ 5% on ₹ 4,000)	Dr.	200	200

**Explanation:** As per the instructions of question, depreciation on furniture has to be charged @ 5% on original cost. The original cost of the furniture is ₹ 4,000, so depreciation on furniture will be charged every year on its original value, i.e., ₹ 4,000. This is why, every year ₹ 200 has been charged as depreciation.

**Fixed Instalment Method  
Furniture Account**

Dr.

Cr.

Date	Particulars	J.F.	Amount (₹)	Date	Particulars	J.F.	Amount (₹)
1st year				1st year			
Jan. 1	To Bank A/c		4,000	Dec. 31	By Depreciation A/c		200
					By Balance c/d		3,800
			4,000				4,000
2nd year				2nd year			
Jan. 1	To Balance b/d		3,800	Dec. 31	By Depreciation A/c		200
					By Balance c/d		3,600
			3,800				3,800
3rd year				3rd year			
Jan. 1	To Balance b/d		3,600	Dec. 31	By Depreciation A/c		200
					By Balance c/d		3,400
			3,600				3,600

Notes

4th year				4th year			
Jan. 1	To Balance b/d		3,400	Dec. 31	By Depreciation A/c		200
					By Balance c/d		3,200
			3,400				3,400
5th year							
Jan. 1	To Balance b/d		3,200				

**Illustration 2. (Straight Line Method: Original cost, expected life and scrap value).** On January 1, 2009 M/s Ram & Sons purchased a Machinery for ₹ 2,00,000. They spent ₹ 12,000 on its freight and ₹ 8,000 for its installation. The expected life of the machine is 10 years. It is expected that the machine will be sold for ₹ 20,000 after its useful life. Prepare machinery account and depreciation account for 3 years. Books of Accounts are closed on December 31, every year.

Solution:

M/s Ram & Sons

Machinery Account

Dr.

Cr.

Date	Particulars	J.F.	Amount (₹)	Date	Particulars	J.F.	Amount (₹)
2009				2009			
Jan. 1	To Bank A/c		2,20,000	Dec. 31	By Depreciation A/c		20,000
				Dec. 31	By Balance c/d		2,00,000
			2,20,000				2,20,000
2010				2010			
Jan. 1	To Balance b/d		2,00,000	Dec. 31	By Depreciation A/c		20,000
				Dec. 31	By Balance c/d		1,80,000
			2,00,000				2,00,000
2011				2011			
Jan. 1	To Balance b/d		1,80,000	Dec. 31	By Depreciation A/c		20,000
				Dec. 31	By Balance c/d		1,60,000
			1,80,000				1,80,000
2012							
Jan. 1	To Balance b/d		1,60,000				

Depreciation Account

Dr.

Cr.

Date	Particulars	J.F.	Amount (₹)	Date	Particulars	J.F.	Amount (₹)
2009				2009			
Dec. 31	To Machine A/c		20,000	Dec. 31	By P/L A/c		20,000
2010				2010			
Dec. 31	To Machine A/c		20,000	Dec. 31	By P/L A/c		20,000
2011				2011			
Dec. 31	To Machine A/c		20,000	Dec. 31	By P/L A/c		20,000

## Working Note

### Calculation of Depreciation:

$$\frac{\text{Cost of machine} - \text{Scrap value}}{\text{Expected life of machinery}} = \frac{2,20,000 - 20,000}{10} = ₹ 20,000$$

**Illustration 3. (Straight Line Method: Additions to assets).** On 1st January, 2008 a Company bought Plant and Machinery costing ₹ 35,000. It is estimated that its working life is 10 years, at the end of which it will fetch ₹ 5,000. Additions are made on 1st January, 2009 to the value of ₹ 20,000 (Residual value ₹ 2,000). More additions are made on July 1, 2010 to the value of ₹ 10,000. (Breakup value ₹ 1,000). The working life of both the additional Plants and Machinery is 20 years.

Show the Plant and Machinery account for the first four years, if depreciation is written off according to Straight Line Method. The accounts are closed on 31st December every year.

### Solution: Plant and Machinery Account

Notes

Dr.

Cr.

Date	Particulars	J.F.	Amount (₹)	Date	Particulars	J.F.	Amount (₹)
2008				2008			
Jan. 1	To Bank A/c		35,000	Dec. 31	By Depreciation A/c		3,000
				Dec. 31	By Balance c/d		32,000
			35,000				35,000
2009				2009			
Jan. 1	To Balance b/d		32,000	Dec. 31	By Depreciation A/c		
Jan. 1	To Balance b/d		20,000	(i) ₹ 3,000			
				(ii) ₹ 900			3,900
				Dec. 31	By Balance c/d		
				(i) ₹ 29,000			
				(ii) ₹ 19,100			48,100
			52,000				52,000
2010				2010			
Jan. 1	To Balance b/d			Dec. 31	By Depreciation A/c		
	(i) ₹ 29,000			(i) ₹ 3,000			
	(ii) ₹ 19,100			(ii) ₹ 900			
			48,100	(iii) ₹ 225			
July 1	To Bank A/c		10,000	(for 6 months)			4,125
				Dec. 31	By Balance c/d		
				(i) ₹ 26,000			
				(ii) ₹ 18,200			
				(iii) ₹ 9,775			53,975

Notes

			58,100				58,100
2011				2011			
Jan. 1	To Balance b/d			Dec. 31	By Depreciation A/c		
	(i) ₹ 26,000				(i) ₹ 3,000		
	(ii) ₹ 18,200				(ii) ₹ 900		
	(iii) ₹ 9,775		53,975		(iii) ₹ 450		4,350
				Dec. 31	By Balance c/d		
					(i) ₹ 23,000		
					(ii) ₹ 17,300		
					(iii) ₹ 9,325		49,625
							53,975
			53,975				
2012							
Jan. 1	To Balance b/d						
	(i) ₹ 23,000						
	(ii) ₹ 17,300						
	(iii) ₹ 9,325		49,625				

Working Notes

1. Calculation of Depreciation =  $\frac{\text{Cost of Plant and Machinery} - \text{Residual value}}{\text{Working life}}$

(i)  $\frac{₹ 35,000 - ₹ 5,000}{10 \text{ years}} = \frac{30,000}{10} = ₹ 3,000 \text{ per year.}$

(ii)  $\frac{₹ 20,000 - ₹ 2,000}{20 \text{ years}} = \frac{18,000}{20} = ₹ 900 \text{ per year}$

(iii)  $\frac{₹ 10,000 - ₹ 1,000}{20 \text{ years}} = \frac{9,000}{20} = ₹ 450 \text{ per year.}$

2. The amount of depreciation on all the three machines will be ascertained separately as above.

**Illustration 4. (Straight Line Method: Sale of assets).** On 1st July 2008 Raj & Co. purchased machinery worth ₹ 40,000. On 1st July, 2010 it buys additional machinery worth ₹ 10,000. On 30th June, 2011 half of the machinery purchased on 1st July, 2008 is sold for ₹ 9,500. The company writes off 10% on the original cost. The accounts are closed every year on 31st December.

Show the machinery account for four years, Accounts are closed on December 31, every year.

Solution: Machinery Account

Dr.

Cr.

Date	Particulars	J.F.	Amount (₹)	Date	Particulars	J.F.	Amount (₹)
2008				2008			
July 1	To Bank A/c		40,000	Dec. 31	By Depreciation A/c		2,000

				(On ₹ 40,000 for six months)	
			Dec. 31	By Balance c/d	38,000
		40,000			40,000
<b>2009</b>			<b>2009</b>		
Jan. 1	To Balance b/d	38,000	Dec. 31	By Depreciation A/c (On ₹ 40,000 for one year)	4,000
			Dec. 31	By Balance c/d	34,000
		38,000			38,000
<b>2010</b>			<b>2010</b>		
Jan. 1	To Balance b/d	34,000	Dec. 31	By Depreciation A/c (On ₹ 40,000 for one year and on 10,000 for six months)	4,500
July 1	To Bank A/c	10,000	Dec. 31	By Balance c/d	39,500
					44,000
		44,000			44,000
<b>2011</b>			<b>2011</b>		
Jan. 1	To Balance b/d	39,500	June 30	By Bank A/c	9,500
				By Depreciation A/c (On ₹ 20,000 for six months)	1,000
				By profit and Loss A/c	4,500
			Dec. 31	By Depreciation A/c (On ₹ 20,000 for one year + On ₹ 10,000 for one year)	3,000
					21,500
		39,500	Dec. 31	By Balance c/d	39,500
<b>2012</b>					
Jan. 1	To Balance b/d	21,500			

**Notes**

**Working Notes**

(i) Calculation of loss on sale of Machinery:

Book value of full machine (on July 1, 2008) = 40,000

Book value of half machinery (on July 1, 2008) =  $40,000 \times \frac{1}{2} = 20,000$

Less: Depreciation on half machinery @ 10% on straight line method:

2008 (July 1 – Dec. 31) 1,000

2009 (for full year) 2,000

2010 (for full year) 2,000

2011 (Jan. 1—June 30) 1,000

6,000

Book value as on June 30, 2011	14,000
<i>Less:</i> Amount received from sale	<u>9,500</u>
Loss on sale of machinery	<u><u>4,500</u></u>

**(ii) Journal entry for sale of machinery:****Notes**

2011

June 30,	Bank A/c	Dr.	9,500	
	Profit and Loss A/c	Dr.	4,500	
	Depreciation A/c	Dr.	1,000	
	To Machinery A/c			15,000

**Calculation of Depreciation on Additions to Asset**

Business is a continuing activity, so we may purchase additional assets or we may add to the existing assets. Addition to the fixed assets, such as land and building, plant and machinery, vehicles and furniture etc. are capital expenditure. It will increase the value of assets, so depreciation will also be charged on these additions. Depreciation on additions will be charged since the date of additions at the specified rate.

*For example,* if addition to machinery worth ₹ 20,000 on July 1, 2010, will be depreciated at the rate of 10% (specified) for six months together with the depreciation on the book value of old machinery, depreciation on the additions during the first year will be the same under straight line or written down value method.

**Treatment of Sale of Asset**

The firm may sell asset, if it is obsolete. It may also be sold when it is not in perfect order. The disposal of asset will take place, when purchase of fresh, up-to-date asset is made and the old asset becomes unwanted. In any case, the sale of asset has to be accounted for. The treatment of asset in case of sale will be made as under:

**Treatment of Sale of Asset****(i) If asset is sold at the book value**

Bank A/c	Dr.
To Asset A/c	

**(ii) If the asset is sold at lesser than book value (loss)**

Bank A/c	Dr.
Profit and Loss A/c	Dr.
To Asset A/c	

**(iii) If the asset is sold for more than the book value**

Bank A/c	Dr.
To Asset A/c	
To Profit and Loss A/c	

## 2.3 DIMINISHING OR REDUCING OR WRITTEN DOWN VALUE METHOD

This method has been developed to remove the shortcomings of straight line method. Equal amount of depreciation is charged every year under straight line method. The method is criticised for showing disfavour to final years of the life of the assets. During final years repairs and maintenance charges are more but the depreciation is the same. It shows that the final years are over burdened with charges. Diminishing balance method was developed to remedy the weakness of straight line method.

Under the diminishing balance method, the value of asset upon which depreciation is to be calculated goes on diminishing, so the amount of depreciation to be charged every year also goes on declining. *For example*, if a machine has been acquired for ₹ 1,00,000 and depreciation is charged @ 10% according to written down value method the depreciation to be charged will be made as under:

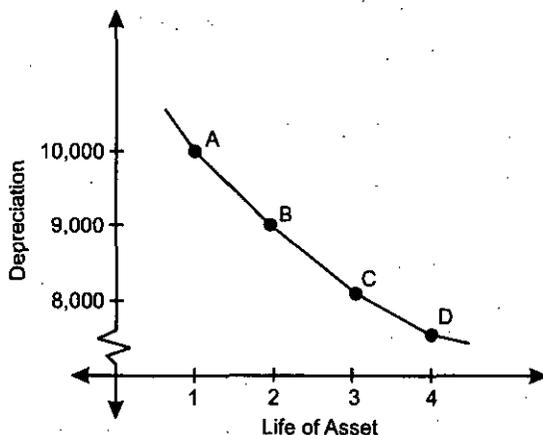
$$\text{1st year on ₹ 1,00,000 @ 10\%} = \frac{10}{100} \times 1,00,000 = ₹ 10,000$$

$$\text{2nd year on ₹ 90,000, i.e., ₹ 1,00,000 - 10,000} = 90,000 \times \frac{10}{100} = ₹ 9,000$$

$$\text{3rd year on ₹ 81,000, i.e., ₹ 90,000 - 9,000} = 81,000 \times \frac{10}{100} = ₹ 8,100$$

$$\text{4th year on ₹ 72,900, i.e., ₹ 81,000 - 8,100} = 72,900 \times \frac{10}{100} = ₹ 7,290 \text{ and so on.}$$

It will be observed from the above calculation that the balance of machine upon which depreciation is being calculated goes on diminishing or reducing or it is being written down. It should also be noted that the amount of depreciation goes on declining year after year. In the first year it was ₹ 10,000, in the second year, it came down to ₹ 9,000. It reduced further to ₹ 8,100 in the third year. In the 4th year, it remained only ₹ 7,290. In this way, depreciation will go on declining year after year. This can be represented in graph as follows:



### Advantages of Written Down Value Method

Diminishing balance method has got the following advantages:

1. **Easy calculation:** Calculation of depreciation is easier as compared to

Notes

Notes

other methods of calculating depreciation except straight line method. Depreciation is calculated every year on the opening balance of asset. Depreciation on additions is separately calculated.

2. **Balanced effect on the profit and loss account of different years:** In the initial years depreciation is more and the maintenance charges are lesser. In the final years, depreciation is lesser but repairs and maintenance charges are more, so every year bears the charges almost the same as regards depreciation and maintenance.
3. **Approved method by income tax authorities:** The method is approved by income tax authorities.
4. **Logical method:** It seems logical even to layman that the value of asset goes on diminishing year after year, so the depreciation should also be charged on the reducing balances.
5. **Suitable for assets having long life:** This method is suitable for those assets which have long life. It is also suitable for those assets, where additions and extensions are common feature, such as land, building and plant and machinery.

**Disadvantages or Limitation of the Written Down Value Method**

Diminishing balance method of providing depreciation suffers from following weaknesses:

1. **The value of assets cannot be reduced to zero:** It is very difficult to determine the rate by which the value of asset could be written down to zero.
2. **No funds for replacement:** Though depreciation is charged every year but the amount charged is retained in the business and used in routine business operations. At the time of replacing assets, firm has to bother for making arrangement of funds, although it has charged depreciation every year.
3. **Loss of interest:** The amount charged as depreciation is not invested outside the business, so no interest is received. In certain methods, the amount is invested outside the business in securities and interest is received.
4. **Higher rate of depreciation:** The rate of depreciation in this method is higher, because it will require longer period to write off the asset, if the rate is lower and the assets may become useless earlier.
5. **Inequal burden on profit and loss account:** The amount of depreciation goes on declining year after year, whereas the asset is used equally by every year.

**Uses of Diminishing Balance Method**

1. Diminishing balance is the method for assets having long life.
2. It is also suitable for those assets which are subject to additions and extensions from time to time, such as land and building, plant and machinery etc.



				Dec. 31	By Profit & Loss (Loss on sale)		2,000
			16,000				16,000

**Notes**

**Working Notes**

The amount of depreciation has been calculated @ 20% on diminishing (reducing) balances of machinery. In 2010, depreciation has been calculated on 25,000. Amount spent on repairs of second hand machinery is capital expenditure. It was necessary to bring the old machinery in working order. It is the part of the cost of machinery, so it has been added to its cost. The balance of machinery reduced to ₹ 20,000 in 2011 and further reduced to ₹ 16,000 in 2012, so depreciation for 2011 has been calculated on 20,000 and for 2012 on ₹ 16,000.

Loss on sale of machinery has been calculated as under:

Book value of machinery as on January 1, 2010 ₹ 25,000

Less: Depreciation:

2010 (for full year)	5,000
2011 (for full year)	4,000
2012 (for full year)	<u>3,200</u>

12,200

Book value of machinery as on December 31, 2012 12,800

Less: Amount received from sale of machinery 10,800

Loss on sale of machinery 2,000

**Illustration 6. (WDV: Assets sold partly).** A company whose accounting year is the calendar year purchased on 1st April, 2008 machinery costing ₹ 30,000.

It further purchased machinery on 1st October, 2008 costing ₹ 20,000 and on 1st July, 2009 costing ₹ 10,000.

On 1st January, 2010 one-third of the machinery which was installed on 1st April, 2008 became obsolete and was sold for ₹ 3,000.

Show how the machinery account would appear in the books of company. The depreciation is charged at 10% p.a. on Written Down Value Method.

**Solution: Written Down Value Method**

**Machinery Account**

Dr.

Cr.

Date	Particulars	J.F.	Amount (₹)	Date	Particulars	J.F.	Amount (₹)
2008				2008			
April 1	To Bank A/c		30,000	Dec. 31	By Depreciation A/c		2,750
Oct. 1	To Bank A/c		20,000	Dec. 31	By Balance c/d		47,250
			<u>50,000</u>				<u>50,000</u>
2009				2009			
Jan. 1	To Balance b/d		47,250	Dec. 31	By Depreciation A/c		5,225

July 1	To Bank A/c		10,000		By Balance c/d		52,025
			57,250				57,250
2010				2010			
Jan. 1	To Balance b/d		52,025	Jan. 1	By Bank A/c		3,000
				Jan. 1	By P & L A/c (Loss)		5,325
				Dec. 31	By Depreciation A/c		4,370
				Dec. 31	By Balance c/d		39,330
			52,025				52,025
2011							
Jan. 1	To Balance b/d		39,330				

Notes

Working Notes

(i) Calculation of depreciation for year 2010:	₹
Total Written Down Value as on January 1, 2010	52,025
Less: Written Down Value of 1/3rd of plant sold (10,000 – 750 – 925)	<u>- 8,325</u>
Written down value of remaining machine	<u>43,700</u>
Depreciation at 10% on Written Down Value $(43,700 \times \frac{10}{100})$	<u>4,370</u>

(ii) Calculation of loss on sale of machinery:	
Book value of 1/3rd machinery purchased on April 1, 2008 as on January 1, 2010 (10,000 – 750 – 925)	8,325
Less: Amount received from sale	<u>(-) 3,000</u>
Loss on sale of machinery	<u>5,325</u>

**Illustration 7. (WDV: Sale of assets).** A manufacturing concern, whose books are closed on 31st December, purchased machinery for ₹ 50,000 on 1-1-2008. Additional machinery was acquired for ₹ 10,000 on 1-7-2009 and for ₹ 16,061 on 1-1-2012. Certain machinery purchased for ₹ 10,000 on 1-1-2008 was sold for ₹ 5,000 on 30-6-2011.

Give the machinery account for 5 years. Depreciation is written off at 10% per annum on written down value method.

Solution: Machinery Account

Dr.

Cr.

Date	Particulars	J.F.	Amount (₹)	Date	Particulars	J.F.	Amount (₹)
2008				2008			
Jan 1	To Bank A/c		50,000	Dec. 31	By Depreciation A/c		5,000
				Dec. 31	By Balance c/d		45,000
			50,000				50,000

Notes

<b>2009</b>			<b>2009</b>		
Jan. 1	To Balance b/d	45,000	Dec. 31	By Depreciation A/c	5,000
July 1	To Bank A/c	10,000	Dec. 31	By Balance c/d	50,000
		55,000			55,000
<b>2010</b>			<b>2010</b>		
Jan. 1	To Balance b/d	50,000	Dec. 31	By Depreciation A/c	5,000
			Dec. 31	By Balance b/d	45,000
		50,000			50,000
<b>2011</b>			<b>2011</b>		
Jan. 1	To Balance b/d	45,000	June 30	By Bank A/c	5,000
			June 30	By Profit & Loss A/c	1,925
			Dec. 31	By Depreciation A/c	4,136
			Dec. 31	By Balance b/d	33,939
		45,000			45,000
<b>2012</b>			<b>2012</b>		
Jan. 1	To Balance b/d	33,939	Dec. 31	By Depreciation A/c	5,000
Jan. 1	To Bank A/c	16,061	Dec. 31	By Balance c/d	45,000
		50,000			50,000
<b>2013</b>					
Jan. 1	To Balance b/d	45,000			

Working Notes

(i) Calculation of loss on sale of machinery:	₹
Book value of machinery as on January 1, 2008	10,000
Less: Depreciation according to diminishing balance method:	
2008 (for full year)	1,000
2009 (for full year)	900
2010 (for full year)	810
2011 (for six months)	<u>365</u>
	<u>3,075</u>
Book Value of Machine sold as on June 30, 2011	6,925
Less: Amount received from sale	<u>(-) 5,000</u>
Loss on sale of machine	<u>1,925</u>
(ii) Calculation of depreciation for the year 2011:	
Book value of all machineries as on January 1, 2011	45,000
Less: Book value of machinery to be sold as on January, 1, 2011	<u>(-) 7,290</u>
	<u>37,710</u>
Depreciation on 37,710 @ 10% for full year	3,771
Add: Depreciation on 7,290 @ 10% for six months	<u>365</u>
Total depreciation for 2011	<u>4,136</u>

### Calculation of Rate of Depreciation under Written Down Value Method

Under this method of depreciation, the amount of depreciation goes on decreasing whereas the rate of depreciation remains fixed. This is due to the reason that pre-determined rate is applied to a gradually shrinking balance of the assets every year. If the rate of depreciation is not given we shall apply the following formula for its calculation.

$$R = \left[ 1 - \sqrt[n]{\frac{S}{C}} \right] \times 100$$

where  $n$  = indicates number of years  
 $S$  = indicates Scrap values  
 $C$  = indicates cost of the machine.

In this formula  $\sqrt[n]{S/C}$  indicates the nth root of the ratio of  $S$  and  $C$ . It should be noted that log table will be required to calculate the rate with this formula if number of years are more than 2. Although this formula and its application is in the NCERT Textbook but question may not be asked because calculation requires log and anti log. Even though we are discussing it through following illustrations.

**Illustration 8.** On January 1, 2010, Karim Printing Press purchased a printing machinery costing ₹ 50,000. Its scrap value is ₹ 2,000 and expected life is 10 years. It is decided to depreciate printing machinery by written down value method for initial 3 years.

Calculate the rate of depreciation, under this method and show the written down value (book value) at the end of the year.

#### Solution: Calculation of Rate of Depreciation

$$R = \left[ 1 - \sqrt[n]{\frac{S}{C}} \right] \times 100 = \left[ 1 - 10\sqrt[10]{\frac{2,000}{50,000}} \right] \times 100 = [1 - 10\sqrt[10]{0.04}] \times 100$$

Let us determine the value of  $10\sqrt[10]{0.04}$

$$\begin{aligned} \text{Let } Y &= 10\sqrt[10]{0.04} \\ \Rightarrow \log Y &= \log (0.04)^{1/10} && [10\sqrt[10]{0.04} = (0.04)^{1/10}] \\ \Rightarrow \log Y &= \frac{1}{10} \log (0.04) && \Rightarrow \log Y = \frac{1}{10} \times (-1.3979) \\ \Rightarrow \log Y &= -0.13979 && \Rightarrow Y = \text{Antilog} (-0.13979) \\ \Rightarrow Y &= 0.0725 && \Rightarrow 10\sqrt[10]{0.04} = 0.725 \end{aligned}$$

$$\text{Now, } R = [1 - 0.725] \times 100 = 0.275 \times 100 = 27.5\%$$

$$\text{Depreciation for 2010 year} = \frac{\text{₹ } 50,000 \times 27.5}{100} = \text{₹ } 13,750$$

$$\text{Book value of Machine} = \text{₹ } 50,000 - \text{₹ } 13,750 = \text{₹ } 36,250$$

$$\text{Depreciation for 2011 year} = \frac{36250 \times 27.5}{100} = \text{₹ } 9,968.75$$

$$\text{Book value of Machine} = 36250 - 9968.75 = \text{₹ } 26,281.25$$

$$\text{Depreciation for 2012 year} = \frac{\text{₹ } 26,281.25 \times 27.5}{100} = \text{₹ } 7,227.34$$

$$\text{Book value of Machine} = 26,281.25 - 7,227.34 = \text{₹ } 19,053.91.$$

### Notes

## 2.4 BY CREATING / MAINTAINING PROVISION FOR DEPRECIATION ACCOUNT

### Notes

According to this method depreciation is not charged to assets A/c. It means that Depreciation A/c is not posted to the credit side of assets A/c. For depreciation a separate and different entry, debiting Depreciation A/c and crediting Provision for Depreciation A/c is passed. Depreciation A/c is written off by transfer to P/L A/c.

Provision for Depreciation A/c is built up progressively year after and depreciation is accumulated therein. While showing Assets A/c in the Balance sheet total depreciation from the date of purchase to the date of sale is deducted from the original value of Assets. In this method following Journal entries are passed.

#### 1. For Purchase of an Asset

Asset A/c	Dr.
To Bank A/c	

#### 2. For depreciation on Asset

Depreciation A/c	Dr.
To Provision for Depreciation A/c or Accumulated Depreciation A/c	

#### 3. For writing off Depreciation

P/L A/c	Dr.
To Depreciation A/c	

#### For sale of Asset

Bank A/c	Dr.
Provision for Depreciation A/c or Accumulated Depreciation A/c	Dr.
P/L A/c (For loss on sale)	Dr.
To Asset A/c	

**Illustration 9. (Provision for depreciation Account).** A Company purchased a plant for ₹ 20,000 on January 1, 2010. The Plant was subjected to depreciation @ 10% according to straight line method. It was sold on December 31, 2011 for ₹ 15,000. Additional Plant was purchased on January 1, 2012 for ₹ 10,000.

Pass requisite journal entries and prepare Plant Account, Depreciation A/c and Provision for Depreciation A/c for 3 years. Also show Plant in the Balance Sheet.

**Solution:**

**Machinery Account**

Date	Particulars	L.F.	Amount	
			Debit (₹)	Credit (₹)
2010 Jan. 1	Plant A/c <span style="float: right;">Dr.</span> To Bank A/c (Being Plant Purchased)		20,000	20,000

Notes

Dec. 31	Depreciation A/c	Dr.	2,000		
	To Provision for Depreciation A/c				2,000
	(Being Depreciation charged on Plant)				
Dec. 31	Profit & Loss A/c	Dr.	2,000		
	To Depreciation A/c				2,000
	(Being Depreciation A/c written off)				
<b>2011</b>					
Dec. 31	Depreciation A/c	Dr.	2,000		
	To Provision for Depreciation A/c				2,000
	(Being Depreciation charged on Plant)				
Dec. 31	P/L A/c	Dr.	2,000		
	To Depreciation A/c				2,000
	(Being Depreciation A/c written off)				
Dec. 31	Bank A/c	Dr.	15,000		
	Provision for Depreciation A/c	Dr.	4,000		
	P/L A/c	Dr.	1,000		
	To Plant A/c				20,000
	(Being Sale of Plant for ₹ 15,000 and ₹ 1,000 loss on sale of plant)				
<b>2012</b>					
Dec. 31	Plant A/c	Dr.	10,000		
	To Bank A/c				10,000
	(Being Plant Purchased)				
Dec. 31	Depreciation A/c	Dr.	1,000		
	To Provision for Depreciation				1,000
	(Being Depreciation charged)				
Dec. 31	Profit & Loss A/c	Dr.	1,000		
	To Depreciation A/c				1,000
	(Being Depreciation A/c written off)				

Plant Account

Date	Particulars	J.F.	Amount (₹)	Date	Particulars	J.F.	Amount (₹)
<b>2010</b>				<b>2010</b>			
Jan. 1	To Bank A/c		20,000	Dec. 31	By Balance c/d		20,000
			20,000				20,000
<b>2011</b>				<b>2011</b>			
Jan. 1	To Balance b/d		20,000	Dec. 31	By Bank A/c (Sale)		15,000
					By Provision for Depreciation A/c		4,000

Notes

					By P/L A/c (Loss on sale)		1,000
			20,000				20,000
2012				2012			
Jan. 1	To Bank A/c		10,000	Dec. 31	By Balance c/d		10,000
			10,000				10,000
2013							
Jan. 1	To Balance b/d		10,000				

Provision for Depreciation Account

Date	Particulars	J.F.	Amount (₹)	Date	Particulars	J.F.	Amount (₹)
2010				2010			
Dec. 31	To Balance c/d		2,000	Dec. 31	By Depreciation A/c		2,000
			2,000				2,000
2011				2011			
Dec. 31	To Plant A/c		4,000	Jan. 1	By Balance b/d		2,000
				Dec. 31	By Depreciation A/c		2,000
			4,000				4,000
2012				2012			
Dec. 31	To Balance c/d		1,000	Dec. 31	By Depreciation A/c		1,000
			1,000				1,000

Extract of Depreciation Account

Date	Particulars	J.F.	Amount (₹)	Date	Particulars	J.F.	Amount (₹)
2010				2010			
Dec. 31	To Provision for Depreciation A/c		2,000	Dec. 31	By P/L A/c		2,000
2011				2011			
Dec. 31	To Provision for Depreciation A/c		2,000	Dec. 31	By P/L A/c		2,000
2012				2012			
Dec. 31	To Provision for Depreciation A/c		1,000	Dec. 31	By P/L A/c		1,000

Plant A/c will be shown in the Balance Sheet as under:

Extract of Balance Sheet  
as on 31st December, 2010

Liabilities	Amount	Assets	Amount
		Plant	20,000
		Less: Provision of Depreciation	2,000
			18,000

Or  
Extract of Balance Sheet  
as on 31st December, 2011

Provision for Depreciation	4,000	Plant	20,000
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Balance Sheet  
as on 31st December, 2012

Plant	10,000
Less: Provision for Depreciation	<u>1,000</u> 9,000

Notes

**Difference between Provision for Depreciation A/c is Not Maintained and Provision for Depreciation Account is Maintained**

Bases of Difference	If Provision for Depreciation A/c is Not Maintained	If Provision for Depreciation A/c is Maintained
1. Preparing Assets A/c	Assets A/c is shown at Book value less Depreciation written off during the year.	Assets A/c always appears at original cost year after year.
2. Showing Assets A/c in the Balance Sheet	Assets is shown at the value in the beginning of the year less depreciation written off during the year.	Assets is shown at original cost less total depreciation provision from the date of original purchase to the date of sale.
3. Revealing	This method is not revealing in the absence of further details. It is difficult to form an idea as to whether the asset is new or old.	This method is revealing as it shows the revealing age of asset with regard to the cost of asset and the cumulative depreciation.

**Use of Asset Disposal Account**

Disposal of fixed asset is a sale which generates profit or loss, which is a difference between sales price and net book value at the disposal time. Fixed assets are purchased by the business not with a purpose to resell them, therefore they are being sold after some period of time during which the asset was used or when it become non-efficient and should be replaced with the new technology.

Gains or losses due to the sale of the fixed asset are reported in the profit and loss account and called "profit on disposal of fixed assets" or "loss on disposal of fixed asset".

**Accounting Entries for the Asset Disposal Account**

Following entries need to be posted for the asset disposal:

**Step 1:** Cost of fixed asset sold should be transferred to Asset Disposal Account as shown in the below entry

Disposal Account	Dr.
To Fixed Asset A/c (Cost)	

**Step 2:** Accumulated Depreciation pertaining to the asset sold is transferred to the Asset Disposal Account. As shown in the below entry:

Accumulated Depreciation Account	Dr.	
To Disposal Account		

**Notes**

**Step 3:** Sales entry for asset should be done depending whether the sale is on cash or credit basis

Bank/Account Receivable	Dr.	
To Disposal A/c		

**Step 4:** Transfer profit or loss on disposal from Disposal Account to the profit and loss account. In case Disposal Account will have final debit balance, this will be a loss on disposal and transferring this loss to the income statement, the following entry will be done:

Loss on disposal of fixed asset	Dr.	
To Disposal A/c		

In case Disposal Account will have final credit balance, this will be a profit on disposal and transferring this profit to the income statement the following entry will be done:

Disposal Account	Dr.	
To Profit on disposal of fixed asset		

**Disposal of Fixed Asset—Example**

The company has equipment, cost of which is ₹ 5000, accumulated depreciation is ₹ 1500. The equipment is sold for ₹ 3000 for cash.

**Step 1:** Transfer cost of equipment to Disposal Account

Asset Disposal Account	Dr.	₹ 5,000	
To Cost of Equipment			₹ 5,000

**Step 2:** Transfer accumulated depreciation to Disposal Account

Accumulated depreciation	Dr.	₹ 1,500	
To Asset Disposal Account			₹ 1,500

**Step 3:** Record sales revenue in the Disposal Account

Cash A/c	Dr.	₹ 3,000	
To Asset Disposal Account			₹ 3,000

**Step 4:** The balance of asset disposal account of ₹ 500 (loss on sale) is transferred to loss on sale of fixed assets accounts.

Loss on Sale of Fixed Assets	Dr.	₹ 500	
To Asset Disposal Account			₹ 500

**Effect of Any Addition or Extension to the Existing Asset**

When any addition or extension of existing takes place then the cost of such addition or extension is added to the value of the asset. This is also known as the capitalization of asset. The addition or extension of asset adds to the capacity of the asset. The following entry is passed for the asset capitalization

## To Bank/Vendor Account

It should be noted that normal repair and maintenance of the asset is not added to the value of the asset. It is debited to the profit and loss account.

**Illustration 10. (Assets disposal account).** On 1st January, 2011, M/s Swaminathan and Bros. purchased 5 washing machines for ₹ 15,000 each. They sold on January 1, 2012 one machine for ₹ 12,500. They have decided to write off depreciation @ 10% on straight line method.

Notes

Prepare washing machines A/c, Washing Machine Disposal Account and Provision for Depreciation A/c for two years. Accounts are closed on 31st December, every year.

Solution:

## Washing Machine Account

Dr.

Cr.

Date	Particulars	J.F.	Amount (₹)	Date	Particulars	J.F.	Amount (₹)
2011 Jan. 1	To Bank A/c		75,000	2011 Dec. 31	By Balance c/d		75,000
			75,000				75,000
2012 Jan. 1	To Balance b/d		75,000	2012 Dec. 31	By Machine Disposal A/c		15,000
				Dec. 31	By Balance c/d		60,000
			75,000				75,000
2013 Jan. 1	To Balance b/d		60,000				

## Provision for Depreciation Account

Date	Particulars	J.F.	Amount (₹)	Date	Particulars	J.F.	Amount (₹)
2011 Dec. 31	To Balance c/d		7,500	2011 Dec. 31	By Depreciation A/c		7,500
			7,500				7,500
2012 Dec. 31	To Machinery Disposal A/c		1,500	2012 Jan. 1	By Balance b/d		7,500
Dec. 31	To Balance c/d		12,000	Dec. 31	By Depreciation A/c		6,000
			13,500				13,500

## Washing Machine Disposal Account

Date	Particulars	J.F.	Amount (₹)	Date	Particulars	J.F.	Amount (₹)
2012 Jan. 1	To Washing			2012 Jan. 1	By Provision for		

## Notes

Machine A/c	15,000	Depreciation A/c	1,500
		By Bank A/c	12,500
		By P/L A/c	1,000
	15,000		15,000

**Alternatively:** This problem can also be solved without opening Asset Disposal A/c. In such treatment adjustments, are made in the Assets Account as discussed previously in the first method.

**Illustration 11.** (Existing balance of machine and provision account). The following balances appear in the books of M/s Kushawaha Sons.

Jan. 1, 2012 Machinery Account ₹ 40,000

Jan. 1, 2012 Provision for Depreciation ₹ 18,000

On 1st Jan. 2012 they decided to sell a machinery for ₹ 4,350.

This Machine was purchased in January 2009 for ₹ 8,000.

You are required to prepare "Machinery A/c" and the "Provision for Depreciation A/c" on 31st December, 2012. Assume that the firm has been charging depreciation at 10% p.a. on Straight Line Method.

**Solution:** Washing Machine Account

Dr.				Cr.			
Date	Particulars	J.F.	Amount (₹)	Date	Particulars	J.F.	Amount (₹)
2012				2012			
Jan. 1	To Balance b/d		40,000	Jan. 1	By Bank A/c (Sale)		4,350
				Jan. 1	By Provision for Depreciation A/c		3,200
				Jan. 1	By P & L A/c (Loss on sale)		450
				Dec. 1	By Balance c/d		32,000
			40,000				40,000
2013							
Jan. 1	To Balance b/d		32,000				

## Provision for Depreciation Account

Dr.				Cr.			
Date	Particulars	J.F.	Amount (₹)	Date	Particulars	J.F.	Amount (₹)
2012				2012			
Jan. 1	To Machinery A/c		3,200	Jan. 1	By Balance b/d		18,000
Dec. 31	To Balance c/d		18,000	Dec. 31	By P & L A/c		3,200
			21,200				21,200

## Working Notes

### (i) Calculation of loss on sale of Machine:

Cost of Machinery Sold:	₹ 8,000
Less: Depreciation @ 10% for 4 years	3,200
Value of Machinery on 1-1-2012	4,800
Less: Sales Price	4,350
Loss on sale of Machinery	₹ 450
(ii) Depreciation for the year 2012	
10% on ₹ 32,000	₹ 3,200

### Asset Disposal Account: Loss by Fire

In certain cases assets are destroyed partly or wholly due to fire. There may be two possibilities in such a case

- (i) Fire insurance is applicable to the asset.
- (ii) Fire insurance is not applicable to the asset.
- (i) **Fire insurance is applicable to the asset:** The Journal entries in such a case will be as follows:

(a) Asset Disposal A/c	Dr.	
		(with cost of asset destroyed due to fire)
To Asset A/c		
(b) Insurance Co. A/c	Dr.	
		(with amount of insurance claim admitted)
Accumulated Depreciation A/c	Dr.	
		(with amount of depreciation accumulated on destroyed asset)
Loss by Fire A/c	Dr.	
		(difference between cost of asset and sum of Insurance claim admitted and accumulated depreciation)
To Asset Disposal A/c		(total cost of asset destroyed)
(c) P/L A/c	Dr.	[transfer of loss to P/L A/c]
To Loss by Fire		

- (ii) **Fire insurance not applicable to the asset:** The Journal entries will be as follows:

(a) Asset Disposal A/c	Dr.	
		[with the cost of asset destroyed due to fire]
To Asset A/c		
(b) Accumulated Depreciation A/c	Dr.	
		(Depreciation accumulated on asset destroyed)
Loss by Fire A/c	Dr.	(Balancing figure)
To Asset Disposal A/c		(Cost of asset destroyed)

Depreciation, Provisions  
and Reserves

Notes

**Illustration 12. (Accumulated Depreciation and Assets Disposal Account).** On 1-1-2009, plant purchased from Y Ltd. costing ₹ 4,00,000 on instalment basis follows:

On	1-1-2009	1,00,000
On	1-7-2009	1,00,000
On	1-1-2010	1,00,000
On	1-1-2011	1,00,000

The Company spent ₹ 10,000, on transportation and installation of the plant. It was decided to provide for depreciation on straight line method. For this purpose, the useful life of the plant was estimated at 5 years. It was also estimated that at the end of useful life, realizable value of the plant would be ₹ 12,000 (Gross) and dismantling cost of plant, to be paid by the company, was estimated at ₹ 2,000. The plant was destroyed by fire on 31-12-2012 and an insurance claim of ₹ 50,000 was admitted by the insurance company.

Prepare plant account, Accumulated Depreciation Account, Plant Disposal Account and Loss on sale of plant assuming that the company closes its books on 31st Dec. every year.

**Solution:** Books of X Ltd.  
Plant Account

Dr.				Cr.			
Date	Particulars	J.F.	Amount (₹)	Date	Particulars	J.F.	Amount (₹)
2009				2009			
Jan. 1	To Y Ltd.		4,10,000	Dec. 31	By Balance c/d		4,10,000
			4,10,000				4,10,000
2010				2010			
Jan. 1	To Balance b/d		4,10,000	Dec. 31	By Balance c/d		4,10,000
			4,10,000				4,10,000
2011				2011			
Jan. 1	To Balance b/d		4,10,000	Dec. 31	By Balance c/d		4,10,000
			4,10,000				4,10,000
2012				2012			
Jan. 1	To Balance b/d		4,10,000	Dec. 31	By Plant disposal A/c		4,10,000
			4,10,000				4,10,000

**Accumulated Depreciation Account**

Dr.				Cr.			
Date	Particulars	J.F.	Amount (₹)	Date	Particulars	J.F.	Amount (₹)
2009				2009			
Dec. 31	To Balance c/d		80,000	Dec. 31	By Depreciation A/c		80,000

**Notes**

2010			80,000	2010			80,000
Dec. 31	To Balance c/d		1,60,000	Jan. 1	By Balance b/d		80,000
				Dec. 31	By Depreciation A/c		80,000
			1,60,000				1,60,000
2011				2011			
Dec. 31	To Balance c/d		2,40,000	Jan. 1	By Balance b/d		1,60,000
				Dec. 31	By Depreciation A/c		80,000
			2,40,000				2,40,000
2012				2012			
Dec. 31	To Plant disposal A/c		3,20,000	Jan. 1	By Balance b/d		2,40,000
				Dec. 31	By Depreciation A/c		80,000
			3,20,000				3,20,000

**Plant Disposal Account**

Dr.

Cr.

Date	Particulars	J.F.	Amount (₹)	Date	Particulars	J.F.	Amount (₹)
2012				2012			
Dec. 31	To Plant		4,10,000	Dec. 31	By Accumulated Depreciation		3,20,000
				Dec. 31	By Insurance Company		50,000
				Dec. 31	By Loss by Fire		40,000
			4,10,000				4,10,000

**Loss on Sale of Plant Account**

Dr.

Cr.

Date	Particulars	J.F.	Amount (₹)	Date	Particulars	J.F.	Amount (₹)
2012				2012			
Dec. 31	To Plant Disposal		40,000	Dec. 31	By Profit & Loss A/c		40,000
			40,000				40,000

**Working Notes**

**1. Calculation of Depreciation**

$$\frac{4,10,000 - (12,000) - 2,000}{5} = 80,000$$

**2. Journal Entries for Loss by Fire**

(a) Plant Disposal A/c	Dr.	4,10,000	
To Plant A/c			4,10,000

Notes

(b) Accumulated Depreciation A/c	Dr.	3,20,000	
Insurance Company A/c	Dr.	50,000	
Loss by Fire A/c	Dr.	40,000	
To Plant Disposal			4,10,000
(c) P/L A/c	Dr.	40,000	
To Loss by Fire A/c			40,000

## 2.5 PROVISIONS AS-29

Provision is a charge against profit to meet certain known liabilities or contingencies. It is a specific reserve and must be maintained, whether there is profit or loss. The objective of creating provision is to cover the loss for which it was created. Provision is created for a definite object such as:

### Special Features of Provision

It is maintained:

- (i) To meet known losses, e.g., depreciation, heavy repairs and renewals.
- (ii) To meet expected contingency, e.g., doubtful debts, discount on debtors, liability for disputed claim, any contingent liability under Workmen's Compensation Act.
- (iii) To meet an outstanding liability such as outstanding salaries, wages, rent and income tax etc.

Provision or Specific reserve is not surplus. It is not represented by any asset. Provision is not available for distribution among shareholders. If the provision exceeds the required amount the excess is treated as reserve.

Provisions or specific reserve is deducted from the assets in the Balance Sheet. Depreciation is deducted from concerned assets. Provision for bad debts and discounts are deducted from debtors. Reserve for outstanding liabilities such as outstanding expenses are shown at the liabilities side.

**1. Provision for bad and doubtful debts:** It is created to meet any future loss, if the debtors fail to pay the whole or part of the debt, owing by them. The amount set aside for this provision is charged out of the current year's profit and loss account. The logic behind it is that debtors also belong to current year and we are conservative in this matter.

Provision for doubtful debts is posted at the debit side of profit and loss account. This provision for doubtful debts is also deducted from sundry debtors at the assets side of the Balance Sheet. In the next year, if there is actual bad debts, it will be charged from the provision for doubtful debts.

*Illustration 13. (Provision for discount on debtors). Following is the extract of Trial Balance as at March 31, 2015. Pass Journal entries and show ledger accounts and balance sheet.*

Name of Account	Debit	Credit
Sundry Debtors	5,00,000	

Discount Allowed	4,000
Provision for Discount Allowed	

**Additional Information**

Provision for Discount Allowed is to be maintained at 2%.

**Solution:**

**Journal Entries**

Date	Particulars	L.F.	Amount	
			Debit (₹)	Credit (₹)
2015				
Mar. 31	Provision for Discount on Debtors A/c Dr. To Discount A/c (Discount Allowed written off)		4,000	4,000
Mar. 31	Profit & Loss A/c Dr. To Provision for Discount on Debtors A/c (Being provision for discount on debtors charged out of P/L A/c)		11,000	11,000

**Discount Allowed Account**

Dr.

Cr.

Date	Particulars	J.F.	Amount (₹)	Date	Particulars	J.F.	Amount (₹)
2015				2015			
Mar. 31	To Balance b/d		4,000	Mar. 31	By Provision for discount on debtors		4,000
			4,000				4,000

**Provision for Discount on Debtors Account**

Dr.

Cr.

Date	Particulars	J.F.	Amount (₹)	Date	Particulars	J.F.	Amount (₹)
2015				2014			
Mar. 31	To Discount Allowed		4,000	Apr. 1	By Balance b/d		3,000
Mar. 31	To Balance c/d		10,000	2015			
			14,000	Mar. 31	By P/L A/c		11,000
							14,000

**Extract Profit & Loss A/c for the year ended Mar. 31, 2012**

Cr.

Dr.	Particulars	J.F.	Amount (₹)	Date	Particulars	J.F.	Amount (₹)
15							
Mar. 31	To Provision for discount on debtors		11,000				
			11,000				

**Extract of Balance Sheet as at Mar. 31, 2012**

Liabilities	Amount	Assets	Amount
		Current Assets	
		Debtors	5,00,000
		Less: Provision for discount on debtors	10,000
			<u>4,90,000</u>
			4,90,000

**Working Note**

Provision required @ 2% on ₹ 5,00,000		10,000
Discount allowed	4,000	
Less: opening balance	<u>3,000</u>	<u>1,000</u>
Provision for discount on debtors		<u>11,000</u>

**2. Provision for discount on debtors:** It is a trade practice that when debtors make immediate payment or payment at an early date, we allow them discount at a certain rate. As it is customary trade practice, it seems to be judicious that we should make provision for discount on debtors. As the provision for discount on debtors relates to current year's debtors so it should be charged out of current year's profit and loss account. The provision for discount on debtors will be deducted from sundry debtors at the assets side of the Balance Sheet.

It may also be argued that provision of discount on debtors should not be maintained at the end of the year because debtors may not take advantage of this discount. Moreover, discount is allowed to those debtors who make payment before the due date.

The amount of the provision for discount on debtors is calculated on debtors. Further bad debts and provision for doubtful debts are also to be created. This provision will be calculated after deducting both further bad debts and provision for doubtful debts from debtors.

**3. Provision for taxation:** Taxes have to be paid to the Government at the end of the profit of the current year in the following assessment year. It seems necessary to set aside out of the current year's profit a certain specific amount for this known liability must be set aside out of the profit and loss account of the current year to make payment of the taxes. The amount for this purpose will be debited to profit and loss account. It will also be shown on the liability side of the current year's Balance Sheet because the account is still payable.

During the next year, taxes of the current year will be paid. For making payment of taxes, we shall debit provision for taxes account and credit Bank account. The balance of provision for taxation account will be shown at the liabilities, so far its balance exists.

Provision for taxation may be treated as both, the current or non-current liability. If it is assumed to be non-current liability previous year's provision for taxation will be paid during the current year. Taxes payable on the profits of the current year will be charged out of the profit and loss account of the current year.

## Notes

### Some Examples of Provision

- Provision for bad and doubtful debts
- Provision for discount on debtors
- Provision for taxation
- Provision for depreciation
- Provision for repairs and renewals.

### Accounting Treatment of Provisions

Provisions are charged against profit. Provisions are created by debiting profit and loss account for specific and known contingency or expected loss, e.g., provision for doubtful debts, provision for discount on debtors and provision for taxation etc. A definite sum is charged every year out of profit and loss account to meet the known contingency. Provisions account should be compulsorily posted at the debit side of profit and loss account, whether the firm earns profit or suffers loss.

The provisions are generally shown at the assets side of Balance Sheet by way of deducting it from concerned assets. Provision for doubtful debts and provision for discount on debtors are shown by way of deduction from debtors on the assets side of the Balance Sheet. It may sometimes be shown at the liabilities side also, i.e., provision for taxation.

Making provision is must but making reserves is discretionary as a matter of financial prudence and subject to profit.

Provision for doubtful debts generally has old balance. The old provision is deducted from the total of bad debts and new provision at the debit side of profit and loss account. In case old provision exceeds the total of bad debts and new provision, the treatment should preferably be made at the credit side of profit and loss account, where the total of bad debts and new provision should be deducted from old provision.

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## 2.6 RESERVES

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Generally an ordinary person understands by the term "reserve" that something has been kept a part for emergency. From accountancy point of view "reserve" means the part of profit retained for any known or unknown contingency, liability or decrease in the value of asset. American Institute of Accounting views, "The use of the term reserve be limited to indicate that an undivided part of the asset is being held or retained for general or specific reserve."

It is the appropriation of profit. It is created out of undistributed profit. General reserve is also known as "free reserve" or "revenue reserve". It is created to meet

## Notes

unforeseen future uncertainties. The general reserve is maintained to meet unknown liability or contingency or commitment.

General reserve is a source of internal financing. It is the retained profit and technically known as 'ploughing back of profit'. If the reserve would not have been maintained the profit would have been distributed among shareholders as dividend and the amount would have gone outside the business. In case of general reserve profit and loss account shows a credit balance. The debit balance of profit and loss account (loss) and general reserve cannot exist simultaneously.

It is not compulsory and binding upon business to maintain general reserve. The Companies act does not make it obligatory to set aside a certain sum of money for general reserve. It may be created if the management thinks it advisable and the profit are sufficient. It should once more be noted that it is the appropriation of profit not a charge.

### Broad Classification of Reserve

Reserves are broadly classified as: (1) Capital Reserve (2) Revenue Reserve (3) General Reserve (4) Specific Reserve and (5) Secret Reserve.

**1. Capital reserve:** Capital reserve is a gain which arises either on sale of long term assets or in the settlement of liabilities. The transaction is of capital nature. Capital Reserve acts as an accounting mechanism for conserving profits. It imparts an element of stability to the overall finance of a business enterprise. Allocation of revenue reserve may be made to capital reserve due to legal obligations. Capital reserve does not include any free balance which might be used for distribution of profits.

### Some Examples of Reserve

- Issue of shares at premium
- Profits emerging from revaluation of fixed assets after observing all restrictions
- Profits accruing on sale of fixed assets
- Premium on issue of shares and debentures
- Profit on redemption of debenture
- Balance of forfeited shares A/c
- Profit prior to incorporation
- Creation of Capital Redemption reserve upon the redemption of preference shares.

**2. Revenue reserve:** These reserves are created out of revenue profit which are usually distributable profits. In other words, it is the profit which has been withheld from paying dividend out of the total distributable profit.

Examples of Revenue Reserve are:

- General reserve
- Dividend equalization reserve
- Debenture redemption reserve
- Retained earnings.



**Notes**

2. Usage	It can be used for any purpose.	It cannot be used for any other purpose except for which it is created.
3. Purpose	It is created for general purpose.	It is created for specific purpose.
4. Examples	Reserve, Reserve fund, contingencies reserve, retained earnings etc.	Dividend equalisation reserve, debenture redemption reserve, investment fluctuation reserve etc.

**5. Secret reserve:** It may be defined as, “any reserve which is not apparent on the face of balance sheet”. It is also called as “hidden reserve” or inner reserve. Secret reserve is created by under-statement of assets or over statement of liabilities. It is not disclosed in the books of accounts.

**How secret reserve is created?**

The secret reserve is created by the following methods:

- (i) Under estimation of assets.
- (ii) By not writing up any asset whose price has permanently gone up.
- (iii) By creating more reserve for bad debts and discounts than what is necessary.
- (iv) By providing excessive depreciation.
- (v) By omitting some of the assets from Balance Sheet.
- (vi) By showing contingent liabilities as real liabilities.
- (vii) By charging capital expenditure to revenue account.

**Objectives of creating secret reserve**

The objectives of creating secret reserve are as under:

- (i) To meet extra-ordinary loss without disclosing it to share-holders and outsiders.
- (ii) To with-hold information of the progress of the company from trade competition.
- (iii) To utilise funds in lean years.
- (iv) To increase working capital.
- (v) To increase financial soundness.
- (vi) To equalise the payment of dividend.

**Dangers or objections in creating secret reserve**

The following are the dangers from creating secret reserve:

- (i) The true financial position is not available from Balance Sheet.
- (ii) Shareholders do not get due share of profit.
- (iii) Value of assets goes down in the market.
- (iv) Indulgence of directors in speculation.
- (v) Concealment of the weakness of the management.

According to Companies Act, creation of secret reserve is prohibited except in the case of banking, insurance or finance companies.

### Accounting Treatment of Reserve

Reserve is an appropriation of profit. It is created by debiting profit and loss appropriation account. In case of company's final accounts we prepare profit and loss appropriation account in addition to profit and loss account. Profit and loss appropriation account shows the distribution of profit among reserves, funds and dividend. While appropriating profit we pass the following journal entry:

**For appropriating amount for replacement of an asset:**

Profit and Loss Appropriation A/c Dr.  
     To Depreciation Fund A/c

(Being amount set aside to replace the asset)

**For appropriating amount for redemption of liability:**

Profit and Loss Appropriation A/c Dr.  
     To Debenture Sinking Fund A/c

Or

Profit and Loss Appropriation A/c Dr.  
     To Debenture Redemption Reserve A/c

Reserve accounts such as depreciation fund account, debenture redemption reserve account, debenture sinking fund account, reserve fund account and general reserve will also be shown at the liabilities side.

Reserves are always created out of profit.

### Distinction between Reserve and Provision

Bases of Difference	Reserve	Provision
1. Appropriation and Charge	Reserve is an appropriation (distribution) of profits.	Provision is a charge against profit.
2. Exactness of the Charge	Reserve is created without taking into consideration the exact and definite amount required.	Provision is made for a definite amount.
3. Side of the Balance Sheet	It is usually shown on the liabilities side of the Balance Sheet.	It is usually shown at the assets side of 'Balance Sheet' by way of deduction from the assets concerned, i.e., reserve for doubtful debts is deducted from debtors.
4. Necessity	Maintenance of reserve is discretionary and is a matter of financial prudence. Reserves are created subject to the policy of the management, if profits permit. Maintenance of reserve is not must.	Maintenance of provision is a 'must'.

Notes

## Notes

5. Dependence upon Profit	Reserve depends upon profit. If there are no profits, reserve cannot be created.	Provisions are created even if there is a loss.
6. Purpose	Reserve is created for general purpose. The object for which, it is created is not known.	Provisions are made for specific purpose. The object for provisions are known.
7. Charge	Reserve is charged from profit and loss appropriation account.	Provision is made out of profit and loss account.

**Importance of Reserves**

Reserves means amounts retained in the business and not distributed to owners. Reserves can be:

–Profits made and not passed on to owners. These are sometimes known as retained earnings.

–Capital reserves which cannot be passed on to owners and represent the perceived increase in valuation of some fixed assets.

Reserves have special importance in accounting as it helps the management of the company to retain the profits of the company to fund its future expansion plans. The cost of funding the projects is very high in the form of the loan from banks or financial institution. Reserves help the company to ensure that it can use the funds and maximise the shareholders earning.

**2.7 SUMMARY**

- **Depreciation:** Loss in the value of an asset due to its constant use and expiry of time is termed as Depreciation. According to **R.N. Carter**, “Depreciation is gradual and permanent decrease in the value of an asset from any cause.”
- **Causes Responsible for Depreciation:** (1) By Constant use (2) By Expiry of time (3) By Obsolescence (4) By Depletion (5) By Permanent fall in price (6) By Abnormal factors.
- **Need for Charging Depreciation:** (1) For determination of net profit or net loss (2) For showing assets at fair and true value in the Balance Sheet (3) Provision of funds for replacement of assets (4) Ascertaining accurate cost of production (5) Distribution of dividend out of profit only (6) Avoiding over payment of income tax.
- **Factors Affecting Depreciation:** (1) Total cost of assets (2) Estimated useful-life of assets (3) Estimated scrap value (4) Chances to obsolescence (5) Addition to assets (6) Legal Provisions.
- **Methods of Calculating Depreciation:** (1) Straight line method (2) Written down value method (3) Annuity method (4) Depreciation fund method (5) Insurance policy method (6) Revaluation method (7) Depletion method (8) Machine hour rate method (9) Sum of years digit method (10) Replacement method.
- **Straight Line Method:** It is a method by which Depreciation is charged on the original cost of the asset. It is the simplest method of charging

depreciation. The original cost of the asset is divided by the estimated life period of the asset.

$$\text{Depreciation} = \frac{\text{Cost of asset} - \text{Scrap value}}{\text{Estimated life of asset}}$$

- **Advantages of Straight Line Method:** (1) Simplicity (2) Assets can be completely written off (3) Knowledge of total depreciation charged (4) Suitable for small firms (5) Suitable for firms having large number of old and new machines (6) Useful for assets having lesser value.
- **Disadvantages or Limitations of Straight Line Method:** (1) Undue pressure on final years (2) No provision for replacement (3) Loss of interest (4) Illogical method (5) Unsuitable for assets having long life and more value.
- **Diminishing or Reducing or Written Down Value Method:** Charging depreciation on reducing balance of assets resulting in the diminishing amount of depreciation is known as written down value method.
- **Advantages of Written Down Value Method:** (1) Easy calculation (2) Balanced effect on the profit and loss A/c of different years (3) Approved method by income tax authorities (4) Logical method (5) Suitable for assets having long life.
- **Disadvantages or Limitations of Written Down Value Method:** (1) The value of assets cannot be reduced to zero (2) No funds for replacement (3) Loss of interest (4) Higher rate of depreciation (5) Inequal burden on profit and loss account.
- **Bases of Difference between Straight Line and Reducing Balance Method:** (1) Amount of depreciation (2) Calculation of depreciation (3) Zero level (4) Effect on profit and loss account (5) Suitability (6) Recognition by Income tax law.
- **Methods of Recording Depreciation:** A. By charging depreciation to assets account or not maintaining provision for depreciation account. B. By creating or maintaining provision for depreciation account or accumulated depreciation account.
- **Provision:** Charge against Profit to meet certain known liabilities or contingencies is known as Provision. It is a specific reserve and must be maintained, whether there is Profit or loss. Provision is created for definite purpose, such as: (i) Known losses (ii) Expected contingency (iii) Outstanding liability.  
**Examples:** (1) Provision for bad and doubtful debts (2) Provision for discount on debtors (3) Provision for taxation. (4) Provision for outstanding liabilities.
- **Reserve:** Reserve means part of profit retained for any known or unknown contingency, liability or decrease in the value of asset. It is appropriation of Profit.
- **Broad Classification of Reserve:**
  - (1) **Capital Reserve.** Gain arising either on sale of long term asset or settlement of liabilities is known as capital reserve. It consists of securities premium, Profit on revaluation or sale of fixed assets, profit

**Notes**

Notes

prior to incorporation, profit on redemption of debentures, balance of forfeited shares A/c etc.

(2) **Revenue Reserve.** Reserves created out of distributable profit to meet unforeseen future contingencies are known as Revenue reserve. Examples of these reserve are General reserve, Dividend equalisation reserve and debenture redemption reserve.

• **Bases of Distinction between Revenue Reserve and Capital Reserve:** (1) Source (2) Dividend (3) Objective (4) Usage.

(3) **General Reserve.** The reserve, which is not maintained for any specific and specified purpose is known as General Reserve, such as reserve, Reserve fund and contingency Reserve.

(4) **Specific Reserve.** The reserve created for certain specific and specified purpose is known as specific reserve such as Dividend Equalisation Reserve and Investment Fluctuation Reserve.

(5) **Secret Reserve.** The reserve, which is not placed in the Balance Sheet is known as 'Secret Reserve' or 'Hidden Reserve or Inner Reserve'. Secret reserve is secretly created by under-estimating assets and over-estimating liabilities. Creation of secret reserve is prohibited except in the case of banking, insurance and finance companies.

• **Bases of Distinction between Reserve and Provision:** (1) Appropriation and charge (2) Exactness of charge (3) Side of the balance sheet (4) Necessity (5) Dependence upon profit (6) Purpose (7) Charge.

## 2.8 REVIEW QUESTIONS

1. Explain the meaning of depreciation. Enumerate different methods of depreciation. Explain straight line method.
2. Discuss the advantages and disadvantages of fixed instalment method and diminishing balance method.
3. Explain the following:
 

(a) Obsolescence	(b) Amortisation
(c) Depletion	(d) Fluctuation.
4. Explain the term "reserve" and "provision". Give three examples of each.
5. Differentiate between reserve and provision.
6. What do you mean by secret reserve? How is it created? What purpose does it serve? Is there any danger in the creation of secret reserve?
7. Define depreciation as per accounting standard. Explain the need and significance of providing depreciation.
8. Distinguish between capital reserve and revenue reserve.

### Numerical Questions

1. A firm purchase on 1st January 2010, a machinery for ₹ 10,000. Depreciation was to be charged @ 20% per annum on the original cost.

You are required to show the machinery account for the first three years assuming that accounts are closed on 31st December.

[Ans. Closing balance = ₹ 4,000]

2. Sanjay purchased a machinery for ₹ 21,000 on 1st January, 2010. The estimated life of the machine is 10 years after which its residual value will be ₹ 1,000 only. Find out the amount of depreciation and prepare machinery account for the first three years according to the fixed instalment method.

**Notes**

**Note.**      **Depreciation** =  $\frac{\text{Cost price} - \text{Scrap value}}{\text{Life of the Assets}}$

$$= \frac{21,000 - 1,000}{10} = ₹ 2,000.$$

[Ans. Closing balance = ₹ 15,000]

3. A boiler was purchased from abroad for ₹ 10,000. Shipping and forwarding charges amounted to ₹ 2,000, import duty ₹ 7,000 and expenses of installation amounted to ₹ 1,000. Calculate depreciation for the first three years separately for each year @ 10% on diminishing balance method.

[Ans. ₹ 2,000, ₹ 1,800 and ₹ 1,620 ; Closing balance = ₹ 14,580]

4. The book value of plant and machinery on 1-1-2010 was ₹ 2,00,000. New machinery for ₹ 10,000 was purchased on 1-10-2010 and for ₹ 20,000 on 1-7-2011. On 1-4-2012, a machinery whose book value had been ₹ 30,000 on 1-1-2010 was sold for ₹ 16,000 and the entire amount was credited to plant and machinery account. Depreciation had been charged at 10% per annum on straight line method. Show the plant and machinery account from 1-1-2010 to 31-12-2012.

[Ans. Loss on sale of machinery = ₹ 7,250; Balance of machinery account on 31st December, 2012 = ₹ 1,43,750]

5. From the following transactions of a concern, prepare machinery account and Provision for Depreciation A/c for the year ending 31, December, 2012:

2012

January 1 : Purchased a second-hand machinery for ₹ 40,000.

January 1 : Spent ₹ 10,000 on repairs for making it serviceable.

June 30 : Purchased additional new machinery for ₹ 20,000.

September 30 : Repairs and renewals of machinery ₹ 2,000.

December 31 : Depreciate the machinery at 10% p.a.

[Note: Repair will not be capitalised] [Ans. Closing balance = ₹ 64,000]

6. A company had bought machinery for ₹ 2,00,000 including a boiler worth ₹ 20,000. The machinery account had been credited for depreciation on the reducing instalment system for the past four years at the rate of 10%. During the fifth year, i.e., the present year, the boiler became useless on account of damage to some of its vital parts and the damaged boiler is sold for ₹ 4,000. Write up the machinery account.

[Ans. Loss on sale = ₹ 9,122; Closing balance = ₹ 1,06,288]

## Notes

7. The original cost of furniture amounted to ₹ 4,000 and it is decided to write off 5 per cent on the original cost as depreciation at the end of each year. Show the ledger account as it will appear during the first four years. Show also how the same account will appear if it was decided to write off 5% on the diminishing balance.

[Ans. Closing balance: (i) Straight line method = ₹ 3,200;

(ii) Diminishing balance = ₹ 3,258]

8. On 1st January, 2010 machinery was purchased for ₹ 20,000. On 1st July, 2011 another machine was purchased for ₹ 10,000 and on 1st January, 2012 one more machine was purchased for ₹ 5,000. The firm depreciates its machines @ 20% on the diminishing balance method. Show machine account for four years.

[Ans: Closing balance = ₹ 17,152]

9. On 1st January, 2008 a merchant purchased a furniture costing ₹ 55,000. It is estimated that its working life is 10 years at the end of which it will fetch ₹ 5,000. Additions are made on 1st Jan., 2009 and 1st July, 2011 to the value of ₹ 9,500 and ₹ 8,400 (residual values ₹ 500 and ₹ 400 respectively). Show the furniture account for the first four years, if depreciation is written off according to the straight line method.

[Ans. Balance furniture account on 1st Jan., 2012 = ₹ 49,800]

10. A joint stock company had bought machinery for ₹ 1,00,000 including therein a boiler worth ₹ 10,000. The machinery account was for the first four years credited for depreciation on the reducing instalment system at the rate of 10% per annum. During the fifth year, i.e., the current year, the boiler becomes useless on account of damage to its parts. The damaged boiler is sold for ₹ 2,000 which amount is credited to machinery account. Prepare the machinery account for the current year, adjusting therein the cash received and the loss suffered on the damage boiler and the depreciation of the machinery for the current year.

[Ans. Loss on sale of boiler = ₹ 4,561; Closing balance of machinery account = ₹ 53,144]

11. Kumar & Company purchased a machinery on 1st January, 2009 for ₹ 54,000 and spent ₹ 6,000 on its installation. On 1st September, 2010 it purchased another machine for ₹ 30,000.

On 31st March, 2011 the first machine purchased on 1st January, 2011 is sold for ₹ 36,000 and on the same date it purchased a new machinery for ₹ 80,000.

On September 1, 2012 the second machine (purchased on September 1, 2010) was also sold off for ₹ 26,000. Depreciation was provided on machinery @ 10% p.a. on original cost method annually on 31st December. Give the machinery account from 2011 to 2012.

[Ans. Loss on sale of first machine ₹ 10,500, profit on sale of second machine = ₹ 2,000; Balance of Machinery A/c on 31st December, 2012 ₹ 66,000]

12. A company purchased a machine on 1st January, 2010 for ₹ 30,000 and immediately spent ₹ 4,000 on its repairs and ₹ 1,000 on its installation. On July 1, 2012 the machine was sold for ₹ 25,000. Prepare machine account after charging depreciation @ 10% p.a. by diminishing balance method. Also prepare machinery Disposal A/c.

[Ans. Loss on sale of machine = ₹ 1932.50]

13. A firm purchased machinery at a cost of ₹ 46,000 on 1st October, 2010 and incurred ₹ 4,000 expenses on its purchase and installation. The rate of depreciation under straight line method is 10% p.a. The firm closes its books on 31st December each year.

On 1st July, 2011 another machine worth ₹ 20,000 was purchased again. Write up machinery account and depreciation account for 2010, 2011 and 2012.

[Ans. Balance of Machinery Account on 31-12-2012 = ₹ 55,750]

14. The original cost of furniture and fixtures amounted to ₹ 4,000 and it is decided to write off 5% on the diminishing value of assets as depreciated at the end of each year. Show the ledger account as it will appear during the first four years.

[Ans. Balance of Machinery Account after four years ₹ 3,258.03]

15. What is depreciation and how it is calculated? Distinguish between 'straight line method' and 'written down value method' of depreciation. If an asset was purchased for ₹ 50,000 on 1st Jan., 2012, what would be its value three years after if it was depreciated by both these methods @ 10% p.a.

[Ans. Straight line method ₹ 35,000; W.D.V. method ₹ 36,450]

16. A company purchased a machinery for ₹ 50,000 on 1st July 2010. Another machinery costing ₹ 10,000 was purchased on 1st September, 2011. On 31st December, 2012 the machinery purchased in 2010 was sold at a loss of ₹ 5,000. The company charges depreciation at the rate of 15% on diminishing balance method. Accounts are closed on 31st December each year.

Prepare machinery account and Machinery Disposal A/c for three years.

[Ans. Balance on Machinery Account ₹ 8,075]

Notes

### 3. Accounts of Non-trading Institutions

#### Notes

#### Structure

- 3.1 Introduction
- 3.2 Financial Statements or Final Accounts of Not-For-Profit Organisations
- 3.3 Receipts and Payments Account
- 3.4 Income and Expenditure Account
- 3.5 Relevant Items of Income and Expenditure Account
- 3.6 Preparation of Income and Expenditure Account
- 3.7 Steps in the Preparation of Balance Sheet
- 3.8 Incidental Trading Activity
- 3.9 Summary
- 3.10 Review Questions

#### 3.1 INTRODUCTION

Non-Trading Institutions are not for profit organizations like charity hospitals, sports clubs, public library etc. The accounting for these organizations is different from profit making organizations. These institutions are primarily incorporated to promote a particular social cause like promotion of education amongst poor, promotion of sports activities in the society etc. The types of receipts and payments of these organizations is also different from the profit making institutions like receipt of Donation, subscription etc. An accountant should be aware of the treatment of these items in the books of accounts.

In this chapter, we will study the accounting of non-trading institutions. As a business administrator of these types of organization, one should be aware of the accounting so that they can analyze better.

#### Meaning of Not-for-Profit Organisation

Voluntary organisations formed to promote certain cultural recreational, religious, political, educational, medical and professional activities are known as non-profit or not-for-profit of these institutions are as under:

1. Madras Sports Club
2. Free Aid Medical Society
3. National Club
4. Association of Chartered Accountants
5. Cricket Club
6. Mohammedan Sporting Club

7. Modern Educational Society
8. Cricket Club of India
9. Delhi Nursing Society
10. Government School Teacher Association
11. Delhi University Student Union.

**Notes**

**Features/Characteristics of Not-for-Profit Organisations**

1. Not-for-profit organisations are formed to provide services to a specific group or public in general.
2. These are organised by Charitable trust/societies and subscriber to such organisation are called members.
3. Subscription, donations are income from investment are the main sources of these organisations.
4. The surplus generated from income and expenditure account is not distributed. It simply added in the capital fund.
5. These organisations do not follow the complete process of accounting.
6. These organisations prepare Income and Expenditure account instead of Trading and Profit and Loss account.
7. The accounting information provided by such organisations is meant for the present and potential contributors meet the statutory requirement.

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**3.2 FINANCIAL STATEMENTS OR FINAL ACCOUNTS OF NOT-FOR-PROFIT ORGANISATIONS**

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As we discussed above that not-for-profit organisations are not required to maintain a large set of books of accounts but they have to prepare financial statements at the end of every accounting year. Although these organisations are non-profit seeking institutions and they are not required to prepare Trading and Profit and Loss Account, but it is necessary for these organisations to know whether the income during the year was sufficient to meet expenses or not. Not only that, they have to provide the necessary financial information to their members, donors and contributors and also to the Registrar of Societies. For the purpose, such organisations have to prepare financial statements at the end of accounting year and the general principles of accounting are fully followed. The financial statements of not-for-profit organisations consist of the following:

1. Income and Expenditure Account and
2. Balance Sheet.

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**3.3 RECEIPTS AND PAYMENTS ACCOUNT**

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*Receipts and payments account is merely a summary of cash and bank transactions.* It may be said to be synonymous to the cash book. It records only cash transactions. It has got two sides. The left hand side shows receipts and the right hand side shows payments. Actual cash received is posted at the debit side and actual cash paid is recorded at the credit side. This account starts with the opening balance of cash and ends as showing the closing balance of cash.

### Special Features of Receipts and Payments Account

**Notes**

- (i) Receipts and payments account is a 'real account'. While making posting in the account rule of debit and credit regarding real accounts are used.
- (ii) Whenever amount is received, cash account is debited. This is why, all cash receipts are recorded at the debit side.
- (iii) Cash account is credited for all payments, so all cash payments are shown at the payments side.
- (iv) Receipts and payments account is closed as showing the closing cash balance of the year, which is shown as the first item at the debit side.
- (v) Receipts and payments account is closed as showing the closing balance of the period which is available as the last item at the credit side.
- (vi) Receipts and payments account records all cash receipts, whether it is capital receipt or revenue receipt. Amount received from subscription and also amount received from sale of building are shown at the receipt side. No distinction is made between capital receipts and revenue receipts.
- (vii) All cash expenditure whether capital or revenue are shown at the payment side. Both cash payment for salaries and furniture are shown in this account. This account does not differentiate between capital and revenue expenditure.
- (viii) All cash receipts, whether belonging to the current year or previous year or next year are recorded as receipts.
- (ix) All cash payments whether concerning current year or previous year or next year are recorded at the payment side.
- (x) This account does not show net income or net loss.
- (xi) No adjustments are made in it.
- (xii) We cannot prepare Balance Sheet on the basis of this account.

#### Format of Receipts and Payment Account

For the Period ending.....

Receipts	Amount	Payments	Amount
Actual cash receipts irrespective of period (Present, Past and Future) (Both Revenue and Capital)	(₹)	Actual cash payments irrespective of period (Present, Past and Future) (Both Revenue and Capital)	(₹)
To Balance b/d:		<b>Revenue Payments</b>	
Cash in hand	.....	By printing and stationery	
Cash at bank	.....	By News papers, magazines periodicals	
Revenue receipts (Actual cash receipts)	.....	By Postage	
To Subscriptions	.....	By Repairs and Renewal	
To General donations	.....	By Advertisement	

**Notes**

To General grant	.....	By Charity
To Income from lectures	.....	By Audit fee
To Proceeds from entertainment	.....	By Maintenance
To Interest or Dividends on general investment	.....	By Salaries, fee
To Sales of news papers or grass and scraps	.....	By Entertainment expenses
To Rent Received	.....	By Rent paid
To Miscellaneous receipts	.....	By Insurance
<b>Capital Receipts (Actual cash receipts)</b>		By Honorarium
To Endowment fund receipts	.....	By Municipal taxes
To Legacies		By Bar expenses
To Entrance fee		By Bar purchases
To Life membership fee	.....	By Gardening
To Subscriptions for specified Purposes	.....	By Prices paid
		By Conveyance charges
To Donation and grant for specified purposes	.....	<b>Capital Payments</b>
To Receipts on account of special finds i.e., prize fund, match fund, Tournament fund etc.	.....	By Books
To Sales of fixed assets i.e., furniture, sports equipments investments etc.	.....	By Building Purchased
To Interest on special funds	.....	By Building Construction
		By Sports Equipments
		By Cost of land
		By Investment
		By Govt. loan
		By Furniture
		By Drawings
		By Balance c/d (closing balance)
		Cash in hand
		Cash at bank

It may be noted that the receipts side of the Receipts and Payment Account gives a list of revenue receipts (for past, current and future or next year) as well as

capital receipts. Similarly, the payments side of the Receipts and Payments Accounts lists the revenue payments (for past, current and future or next year) as well as capital payments.

**Limitations of Receipts and Payments Account**

**Notes**

The Receipts and Payments A/c shows *cash position only*. It has got the following limitations:

- (i) It does not show the income or expenditure of the current year.
- (ii) It is not prepared on accrual basis. According to this basis income due but not received (accrued) is also not treated as income.
- (iii) It does not tell us the surplus (excess of income over expenditure or the deficit (excess of expenditure over income).
- (iv) It does not take into consideration non-cash items such as outstanding expenses, prepaid expenses, accrued income and unearned income *i.e.*, adjustments are not taken into consideration.
- (v) It begins with the opening balance of cash in hand and cash at bank or overdraft and closed at the end of the year with closing balance of cash in hand and cash at bank.
- (vi) It includes all receipts and payments of revenue as well as capital nature.
- (vii) Balance Sheet, also known as position statement cannot be prepared on its basis.

The above limitations of the Receipts and Payments account show that it has got very limited scope. It may be used by small institutions having very limited number of transactions of cash nature. In this way, this account will not meet the purpose of institutions of bigger size having certain credit transactions. We can not recommend these institutions to prepare all set of books and also trading and profit and loss account. The system will be burdensome and uneconomical to them. In order to overcome these problems, clubs maintain a separate account, which is known as 'Income and Expenditure Account'.

**Difference between Receipt and payment Account and Cash Account**

Basis for Difference	Receipt and Payment A/c	Cash A/c
1. Period	It is prepared at the end of accounting period.	Cash account is maintained daily.
2. Date	Transactions are not recorded in the order of date. There is not date column.	Transactions are recorded in order of dates. There is date column.
3. Institutions	It is prepared by non-trading institutions	It is prepared by all trading institutions.
4. Sides	Left hand side is receipt and the right hand side is payment.	Left hand side is debit and the right hand side is credit.
5. Folio	It does not have any folio column.	It has folio column.
6. No of Pages	Few pages are sufficient to prepare it.	It has got large number of pages.

**Steps in the Preparation of Receipts and Payments Account**

1. Take the opening balance of cash and bank and write them on the debit side of his account. In case of bank overdraft at the beginning of the year, write the same on the credit side of this account.
2. Show the total receipts on the debit side of this account without considering their nature (Whether revenue or capital) and year/periods (whether past, current or future/next year).
3. Show the total payment on the credit side of this account without taking into consideration their nature (whether revenue or capital) and year/periods (whether past, current or future /next year).
4. Neither receivable income nor payable, expenses are to be shown in this account because they do not involve inflow or outflow of cash.
5. Ascertain the difference between the total of debit side and the total of credit side of this account and write the same on the credit side as the closing balance of cash in hand and cash at bank. In case of excess of credit side over debit side *i.e.*, the total of credit side is more than the total of debit side, show the difference on the debit side of this account as bank overdraft and close the account.

**Notes**

**Illustration 1.** From the information given below draft receipts and payments account of Friends Club, Delhi for the year ended December 31, 2020:

Cash on 1.1.2020 ₹ 440; Subscriptions ₹ 3,760; Donations ₹ 800; Entrance Fees ₹ 430; Rent realised from club hall ₹ 525; Electric charges ₹ 344; Taxes ₹ 50; Salaries and wages ₹ 2,150; honorarium to secretary ₹ 250; Interest received on Investments ₹ 295; Printing and stationery ₹ 35; Petty cash payments ₹ 90; Insurance Premium paid ₹ 31.

**Friends Club Delhi****Receipts and Payments Account**

Dr.

For the year ended 31st Dec. 2020

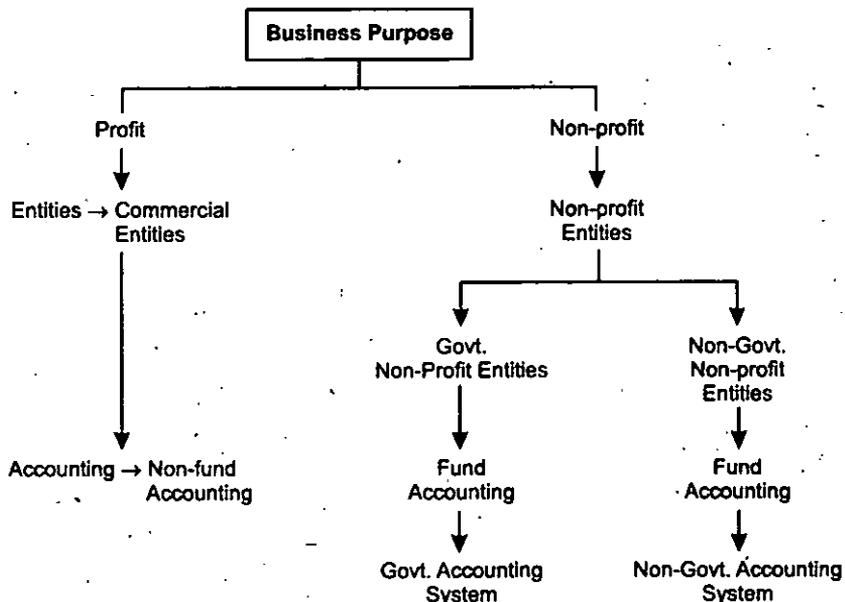
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Receipts	Amount (₹)	Payments	Amount (₹)
To Balance b/d on 1.1.2020		By Electric Charges	334
Cash in hand	440	By Taxes	50
To Subscriptions	3,760	By Salaries and Wages	2,150
To Donations	800	By Honorarium to Secretary	250
To Entrance Fees	430	By Printing and Stationery	35
To Rent	525	By Petty Cash Payments	90
To Interest on Investment	295	By Insurance Premium	31
		By Balance on 31.12.2004	
		Cash in hand	3,300
		(Balancing Figure)	
	6,250		6,250

## Concept of Fund and Non-Fund Accounting

**Non-Fund and Fund Accounting.** The method of Accounting used by organisations depends upon the purpose, for which they are formed. It may be classified as under:

### Notes



### Entities

#### Commercial Entities

These are the business organisations whose main objective is to earn profit by selling goods or providing services. For example, manufacturing, Mining, Farming/ Fishing, Trading, Agency Services, Financing, Banking, Insurance, Professional Services etc.

#### Non-Profit Entities

Organisations formed to promote certain cultural, recreational, religious, political, educational, medical and professional activities are known as non-profit organisations. These are of two kinds:

1. **Govt. Non-Profit Entities.** It includes central, state, local, universities, institutions, colleges, schools etc.
2. **Non Govt. Non-Profit Organisations.** It includes Trust, hospitals, clubs, religious institutions, private educational institutions etc.

#### Distinction between Commercial Entity and Non-Profit Entity

Basis for Difference	Commercial Entity	Non-Profit Entity
1. Motive	Primary motive is to earn profit.	Primary motive is to promote social cause like education, sports, etc.
2. Proprietorship	Individuals or group of individuals who have taken risk of carrying business are the owners.	Subscribers to the institutions are members and owners of the organisation:

3. Profit sharing	Profit belongs to owners.	Profit if any, belongs to members of the institution.
4. Financial statements	Trading, Profit and Loss Account and Balance Sheet is prepared.	Receipt and Payment, Income and Expenditure Account and Balance is prepared.

**Notes**

**Accounting (Additional information)**

**Non-Fund Accounting (applicable to Commercial Entities)**

The accounting is based on matching revenue and cost principle. Profit & Loss account is prepared to calculate profit or loss earned during a period. Apart from this Balance Sheet is prepared to reflect financial position of the company. Double Entry book system on accrual system of accounting is followed under this method.

**Fund Accounting (applicable to Non-Profit Organisations)**

**Meaning:** A system of accounting where fund is taken as an independent fiscal and accounting entity with a self balancing set of accounts. These accounts are used to record cash, assets, liabilities etc. for the purpose of specific activities sought to be achieved out of the fund. For example, in the case of a sports club, the capital will be treated as a fund which can be used only for the activities related to promotion of sports and related assets and liabilities generated out of club activities. That is why capital in this type of accounting is called capital fund.

**Special Feature of Fund Accounting**

Following are the features of fund accounting:

1. The system of accounting is used by non-profit organisations.
2. Fund is treated as separate entity and accounted for accordingly.
3. Specific funds have to be used according to predetermined purpose and income and expenditure arising out of the activities will be charged to these funds.
4. Budget approval and appropriation is the basis of income generation and spending.
5. There are general fund also which can be used for general organisational purposes.

**3.4 INCOME AND EXPENDITURE ACCOUNT**

*Income and expenditure account is the summary of income and expenditure of the current year. It is just like Profit and Loss A/c and also prepared in a fashion, as Profit and Loss account is prepared. Special features of this account are as under:*

**Special Feature of Income and Expenditure A/C**

- (i) Income and expenditure account is Nominal Account for which the rule of debit and credit, is debit all expenses or losses and credit all income or gain.

**Notes**

- (ii) Expenditures are recorded at the debit side and income is posted at the credit side of this account.
- (iii) It records only revenue expenditure, **capital expenditures are not recorded in it.**
- (iv) Only revenue receipt are recorded in it. Capital receipts do not find a place in it.
- (v) Expenditure of revenue nature relating to the current year only are recorded in it. **If the expenditure includes any expenditure relating to the previous or next year, it is deducted.** Current year's outstanding expenditures are added.
- (vi) Revenue receipts of **current year only** are recorded in it.
- (vii) Income and expenditures are shown on accrual basis.
- (viii) Excess of income over expenditure is known as surplus. In case of profit and loss account, it is said as net income.
- (ix) If the expenditure side exceeds the income side, the excess is supposed to be deficit (excess of expenditure over income).
- (x) Balance Sheet can be prepared on the basis of this account.

**Difference between Income and Expenditure Account and Profit and Loss Account**

Basis for Difference	Income and Expenditure A/c	Profit and Loss A/c
1. Institution	It is prepared by non-trading institutions.	It is prepared by trading institutions.
2. Object	Its object is to find out surplus <i>i.e.</i> , excess of income over expenditure or deficit <i>i.e.</i> , excess of expenditure over income	Its object is to find out net profit or net loss
3. Preparation	It is prepared on the basis of Receipts and payments account and additional information.	It is prepared on the basis of Trial balance
4. Opening item	It does not have any opening item of the previous period.	It starts with gross profit or gross loss as shown by Trading account.

**Difference between Receipt and Payment Account and Income and Expenditure Account**

Difference between the two is summarised as under:

Basis for Difference	Receipt and Payment Account	Income and Expenditure Account
1. Form	It is a summary of cash book.	It is a summary of profit and loss account.
2. Nature of Account	It is a real account.	It is nominal account.

**Notes**

3. Sides	Its left hand side is receipts and right hand side is payment.	The left hand side is expenditure and the right hand side is income.
4. Balance	It starts with opening balance of cash and ends as showing closing balance of cash.	It does not start with opening balance of cash and does not show closing balance of cash.
5. Capital and Revenue items	It records receipts and payments of both capital and revenue nature.	It records income and expenditure or revenue nature only.
6. Amount	It records all the cash receipts and payments, whether relating to current year or previous year or next year.	It records all income and expenditure of the current year on accrual basis.

### 3.5 RELEVANT ITEMS OF INCOME AND EXPENDITURE ACCOUNT

**Income.** Income for purpose of making Income and Expenditure account must satisfy the following conditions:

- (i) It should concern the current year whether received or accrued (receivable).
- (ii) It should be of recurring nature.
- (iii) It is not meant for specific use.

While applying the above rule in identifying income we should take into consideration the peculiarity of the following items concerning non-trading organisations.

1. **Subscription.** It is recurring income for non-trading institutions, so generally we take it as income. It is generally routine source of income. In certain cases it may be a liability. Subscription will be treated as liability if:
  - (i) It is of non-recurring nature.
  - (ii) It is received, for certain specific purpose such as:
    - (a) Subscription for Tournament fund
    - (b) Subscription for Governor's party
    - (c) Subscription for Building fund
    - (d) Subscription for Construction of Science Block
    - (e) Subscription for Construction of Pavilion
    - (f) Subscription for Purchase of plant machine or any other fixed assets
    - (g) Subscription received for any specific drama exhibition, Bhagwati Jagaran fete or any other programme
    - (h) If there is any instruction to capitalise any part of subscription
2. **Donation.** It is the amount received from an individual, firms, companies and institutions as a gift. This item appears at the receipts side of Receipts

Notes

and Payments account. Donation may be classified as specific donation and general donation:

- (i) *Specific donation.* Donation received for certain specific purpose is capital receipt. It should be capitalised and posted at the liabilities side of the Balance Sheet. These specific donations may be for tournament fund, construction of building hall, lawn, pavilion, library or Governor's party etc.
- (ii) *General donation.* General donations may be classified as:
  - (a) *General donation of big amount.* It is a donation of non-recurring nature, so it should be capitalised, and shown at the liabilities side of the Balance sheet.
  - (b) *General donation of small amount.* This donation is of a recurring nature. It is expected that such donation, will be received every year. It is a revenue receipt, so it should be treated as income and recorded at the income side of Income and Expenditure account.

Treatment of donation can be summarised as:

- (i) All specific donations are liability
- (ii) General donations of big amount are liability.
- (iii) General donations of small amounts are treated as income.

**Note:** Whether the amount of donation is big or small depends upon the facts and nature of circumstances.

- 3. **Grant.** Grant received from central, state or local government for routine expenses of these institutions is revenue receipt and treated as income. Specific grant for specific purpose is liability i.e., grant for purchase of X-ray equipments.
- 4. **Legacy.** It is the amount received from individuals as per will. It is a receipt of non-recurring nature, so it should be capitalised and shown at the liabilities side. Legacy of small amount may be treated as income. It is recorded at the debit side of Receipts and Payment account.
- 5. **Endowment Fund.** Funds providing permanent means of support are known as endowment fund. It is a capital receipt, because the fund provides permanent source of income. It should be capitalised and shown at the liabilities side. It is shown at the debit side of Receipt and Payments account.
- 6. **Entrance Fee.** It appears at the receipts side of Receipt and Payment account. It may be treated as an income or liability.
  - (a) *Arguments in favour of treating it as income.* Entrance fee is received every year, whenever new members are admitted. In case of schools and colleges admissions are the regular feature and thus entrance fee should be treated as income.
  - (b) *Arguments in favour of capitalising.* Entrance fee is received from every member once forever. It is not of recurring nature, so it should not be treated as income.

In the absence of specific instruction, students may treat it either as an income or a liability and give a note in support of their treatment.

7. **Sale of old Assets.** Amount received from sale of assets is capital receipt, so it will not be shown in Income and Expenditure account. If there is loss on the sale of asset, it will be shown at the expenditure side of Income and Expenditure account. In the same way, excess of sale proceeds over the book value of assets is income and it will be shown at the Income side. For example sale of furniture for ₹ 3,000 (book value of ₹ 4,700) shows that there is loss of ₹ 1,700 i.e., 4,700 – 3,000 on the sale of furniture, so ₹ 1,700 will be shown at the expenditure side of income and Expenditure account. In the same way, if furniture is sold for ₹ 5,000 (book value ₹ 4,700) it shows a profit of ₹ 300 i.e., ₹ 5,000 – 4,700. The profit of ₹ 300 on the sale of furniture will be shown at the income side of Income and Expenditure account.

*Actual amount received from sale of asset will be shown at the receipt side of Receipts and Payments account. Amount received from sale of assets will not be shown as separate item in the Balance Sheet. Cash receipt will increase the closing balance of cash, which will be automatically shown at the assets side.*

8. **Sale of Newspapers.** Sale of newspapers, magazines and periodicals is regular feature, so it is treated as income. The amount received is nominal, so it cannot be capitalised.

*Amount received from sale of newspapers is shown at the debit side of Receipts and Payments account.*

9. **Sale of used old sports material.** Sale of used sports materials such as old bats, balls, net and rackets etc., is the regular feature of club. These used sports materials bring small amount also. It is therefore treated as income and shown at the income side of Income and Expenditure account.

*It is a cash receipt so it is also shown at the debt side of the Receipts and Payments account.*

10. **Sale of Scraps.** Amount received from sale of scraps such as bottles, boxes, gunny bags and grass etc. are income. It is shown at the income side of Income and Expenditure account. The logic behind this treatments is its regular feature and nominal amount.

*Actual cash received is also shown at the debit side of Receipts and Payments account.*

11. **Sale of Grass.** It is revenue, shown at Income side.

12. **Life membership fee.** It is capital receipts of irregular nature received once from the member throughout his life. It is capitalised and shown at the liabilities side.

13. **Payment of honorarium.** It is an expense payable to a person for the specific services rendered by him. The person receiving honorarium is not the regular employee. For example, payment made to artist i.e., singers, dancers, radio, TV artists. It is an expense, so it will be shown at the expenditure side.

14. **Receipts from consumable items.** In certain case clubs/hospitals sell, certain items of regular consumption such as medicines, cigarettes, playing cards, bar materials etc. These receipts are revenue receipts, so they are shown at Income side.

Notes

15. **Purchase of consumable items.** Payments made for the purchase of consumable items is revenue payments, so because they represent cost of these items. This is why, it will be shown at expenditure side. In actual practice the value of consumable stores is calculated and shown at the expenditure side.

16. **Payment for the purchase of following items are shown at the assets side:**

- (i) Library books
- (ii) Sport equipment
- (iii) Crockery utensils
- (iv) Furnishing, furniture
- (v) Investments—shares, debentures and bonds.

Payments for above items are not revenue expenditure. They are capital expenditure, so shown at the assets side. Cash payment in these cases will be shown at the credit side of Receipts and payment account.

17. **Special Funds.** Sometime certain special funds such as 'match fund', 'sports fund' and 'prize funds' are created by not-for-profit organisations for a specific purpose. These organisations invest these funds in securities and earn income on them *but the income earned on such investments is added to the concerned fund, not credited to Income and Expenditure Account. In the same way, expenses incurred on such specific purpose are also deducted from the concerned fund.* For example, A school may maintain a special fund for prize. In this situation, the interest received on prize fund will be added to it and all expenses incurred on prize awarded will be deducted from prize fund. It can better be understood from the following example:

**Example.** Show how would you deal with the following items in the preparation of financial statements of APG school.

Particular	Amount (₹)	Amount (₹)
	Debit	Credit
Prize fund	-	40,000
Investment of prize fund in securities	40,000	-
Interest on prize fund investment	-	4,000
Prize awarded	3,000	-

**Solution :**

**Balance Sheet**

as on .....

Liabilities		Amount (₹)	Assets		Amount (₹)
Prize fund	40,000	41,000	Investment of prize fund in securities	40,000	41,000
Add : Interest on investment	4,000				
	44,000				
Less : Prize awarded	3,000				

## Precautions to be taken while preparing Income and Expenditure A/c

Income and expenditure account of a particular year should show the income and expenditure of the same year. It should not show, income and expenditure of the previous or next year. While preparing Income and Expenditure account the following points should be taken into consideration.

1. We should pick up the income and expenditure of the **current year**, if it is separately given.
2. If current year's receipts of certain income includes the income of the **previous or next year**, it will be **deducted**. If any amount remains outstanding regarding current year that will be added.
3. If current year's payment includes the expenditure of **previous or next year** that should be deducted. If there is any outstanding expenditure of the current year it will be added.
4. Generally we assume that outstanding expenses of the previous year must have been paid during the current year. In the same way outstanding income of the previous year must have been received during the current year.
5. If certain income has been received in advance during the previous year it should be added to the income of the current year.
6. Income received in advance should be deducted from the current year's income. In the same way, prepaid expenses should also be deducted from current year's expenditure.

## Notes

### Format of Income and Expenditure Account

For the year ending.....

Expenditure	Amount (₹)	Income	Amount (₹)
<p>It contains all revenue expenses of the current year whether paid or due? <i>Certain difficult treatments</i></p> <p>To Expenses (<i>suppose rent</i>) <i>Add</i> : Outstanding at the end of the year <i>Less</i> : Outstanding in the beginning of the year or Actual amount of last year paid <i>Add</i> : Advance paid for rent in the current year <i>Less</i> : Advance paid for rent in the current year</p>		<p>It contains all income of revenue nature of the current year, whether received or accrued <i>Certain difficult treatments</i></p> <p>By Income Account (<i>Suppose subscription</i>) Total amount of subscription received during the year ..... <i>Add</i> : Outstanding at the end of the year <i>Less</i> : Outstanding in the beginning of the year ..... <i>Or</i> Actual amount of subscription of last year, received this year</p>	

**Notes**

<p style="text-align: center;"><b>Rent for the year</b></p> <p>To loss on the sale of assets:              Book value of assets sold  <i>Less</i> : sales price .....</p> <p>To Depreciation</p> <p>To <b>Expenses on Consumable materials</b> (suppose stationery)              Opening stock of stationery  <i>Add</i> : Purchases during the year  <i>Less</i> : Creditors for stationery in the beginning  <i>Add</i> : Creditors for stationery at the end  <i>Add</i> : Advance payment for stationery last year  <i>Less</i> : Advance payment for stationery in the current year  <i>Less</i> : Stock of stationery at the end  <b>Value of stationery—              Actually consumed</b></p> <p>To <i>Surplus-Excess of              Income over expenditure</i></p>	<p><i>Add</i> : Advance received last year .....</p> <p><i>Less</i> : Advance received this year .....</p> <p><b>By Profit on sale of assets</b> Sale price of assets.  <i>Less</i> : Book value of assets sold</p> <p><b>By Receipt from specific items</b> say cinema show              Amount received .....</p> <p><i>Less</i> : Amount spent .....</p> <p><b>By Miscellaneous income and gains of revenue nature</b>              By Deficit-excess of Expenditure over income</p>
--	---

**Identifying subscription as income of the current year**

**Income side**

Total subscription received during the year	.....
<i>Add</i> : Subscription outstanding of the current year	.....
<i>Add</i> : Subscription received in advance during previous year	.....
<i>Less</i> : Subscription of previous year, if included in current year's subscription	.....
<i>Less</i> : Subscription received in advance during current year	.....

**Calculation of depreciation.** The rate of depreciation is specified. *In the absence of specified rate* it is ascertained as under:

Opening balance of asset	.....
<i>Add</i> : Additions during the year	.....
<i>Less</i> : Book value of asset sold	.....
<i>Less</i> : Closing balance of asset	.....
Depreciation or assets used or consumed	.....

**Illustration 2.** Subscription received during the year ending 31st December, 2020 are as follows:

Accounts of Non-trading Institutions

	₹
For 2019	180
2020	4,220
2021	160
	4,560

Notes

There are 45 members, each paying annual subscription of ₹ 100 ₹ 190 were in arrears for 2019 at the beginning of 2020. Calculate what amount will be posted to Income and Expenditure account.

Solution. Total subscription received during 2020	4,560
Less : Total subscription received for 2019	180
Less : Total subscription received for 2021	160
	(-) 340
	4,220
Add : Outstanding subscription for 2020 [(45 × 100) - 4,220]	280
	4,500

**Note:** Total subscription for 2020 will be ₹ 4,500 as there are 45 members and each of them are paying ₹ 100 but subscription received for 2020 amounts to ₹ 4,220 only so outstanding subscription for 2020 will be ₹ 4,500 - 4,220 = ₹ 280.

### 3.6 PREPARATION OF INCOME AND EXPENDITURE ACCOUNT

Following are the points that would help you in preparing an income and expenditure account.

1. Read the Receipts and Payments account carefully.
2. Avoid the opening and closing balances of cash in hand and cash at bank because these balances are not income.
3. Avoid all capital receipts and capital payments because these receipts will be shown in the Balance Sheet.
4. Take into consideration only revenue receipts and revenue payments. Some of these need to be adjusted as per the additional information provided relating to them.
5. Consider the following items not appearing in the Receipts and Payments Account that need to be adjusted for ascertaining the surplus/deficit for the current year:
  - (i) Depreciation of fixed assets.
  - (ii) Provision for doubtful debts, if any.
  - (iii) Profit or loss on sale of any asset.
6. Any income (even revenue nature i.e., subscription, donation, entrance fees etc.) which is said to be capitalised (partly or fully) or which has a specific purpose such as donation for building, subscription for land etc.,

will not be shown in income and expenditure account because these are and will be shown at the liabilities side of Balance Sheet.

### 3.7 STEPS IN THE PREPARATION OF BALANCE SHEET

**Notes**

The following are the steps to prepare a Balance Sheet of Not-for-Profit Organizations:

1. Take the Capital Fund (also known as General Fund) as per the opening balance sheet and add the surplus generated from the income and Expenditure Account. In case of deficit, it will be deducted from capital fund.
2. Show all the capitalised income (capital receipts) such as donation for building, legacies and life membership fees etc., at the liabilities side of the Balance Sheet.
3. Show all the fixed assets (except sold or discarded or destroyed during the year) with additions after charging depreciation (if any).
4. Compare the payments side of Receipts and Payments Account with expenditure side of income and expenditure account. This comparison will tell us the amounts of outstanding expenses, prepaid expenses, purchase of assets during the year, depreciation of fixed assets, stock of consumable like stationery in hand, closing balance of cash and bank and so on.
5. Compare the receipts side of the Receipts and Payments Account with income side of Income and Expenditure Account. It will tell us, subscription due but not yet received, income received in advance, sale of assets, items to be capitalised (*i.e.*, these will directly be shown in the Balance Sheet).

**Format of Balance Sheet**

*as on.....*

Liabilities	Amount (₹)	Assets	Amount (₹)
<b>Capital Fund</b>		<b>Fixed Assets</b>	
<i>Add</i> : Surplus if Excess of income over expenditure		Last balance	
<i>Less</i> : Deficit if Excess of expenditure over income	.....	<i>Add</i> : Purchase of assets	
Life membership fee	.....	<i>Less</i> : Book value of assets sold	
<b>Capitalised value of :</b>		<i>Less</i> : Depreciation	.....
Donation/grant	.....	<b>Stock of consumable material:</b>	
Subscription for specified purpose	.....	Last balance	
Legacy		<i>Add</i> : Purchase	.....
Endowment fund		<i>Less</i> : Value Consumed	
Entrance fees		<b>Accrued/outstanding Income</b>	
<b>Special funds</b>		Last balance	
(Suppose Tournament/match fund)		<i>Less</i> : received during the year	.....
Last balance, if any		Prepaid expenses (if any)	
<i>Add</i> : Received during the year		Cash at bank :	.....
<i>Add</i> : Income earned on fund investment		Current A/c	.....
		Fixed Deposit	.....
		Saving Bank Account	.....
		Cash in hand	.....

Notes

Less : Expenses paid out of fund	.....		
Bank overdraft	.....		
Income received in advance	.....		
Outstanding Expenses	.....		
Creditors	.....		

**A. Preparation of Income and Expenditure A/c from Receipt and Payment A/c**

*Illustration 3. Prepare an income and expenditure account relating to 2020 from the figures below:*

Dr.		Cr.	
Receipts	Amount (₹)	Payments	Amount (₹)
To Opening Balance	1,800	By Salaries	4,800
To Subscription	19,000	By Rent	500
To Sales of Investments	2,000	By Stationery	200
To Sale of Old furniture (Book value ₹ 400)	300	By Defence Bonds	13,000
To Donations	100	By Furniture purchased	2,000
		By Bicycle purchased	300
		By Balance c/d	2,400
	<b>23,200</b>		<b>23,200</b>

**Solution.**

**Income and Expenditure Account**

Dr.		Cr.	
For the year ending December 31, 2020			
Receipts	Amount (₹)	Payments	Amount (₹)
To Salaries	4,800	By Subscriptions	19,000
To Rent	500	By Donation	100
To Stationery	200		
To Loss on Sale of Furniture	100		
To Surplus—Excess of Income over Expenditure	13,500		
	<b>19,100</b>		<b>19,100</b>

**Explanation**

1. It should be noted from the above income and expenditure account that expenditure and income of revenue nature only have been recorded in it.
2. Capital expenditure *i.e.*, purchase of defence bonds, furniture and bicycle have not been shown in it.
3. Capital receipts from the sale of investments and furniture have not been shown in it.

4. Loss on sale of furniture has been shown at the expenditure side.
5. Donation has been treated as a revenue receipts *i.e.*, income because of its nominal value. Receiving donation of small amounts is the regular feature of club.

**Notes**

**Illustration 4.** Convert the following 'Receipts and Payments Accounts' of the 'Delhi Nursing Society' for the ended 30th June, 2020 into an 'Income and Expenditure Account'.

Dr.		Cr.	
Receipts	Amount (₹)	Payments	Amount (₹)
Balance at Bank (1.7.2019)	2,010	Salaries of Nurses	656
Subscriptions	1,115	Board, Laundry and Domestic Help	380
Fees from Non-members	270	Rent, Rates and Taxes	200
Municipal Grant	1,000	Cost of car	2,000
Donations for building fund	1,560	Expenses of Car	840
Interest	38	Drugs and Incidental Expenses	670
		Balance c/d	1,247
	<b>5,993</b>		<b>5,993</b>

A donation for ₹ 100 received for building fund was wrongly included in subscription account. A bill medicines purchased during the year amounting to ₹ 128 was outstanding.

**Solution.****Income and Expenditure A/c of Delhi Nursing Society**

Dr.		Cr.	
For the year ending June 30, 2020			
Expenditure	Amount (₹)	Income	Amount (₹)
To Salaries of Nurse	656	By Subscriptions	1,115
To Board, Laundry and Domestic help	380	Less : Donation for Building Fund	100
To Rent, Rate and Taxes	200	By Fees from Non-member	270
To Car Expenses	840	By Municipal Grant	38
To Drugs and Incidental Expenses	670	By Interest	38
		By Deficit—Excess of Expenditure over income	551
Add : Outstanding Bills of medicines	128		
	<b>798</b>		
	<b>2,874</b>		<b>2,874</b>

Notes

Note:

- (i) Donation for building fund is a capital receipt which should be recorded at the liabilities side. It is wrongly included in the subscription, so it will be deducted from subscription.
- (ii) Payment for drugs and incidental expenses is a revenue expenditure for a hospital, so it will be shown as expenditure and outstanding bill for it will also be added.
- (iii) Municipal grant is for general purpose, so it has been treated as income.
- (iv) Cost of car is capital expenditure. Car is an asset, so it will be shown at the assets side. Car expenses are recurring in nature, so treated as expenditure.

*Illustration 5. From the following Receipts and Payments account of a club and from the information supplied, prepare an Income and Expenditure account for the year ended 31 st December, 2003 and a Balance Sheet as on that date:*

**Receipts and Payments Account**

Dr.

Cr.

Receipts	Amount (₹)	Payments	Amount (₹)
To Balance b/d	2,300	By Salaries	4,500
To Subscriptions	6,000	By Office expenses	1,500
To Rent of the hall	2,000	By Sports equipment	1,000
To Sale of grass	200	By Machine	2,000
To Sale of old furniture (Book Value ₹ 200)	100	By 6% Investments	1,000
		By Balance c/d	600
	<b>10,600</b>		<b>10,600</b>

**Other Information:**

Subscription received included ₹ 1,000 for 2002 and ₹ 500 for 2004. Outstanding subscription for 2003 amounted to ₹ 800. Sports Equipment on hand on 31st December, 2002 was of ₹ 3,000. The value placed on this equipment on hand 31st December, 2003 was ₹ 3,100. The machine was purchased on 1st July, 2003 and is to be depreciated at 20 per cent annum. Salaries ₹ 200 for 2003 are yet to be paid. Interest on investments is accrued of 6 months.

On 1st January, 2003, club owned land and building valued at ₹ 1,500 and furniture at ₹ 600.

## Income and Expenditure Account

Dr.

For the year ended 31st, Dec. 2003

Cr.

Notes

Expenditure	Amount (₹)	Income	Amount (₹)
To Salaries	4,500	By Subscription	6,000
Add: Outstanding	200	Less: for 2002	1,000
	4,700		
To Office expenses	1,500		5,000
To Loss on sale of furniture	100	Less: for 2004	500
To Dep. on Sports Equipment	900		
To Dep. on Machinery	200		4,500
To Surplus—Excess of Income over expenditure	130	Add: Outstanding	800
		By Interest accrued on	
		By Investment (1/2 year)	30
		By Rent of hall	2,000
		By Sale of grass	200
	7,530		7,530

## Balance Sheet

Dr.

as on 31st Dec. 2003

Cr.

Liabilities	Amount (₹)	Assets	Amount (₹)
Subscription received in Advance	500	Cash in hand	600
Salaries Outstanding	200	Investment	1,000
Capital Fund	8,400	Add: Interest	30
Add: Surplus	130		1,030
	8,530	Subscription Outstanding	800
		Sports Equipments	3,000
		Add: Purchases	1,000
			4,000
		Less: Depreciation	900
			31,00
		Machinery	2,000
		Less: Depreciation	200
			1,800
		Land and Building	1,500
		Furniture	600
		Less: Sales (Book value)	200
			400
	9,230		9,230

**Working Notes:****(i) Calculation of capital fund as on January 1, 2003.****Balance Sheet**  
as on January 1, 2003

Notes

Dr.		Cr.	
Liabilities	Amount (₹)	Assets	Amount (₹)
Capital Fund	8,400	Cash in hand	2,300
(Balancing Figure)		Land and Building	1,500
		Furniture	600
		Outstanding Subscription	1,000
		Sports Equipments	3,000
	8,400		8,400

**(ii) Subscription**

- (a) Subscription amounting to ₹ 1,000 relating to the previous year *i.e.*, 2002 will be deducted from the amount of subscriptions received during the current year. It is an asset of the previous year, so it will also be shown at the assets of the Balance Sheet of 2002.
- (b) ₹ 500 received as subscription for the next year *i.e.*, 2004 is not the income of the current year, so it will be deducted from the amount of subscription received during the current year. It is also a liability for the current year, as the amount is payable to the next year, so it will also be shown as a liability.
- (c) Subscription amounting to ₹ 800 are outstanding for the current year 2003. As the income has accrued, so it will be shown at the assets side of current year's Balance Sheet and added to the subscription of the current year.

**(iii) Calculation of depreciation on sports equipment**

	₹
Book value of sports equipment as on Dec. 31, 2002	3,000
(+) Additional sports equipment purchased during 2003	1,000
	4,000
(-) Book value of sports equipment as on Dec. 31, 2003	3,100
Depreciation on sports equipment	900

- (iv) **Calculation of depreciation on Machinery.** Machinery has been purchased on July 1, 2003, so depreciation on machinery will be calculated for six months only.

(v) Sale of grass is an income.

- (vi) Loss on sale of furniture = Book value – Sale proceeds  
= 200 – 100 = ₹ 100.

**Illustration 6.** From the following information of a Club, prepare Income and Expenditure account for the year ending 31st March, 2004 and a Balance Sheet as on that date:

Notes

Cash Book	
₹	₹
To Member's Subscription	5,000
To Member's Admission Fees	300
To Sale of old balls, bats etc.	50
To Hire of ground	300
To Subscription for tournament	1,000
To Drawn from bank	4,000
To Donations	10,000
	20,650
By Upkeep of pavilion	2,000
By Expenses regarding tournament	700
By Rates and Insurance	200
By Telephone	50
By Printing and stationery	100
By General charges	50
By Secretary's honorarium	170
By Grass seeds	20
By Bats, ball etc.	710
By Lodgings in Bank	16,650
	20,650

Assets on 1-4-2003:

Cash at Bank	3,000
Stock of balls and bats etc.	1,500
Printing and Stationery (stock)	200
Subscription due	500

**Liabilities:**

Donations and surplus on account of tournament should be kept in reserve for a permanent pavilion. Subscription due on 31st March, 2003 was ₹ 750. Write of 50 per cent of bats, balls account and 25 per cent of printing and stationery account.

**Solution.**

**Income and Expenditure Account of the Club**

for the year ended 31st, Dec. 2004

Dr.		Cr.	
Expenditure	Amount (₹)	Income	Amount (₹)
To Upkeep of pavilion	2,000	By Subscription	5,000
To Rates and insurance	200	Less : For 2003	500
To Telephone	50		4,500
To General charges	50	Add : Outstanding	750
To Secretary's honorarium	170		5,250
To Grass seeds	20		
To Depreciation on bats and balls		By Admission fees	300

@ 50% on opening balance + (additions)		By Old bats, balls etc.	50
	1,150		
To Printing and stationery	100		
Add : Stock on 1-4-2003	200		
	300		
Less : Stock on 31-3-2004	225		
	75		
To Surplus—Excess of income over expenditure	2,230		
	5,900		5,900

Accounts of Non-trading  
Institutions

**Notes**

**Balance Sheet of the Club**  
as on 31st March, 2004

Liabilities	Amount (₹)	Assets	Amount (₹)
Reserve for permanent pavilion	10,3000	Cash at Bank	15,650
Capital Fund	5,200	Stock of Bats, Balls etc.	1,105
Add: Surplus	2,230	Printing and Stationery	225
	7,4340	Subscription	750
	17,730		17,730

**Note: (i) Calculation of Capital Fund.**

**Balance Sheet**  
as on April 1, 2003

Liabilities	Amount (₹)	Assets	Amount (₹)
Capital Fund	5,200	Cash at Bank	3,000
(Balancing Figure)		Stock of balls and bats	1,500
		Printing and Stationery	200
		Subscription due	500
	17,730		5,200

**(ii) Calculation of Closing Bank Balance:**

	₹
Opening balance of cash at bank	3,000
+ Additional lodged (deposited)	16,650
	<u>19,650</u>
(-) Amount drawn	(-) 4,000
Closing Balance	<u>15,650</u>

**(iii) Calculation of Reserve for Permanent Pavilion:**

Donation	10,000
----------	--------

+ Subscription for tournament	+ 1,000
	11,000
(-) Expenses regarding tournament	700
	10,300

**Notes**

(iv) Depreciation on Printing and Stationery has been calculated as under:

Reserve for permanent pavilion (to be shown at the liability side)	₹
Opening balance of printing and stationery	200
+ Additional purchase	+ 100
	300
Depreciation = $300 \times \frac{25}{100} = ₹ 75$	300

(v) Depreciation on bats and balls has been calculated as under: ₹

Opening balance of bats and balls	1,500
+ Additional during the year	710
	2,210
Depreciation @ 50% = $2,210 \times \frac{25}{100} = ₹ 1,105$ .	2,210

**Illustration 7.** The Income and Expenditure Account of Modern Club shows amount of subscriptions for 2003 as ₹ 20,000. Additional information is given as follows:

Subscription for 2003 unpaid on 1st January, 2003 was ₹ 2,000; ₹ 1,800 of which was received in 1992.

Balance of subscriptions paid in advance on 1st January, 2003 ₹ 500

Balance of subscriptions paid in advance on 31st December, 2003 ₹ 400

Balance of subscriptions for 2003 unpaid on 31st December, 2003 ₹ 700

Determine the amount of subscriptions received during 2003.

**Solution.**

**Subscription Amount**

Dr.				Cr.			
Date	Particular	J.F.	Amount (₹)	Date	Particular	J.F.	Amount (₹)
<b>2003</b>				<b>2003</b>			
Jan. 1	To Balance b/d		2,000	Jan. 1	By Balance b/d		500
Dec. 31	To Balance (2004 paid in advance) c/d		400	Dec. 31	By Balance (2002 unpaid) c/d		200
	To Income and expenditure A/c		20,000		By Balance (2003 unpaid) c/d		700
			22,400		By Cash received		21,000
							22,400

**Alternatively:**

	₹
Subscription as per Income and Expenditure Account	20,000
Add: Subscription outstanding of previous year	2,000
Add: Subscription paid in advance during current year	400
	2,400
	22,400
Less: Subscription outstanding for current year	700
Less: Subscription paid in advance during previous year	500
Less: Subscription still unpaid (2,000 – 1,800)	200
	1,400
Amount of subscription received during the year	21,000

Notes

### 3.8 INCIDENTAL TRADING ACTIVITY

Sometimes, a non-profit organisation runs Chemist shop, Bar, Canteen etc. to provide some facilities to its member or public in general to meet its expenses. In such a situation, these organisation need to prepare trading account to find out profit/loss of this trading activity. The profit from this trading activity is used to meet the main objective for which the organisation was formed and this profit is transferred to Income and Expenditure Account. It can better be understood through following illustration.

*Illustration 8. The Accountant of Diana Club furnishes you the following Receipts and Payments account for the year ending 30th September, 2003.*

Receipts	Amount (₹)	Payments	Amount (₹)
Opening Balance:		Honoraria to Secretary	9,600
Cash and Bank	16,760	Misc. Expenses	3,060
Subscription	21,420	Rates and Taxes	2,520
Sale of Old Newspapers	4,800	Groundman's Wages	1,680
Entertainment Fees	8,540	Printing and Stationery	940
Bank Interest	460	Telephone Expenses	4,780
Bar Receipts	14,900	Payment for Bar Purchases	11,540
		Repairs	640
		New car (Less-sal Proceeds of Old Car Rs. 6,000)	25,200
		Closing Balance:	
		Cash and Bank	6,920
	66,880		66,880

Notes	01.10.2002	01.10.2002
	₹	₹
(i) Subscription due (not received)	2,400	1,960
(ii) Cheques issued, but not presented for payment of printing	180	60
(iii) Club premises at cost	58,000	—
(iv) Depreciation on club premises provided so far	37,600	—
(v) Car at cost	24,380	—
(vi) Depreciation on car	20,580	—
(vii) Value of Bar stock	1,420	1,740
(viii) Amount unpaid for bar purchases	1,180	860
(ix) Depreciation is to be provided @ 5% p.a. on the written down value of the club premises and @ 15% p.a. on car for the whole year.		

**Required:** Prepare an Income and Expenditure Account of Diana Club for the year ending 30th September, 2003 and Balance Sheet as on that date.

**Solution.**

**Income and Expenditure Account**  
for the year ending 30th September 2003

Dr.		Cr.	
Expenditure	Amount (₹)	Income	Amount (₹)
To Honoraria to Secretary	9,600	By Subscription	21,420
To Miscellaneous Expenses	3,060	(-) Due on 1.10.2002	2,400
To Rates and Taxes	2,520		19,020
To Groundman's Wages	1,680	(+) Due on 30.9.2003	1,960
To Printing and Stationery	940	By Sale of old newspaper	4,800
To Telephone Expenses	4,780	By Entertainment fees	8,540
To Repairs	640	By Bank interest	460
To Depreciation on:		By Profit from Bar Trading	
Premises	1,020	Account	4,000
Car	4,680	By Profit on sale of car	2,200
To Surplus	12,060		
	40,980		40,980

**Balance Sheet**  
as on 30th September 2003

*Accounts of Non-trading  
Institutions*

Liabilities	Amount (₹)	Assets	Amount (₹)
Capital Fund	43,500	Cash and Bank	6,920
(+) Surplus	12,060	Subscription due (not received)	1,960
Amount unpaid for Bar Purchases	860	Club Premises	20,400
		(-) Depreciation	1,020
		Car	31,200
		(-) Depreciation	4,680
		Bar Stock	1,740
	<b>56,520</b>		<b>56,520</b>

**Notes**

**Working Notes:**

**1. Balance Sheet**  
as on 1.10.2002

Liabilities	Amount (₹)	Assets	Amount (₹)
Capital Fund (Balancing figure)	43,600	Cash and Bank	16,760
Depreciation on Club Premises	37,600	Subscription due (not received)	2,400
Depreciation on car	20,580	Club Premises at Cost	58,000
Amount unpaid for Bar Purchases	1,180	Car at Cost	24,380
		Bar Stock	1,420
	<b>1,02,960</b>		<b>1,02,960</b>

**2. Bar Trading Account**

Particulars	Amount (₹)	Particulars	Amount (₹)
To Opening Stock	1,420	By Bar Receipts	14,900
To Purchase	11,220	By Closing Stock	1,740
To Profit (transferred to Income and Expenditure A/c)	4,000		
	<b>16,640</b>		<b>16,640</b>

**3. Amount unpaid for Bar Purchases Account**

Particulars	Amount (₹)	Particulars	Amount (₹)
To Bank A/c (Paid)	11,540	By Balance b/d	1,180
To Balance c/d	860	By Purchases (Balancing figure)	11,220
	<b>12,400</b>		<b>12,400</b>

**4. Calculation of Profit/Loss on Sale of Car:**

Cost of Car = ₹ 24,380

Less : Accumulated Depreciation = 20,580

Book value of Car = 3,800

Profit on sale of Car = Sales proceeds – Book value  
= 6,000 – 3,800 = ₹ 2,200

**Notes****5. Depreciation on New Car:**

Cost of new Car = 25,200 + 6,000 = ₹ 31,200

$$\text{Depreciation on new Car} = 31,200 \times \frac{15}{100} = ₹ 4,680$$
**6. Depreciation on Club Premises:**

Cost of Premises = ₹ 58,000

Less : Accumulated Depreciation = 37,600

Written down value of Premises = 20,400

$$\text{Depreciation on Premises} = 20,400 \times \frac{5}{100} = ₹ 1,020$$

**Illustration 9.** The following is the Receipts and Payment Account of Caiso Club for the year ended on 31st March, 2002.

Receipts	Amount (₹)	Payments	Amount (₹)
Opening Balance:		Salaries	1,20,000
Cash	10,000	Creditors	15,20,000
Bank	3,850	Printing and Stationery	70,000
Subscription Received	2,02,750	Postage	40,000
Entrance Donation	1,00,000	Telephones and Telex	52,000
Interest Received	58,000	Repairs and Maintenance	48,000
Sale of an Asset	8,000	Glass and Table Linen	12,000
Miscellaneous Income	9,000	Crockery and Cutlery	14,000
Receipts at:		Garden Unkeep	8,000
Coffee Room	10,70,000	Membership Fees	4,000
Wines and Spirits	5,10,000	Insurance	5,000
Swimming Poll	80,000	Electricity	28,000
Tennis Court	1,02,000	Closing Balances:	
		Cash	8,000
		Bank	2,24,600
	21,53,600		21,53,600

The Assets and Liabilities as on 1.4.2001 were as follows:

Fixed Assets (net): ₹ 5,00,000; Stock : ₹ 3,80,000, Investment in 12% Tax Free Government Securities : ₹ 5,00,000; Outstanding Subscription : ₹ 12,000; Prepaid Insurance : ₹ 1,000; Sundry Creditors : ₹ 1,12,000; Subscription received in advance : ₹ 15,000; Entrance Donation Received pending membership : ₹ 1,00,000; Gratuity Fund : ₹ 1,50,000.

Accounts of Non-trading Institutions

Notes

The following adjustments are to be made while drawing up the Accounts :

- Subscription received in advance as on 31st March, 2002 was ₹ 18,000.
- Outstanding Subscription as on 31st March, 2002 was ₹ 7,000.
- Outstanding Expenses are : Salaries : ₹ 8,000 and Electricity : ₹ 15,000.
- 50% of the Entrance Donation was to be capitalised. There was no pending membership as on 31st March, 2002.
- The cost of asset sold net as on 1.4.2001 was ₹ 10,000.
- Depreciation is to be provided at the rate of 10% on assets.
- A sum of ₹ 20,000 received in October 2001 as Entrance Donation from and applicant was to be refunded as he had not fulfilled the requisite membership qualifications. The refund was made on 3.6.2002.
- Purchases Made during the year amounted to ₹ 15,00,000.
- The value of closing stock was ₹ 2,10,000.
- The club as a matter of policy charges off to Income and Expenditure Account all purchases made on Account of crockery, cutlery, glass and linen in the year of purchase.

You are required to prepare an Income and Expenditure Account for the year ended on 31st March, 2002 and the Balance Sheet as on 31st March, 2002 alongwith necessary workings.

**Solution.**

**Income and Expenditure Account**  
for the year ending 31st March 2002

Dr.		Cr.	
Expenditure	Amount (₹)	Income	Amount (₹)
To Salaries	1,20,000	By Subscription	2,02,750
(+) Outstanding	8,000	(-) Outstanding on 1.4.2001	12,000
	1,28,000		1,90,750
To Loss on sale of assets	2,000	(+) Received in advance	
To Printing and Stationery	70,000	on 1.4.2001	15,000
To Postage	40,000	(-) Received in advance	2,05,750
To Telephone and Telex	52,000	on 31.3.2002	18,000
To Repair and Maintenance	48,000		1,87,750
To Glass and Table Linen	12,000	(+) Outstanding on	
To Crockery and Cutlery	14,000		
To Garden Unkeep	8,000		

Notes

To Membership Fees	4,000	31.3.2002	7,000	1,94,750
To Electricity	28,000		By Entrance Donation	90,000
(+) Outstanding	15,000	43,000	(See W.No.)	
To Insurance	5,000		By Interest Received	58,000
(+) Prepaid	1,000	6,000	Add : Accrued interest	2,000
To Depreciation of Fixed Assets	49,000		[Amount of total interest	60,000
			$5,00,000 \times 12/100 = ₹60,000$ ]	
			By Miscellaneous Income	9,000
			By Profit from Trading	
			Account	92,000
			By Deficit	30,250
		<b>4,76,000</b>		<b>4,76,000</b>

**Balance Sheet**  
as on 31st March 2002

Liabilities		Amount	Assets		Amount
		(₹)			(₹)
Capital Fund	10,29,850		Cash		8,000
(-) Deficit	30,250	9,99,600	Bank		2,24,600
Sundry Creditors (See W. No 5)		92,000	Fixed Assets	4,90,000	
Subscription Received in Advance		18,000	(-) Depreciation	49,000	4,41,000
Entrance Donation (Capitalised Amount)		90,000	Stock		2,10,000
Gratuity Fund		1,50,000	Investment	5,00,000	
Outstanding Salaries		8,000	(+) Accrued Interest	2,000	5,02,000
Outstanding Electricity		15,000	Outstanding Subscription		7,000
Refundable Entrance Donation		20,000			
		<b>13,92,600</b>			<b>13,92,600</b>

**Working Notes:**

**1. Calculation of Capital Fund**

**Balance Sheet**  
as on 1.4.2001

Liabilities		Amount	Assets		Amount
		(₹)			(₹)
Capital Fund (Balancing figure)		10,29,850	Fixed Assets (Net)		5,00,000
Sundry Creditors		1,12,000	Stock		3,80,000
Subscription Received in Advance		15,000	Outstanding Subscription		12,000
Entrance Donation Received			Prepaid Insurance		1,000
Pending Membership		1,00,000	Cash		10,000
Gratuity Fund		1,50,000	Bank		3,850
			Investment		5,00,000
		<b>14,06,850</b>			<b>14,06,850</b>

**2. Calculation of Entrance Donation of the Current Year**

	₹
Entrance donation received as per Receipts and Payment A/s	1,00,000
<i>Add:</i> Advance Entrance Donation (See Balance Sheet as on 1.4.2001)	1,00,000
	2,00,000
<i>Less:</i> Refundable Donation	20,000
<b>Total Donations for the Current Year</b>	<b>1,80,000</b>
<i>Less:</i> 50% to be capitalised [ $1,80,000 \times 50/100$ ]	90,000
	<b>90,000</b>

**Notes**

**3. Trading Account of Caiso Club**

Dr.		Cr.	
Particulars	Amount (₹)	Particulars	Amount (₹)
To Opening Stock (See Balance Sheet as on 1.4.2001)	3,80,000	By Receipts at :	
To Purchase A/c	15,00,000	Coffee Room	10,70,000
To Profit	92,000	Swimming Poll	80,000
		Tennis Court	1,02,000
		Wine and Spirits	5,10,000
		By Closing Stock	2,10,000
	<b>19,72,000</b>		<b>17,62,000</b>
			<b>19,72,000</b>

**4. Calculation of Closing Balance of Sundry Creditors**

**Sundry Creditors Account**

Dr.		Cr.	
Particulars	Amount (₹)	Particulars	Amount (₹)
To Bank A/c (Paid)	15,20,000	By Balance b/d	1,12,000
To Balance b/d ( <i>Balancing figure</i> )	92,000	By Purchases A/c	15,00,000
	<b>16,12,000</b>		<b>16,12,000</b>

**B. Preparation of Receipt and Payment Account from Income Expenditure A/c and Additional Information**

We are required to prepare Receipts and Payments account from Income and Expenditure account and additional informations. Receipts and Payments account records all cash receipts and cash payments of both capital and revenue nature. Whatever is received in cash and paid in cash is posted to this account irrespective of the fact that it relates to the previous year or current year or next year. Items of receipts can be identified by the following procedure.

## Procedure for Identifying receipts

## Notes

	₹
Subscription as per the Income and Expenditure Account of current year	4,500
Add : Outstanding subscription of the previous year	100
Add : Subscription received in advance during the current year	300
	4,900
Less : Outstanding subscription of the current year	150
Less : Subscription received in advance at the end of the previous year	200
	350
Cash receipt of subscription during the current year to be shown as the debit side of Receipts and Payment account	4,550

## Procedure for Identifying payment

Salaries as per Income and Expenditure account of the current year	15,00
Add : Outstanding salaries of the previous year	100
Add : Salaries paid in advance ( <i>prépaid</i> ) during the current year	50
	150
	1,650
Less : Salaries outstanding at the end of the current year	150
Less : Salaries prepaid during the previous year	300
	(-) 450
Salaries to be shown at the payment side	1,200

**Illustration 10.** Rehman Cricket Club gives you the following information :

**Income and Expenditure Account**  
for the year ended 31st December, 2003

Expenditure	Amount (₹)	Income	Amount (₹)
To Remuneration to coaches	18,000	By Donation and subscription	1,02,000
To Salaries and Wages	24,000	By Bar Room	
To Rent	12,000	Receipts	24,000
To Repairs	11,000	Expenses	(-) 20,000
To Miscellaneous expenses	7,000		4,000
To Honorarium to Secretary	18,000	By Bank Interest	2,000
To Depreciation on equipment	5,000	By Hire of Club hall	12,000
To Surplus	25,000		
	1,20,000		1,20,000

**Balance Sheet**  
as on 31st December, 2003

Accounts of Non-trading  
Institutions

Liabilities	Amount (₹)	Assets	Amount (₹)
Capital Fund as on 31-12-2003	48,000	Equipment	20,000
Entrance Fees	10,000	Subscriptions Receivable	8,000
Surplus	25,000	Cash in hand	4,000
	83,000	Cash at bank	10,000
Subscription received in advance	3,000	Fixed deposit	50,000
Outstanding Liabilities :			
Miscellaneous Expenses	1,000		
Salary and Wages	3,000		
Honorarium to Secretary	2,000		
	92,000		92,000

Notes

**Balance Sheet**  
as on December 31, 2002

Liabilities	Amount (₹)	Assets	Amount (₹)
Capital	48,000	Equipment	25,000
Subscriptions Received in advance	4,000	Subscriptions receivable	6,000
Outstanding miscellaneous expenses	1,500	Cash at bank	2,500
Outstanding Salaries	2,000	Fixed deposit	20,000
Outstanding honorarium	3,000	Cash in hand	5,000
	58,500		58,500

Prepare the Receipts and Payments account of the Club for the year ended 31st December, 2003.

**Solution.**

**Rehman Cricket Club**

**Receipts and Payment Account**  
for the year ending 31st December 2003

Dr.

Cr.

Receipts	Amount (₹)	Particulars	Amount (₹)
To Balance b/d		By Remuneration to coaches	18,000
Cash	5,000	By Rent	12,000
Bank	2,500	By Repairs	11,000
To Donations and Subscription	99,000	By Miscellaneous expenses	7,500
To Entrance fees	10,000	By Salaries and wages	23,000

Notes

To Bar receipts	24,000	By Honorarium to Secretary	19,000
To Bank interest	2,000	By Fixed deposit	30,000
To Hire of Club hall	12,000	By Bar expenses	20,000
		By Balance c/d:	
		Cash	4,000
		Bank	10,000
	1,54,500		1,54,500

Working Notes:

(i) Donations and Subscription	₹	₹
As per Income and Expenditure A/c		1,02,200
Add : Received for 2002	6,000	
Add : Received in advance 2004	<u>3,000</u>	
		9,000
		<u>1,11,000</u>
Less : Received in 2002 for 2003	4,000	
Less : Outstanding for 2003	<u>8,000</u>	
		12,000
Subscriptions received during the year		<u>99,000</u>
(ii) Miscellaneous Expenses :		₹
As per Income and Expenditure A/c		7,000
Add : Paid in 2003 for 2002		1,500
		<u>8,500</u>
Less : Outstanding for 2003		1,000
Expenses paid during the year		<u>7,500</u>
(iii) Salaries and Wages :		₹
As per Income and Expenditure A/c		24,000
Add : Paid in 2003 for 2002		2,000
		<u>26,000</u>
Less : Outstanding for 2003		3,000
Salaries paid during the year		<u>23,000</u>
(iv) Honorarium to Secretary :		₹
As per Income and Expenditure A/c		18,000
Add : Paid in 2003 for 2002		3,000
		<u>21,000</u>
Less : Outstanding for 2003		2,000
Honorarium paid during the year		<u>19,000</u>

### 3.9 SUMMARY

#### Notes

- **Not-for-Profit Organisations:** Organisation formed promoting certain cultural recreational, religious, political, educational, medical, social and professional activities are known as Not-for-Profit Organizations.
- **Receipts and Payment Account:** It is merely a summary of cash book. The left hand side of this account presents receipts, whereas right hand side shows payments. This account starts with the opening balance of cash and closes with the closing balance of cash.
- **Limitations or Receipts and Payment A/c:**
  1. Does not show income or expenditure
  2. It is prepared on realisation basis not on accrual basis.
  3. It does not tell as about surplus or deficit.
  4. No adjustment is made.
  5. Balance sheet cannot be prepared.
- **Points of difference between Receipts and Payment A/c and Cash Account:** (1) Period (2) Date (3) Institutions (4) Sides (5) Folio (6) Number of Pages
- **Income and Expenditure A/c:** The summary of income and expenditure of current year is known as Income and Expenditure Account. It is just like profit and Loss Account. It is prepared by non-profit institutions.
- **Points of difference between Income and Expenditure A/c and Profit and Loss A/c:** (1) Institutions (2) Object (3) Preparation (4) Opening item.
- **Points of difference between Receipts and Payments Account and Income and Expenditure Account:** (1) Form (2) Nature of account (3) Sides (4) Balance (5) Capital and revenue items (6) Amount (7) Adjustment (8) Net Income/Loss (9) Closing balance (10) Balance Sheet.
- **Relevant Items of Income and Expenditure Account:** Income, Income, for the purpose of Income and Expenditure Account must be routine, recurring, general and must relate to current year.
  - (1) **Subscription**
    - (i) Recurring, routine and current year's subscription is Income.
    - (ii) Subscription received for certain specific purpose is liability.
    - (iii) Subscription for life membership fee is a liability.
    - (iv) Capitalised part of subscription is liability.
  - (2) **Donation**
    - (i) Specific donation is liability.
    - (ii) General donation for bigger amount is also liability.
    - (iii) General donation for smaller amount is Income.
  - (3) **Grant.** Grants received for general purpose is income. Grants received for certain specific purpose is liability.

Notes

- (4) **Legacy.** It is the amount received from individual as per will. It should be treated as liability.
- (5) **Endowment Fund.** It is a receipt of non-recurring nature, so it is treated as a liability.
- (6) **Entrance fee.** It may be treated as both income or liability. Students are advised to make a note of their treatment.
- (7) Amount received from sale of fixed assets is not income. If the amount received exceeds book value, the excess is income. If it falls short of the book value the shortage should be treated as expenditure.
- (8) Sale of old magazines, newspapers, wastes, scraps bottles, bags, boxes and grass is income.
- (9) Life membership fee is liability.
- (10) Books, crockery, utensils and shares purchased are assets.
- (11) Subscription for newspaper and magazines is expenditure.
- (12) Purchase of routine consumable stores are expenditure. Sale of these stores are income.
- (13) Stationery should be treated as asset, if its opening and closing stock is given.

- **Types of Non-Profit entities:** (a) Commercial entity and (b) Non-Profit entity.
- **Points of difference between commercial entity and non-profit entity:** (1) Motive (2) Proprietorship (3) Profit sharing and (4) Accounting
- **Non-Fund Accounting:** It is based upon matching revenue with cost and used by commercial entities.
- **Fund Accounting:** It is used by non-profit organisation. Capital, known here as capital fund is taken as independent entity. This system of Accounting is used by non-profit organisation. Relevant income and expenditure are charged to these funds. Income and Expenditure A/c is prepared to ascertain excess of income over expenditure or excess of expenditure over income.
- **Points of different between Fund and Non-fund Accounting:** (1) Basis (2) Funds (3) Economic interest (4) Accountability (5) Financial statements (6) Usual earning (7) Budget (8) Entity of accounting.

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### 3.10 REVIEW QUESTIONS

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#### A. Very Short Answer Type Questions

1. Explain the meaning of capitalising income.
2. How will the capital balance be affected with the surplus of income over expenditure and *vice versa*?
3. Amount received from the sale of machine. Is it an income or asset?
4. Not-for-profit organisation have some distinguishing features from that of profit organisation. State any one of them.

5. Name the account which shows the classified summary of transactions of a Cash Book in a not-for-profit organisation.

**B. Short Answer Type Questions**

1. Describe briefly the limitations of Receipts and Payment account.
2. Mention items to be added and deducted while calculating subscription of the current year.
3. What is the relationship and distinction between the subscription, donation and grant?
4. How do you calculate Capital Fund?
5. Give four items each of Capital Receipts and Revenue Receipts.

**Notes**

**C. Long Answer Type Questions**

1. Differentiate between commercial entities and Non-profit entities?
2. What are key features of Government Accounting? What is the purpose of Government Accounting System.
3. Explain method of Government Accounting?
4. What is a Receipts and payments account? By whom it is prepared?
5. Distinguish between Receipt and Payment Account and Income and Expenditure Account on the basis of : (a) Object (b) Nature (c) Form and (d) Balance.

## 4. Consignment Accounts

### Notes

#### Structure

- 4.1 Introduction
- 4.2 Meaning of Consignment
- 4.3 Distinction Between Consignment and Sale
- 4.4 Procedure to be Followed in Case of Consignment
- 4.5 Accounting Treatment of Consignment Transactions
- 4.6 Valuation of Stock on Consignment
- 4.7 Accounting for Loss of Goods
- 4.8 Invoicing Goods Higher Than Cost
- 4.9 Summary
- 4.10 Review Questions

#### 4.1 INTRODUCTION

Now-a-days it is quite common that manufacturers or wholesale dealers despatch goods to their agents at home and abroad to increase their sales. The knowledge of the agent of the local conditions where he resides proves useful in increasing the sales. Moreover it is very expensive for the manufactures to sell the goods directly either in home market or in foreign market. Therefore, different agents are appointed for different places.

#### 4.2 MEANING OF CONSIGNMENT

It is common practice with practically all manufacturers or wholesalers to sell goods through agents both within the country and abroad. The goods are sent to be kept and sold on behalf of and at the risk of sender by the recipient. The person who forwards the goods for sale is consignor, the person to whom goods are forwarded for sale is 'consignee' and goods so sent are called 'Goods sent on Consignment'. Consignment is a means of facilitating sale but is not actually a sale. Consignment is different from sales. A consignment is returnable if goods are not sold but in case of sale, the goods are not returnable except for special reasons, such as on account of damage or if below standard goods are supplied. When goods are sold to a person the property in them passes to that person, but when goods are consigned to a person the legal ownership of the goods remains with the consignor. Hence when goods are sold the relationship between two parties is that of a creditor and debtor but when the goods are consigned relationship between the consignor and consignee is that of 'principal' and 'an agent'.

### 4.3 DISTINCTION BETWEEN CONSIGNMENT AND SALE

The following points summarize clearly, the difference between a consignment and a sale.

Sr. Basis	Consignment	Sale
1. Property in goods i.e. Ownership	Ownership remains with the consignor	Ownership passed to the buyer
2. Relation	Consignee is the agent of the consignor	Buyer is debtor of seller until the account is settled.
3. Risk and damage	Consignee holds the goods at the risk of the consignor therefore subsequent damage to the goods is the loss of the consignor	Any subsequent damage to the goods is the loss of the buyer
4. Return of goods	Goods may be returned if not sold	Goods are not returnable except for special reasons e.g., wrong kind or defective goods etc.
5. Expenses after delivery	Recoverable from the consignor	To be borne by the buyer
6. Forwarding letter	Proforma invoice	Invoice

Notes

### 4.4 PROCEDURE TO BE FOLLOWED IN CASE OF CONSIGNMENT

When the goods are despatched by the consignor to the consignee, the consignor makes out a statement known as 'proforma invoice' like a regular invoice giving details about the consignment and price which is normally at cost, but occasionally it may be at invoice price which is above the cost.

The consignee does not become liable for the payment of amount named in the invoice, but as matter of advance for goods, he usually makes payment in advance either by accepting a bill or by remitting a bank draft.

(a) **Account Sale** : The consignee renders to his consignor regularly a statement showing sales, expenses incurred, commission charged and remittance made with the resultant balance due by him. This statement is known as 'Accounts Sales'.

On receipt of Account Sales the consignor shall make entries in his books of account and complete the Consignment account and the Consignee's account.

(b) **Advance on Consignment** : It is common practice for the consignor to ask the consignee for some deposit as a security for goods sent on consignment to the consignee. It may be paid by any mode of payment- cheque, cash or even bills of exchange.

Notes

(c) **Commission** : The consignee usually gets a commission for selling the goods on behalf of the consignor as a fixed percentage on sales. So more the sales more will be the commission earned by the consignor. But there are some other kinds of commission which are sometimes given to the consignee for extra burden and activities i.e. Del Credre Commission and over-riding Commission.

(i) **Del Credre Commission** : Ordinarily the consignee is not responsible to the consignor for the payment of money by the purchasers but sometime he undertakes to guarantee payment due for all the goods he sells on credit and cash whether his customers pay him or not. In consideration of his this warranting the solvency of the buyers, he is paid an extra commission called a Del Credre Commission. The consignee will pay the consignor whether he himself receives payment from debtors or not. The commission is payable on total proceeds.

(ii) **Over-Riding Commission** : It is an extra commission in addition to ordinary commission. This commission is also calculated on sales like ordinary commission. This commission is generally given by the consignor to the consignee to enhance the sale or to boost up the sales of a new product.

(d) **Proforma Invoice** : Since the goods sent on consignment can not be treated as sales, the consignor does not prepare proper invoice. He simply prepares a Proforma invoice and sends it to the consignee, alongwith the goods despatched. This is prepared with a view to inform the consignee about price of goods, expenses incurred, mode of transportation and the minimum sale price at which the goods are to be sold.

(e) **Expenses** : Expenses relating to consignment of goods are divided into two categories vis. (i) Non-recurring expenses and (ii) Recurring expenses.

**Non-Recurring Expenses** : All the expenses which are incurred for bringing goods to the godown of the consignee are non recurring in nature. Such expenses are generally goods have reached the consignee's place or godown.

They are recurring in nature because they may be incurred repeatedly by the consignor and consignee. The examples of recurring expenses incurred by the consignor are advertising, discount of bills, commission on collection of cheques, travelling expenses of salesmen, bad debts etc. The examples of recurring expenses incurred by the consignee are godown rent; godown insurance, sales promotion etc.

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## 4.5 ACCOUNTING TREATMENT OF CONSIGNMENT TRANSACTIONS

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(A) **Books of the Consignor** : The consignor opens three accounts in his ledger.

(1) **Consignment Account** : It is prepared to ascertain profit or loss on each consignment e.g. Consignment to Bombay Account. It is not a personal account but a special Trading and Profit and Loss account or a nominal account.

- (2) **Consignee's Account** : It is prepared to show the balance due to or from consignee at a particular date. It is a personal account.
- (3) **Goods sent on Consignment Account** : It is prepared to show the amount of goods sent to the consignee. This is real account. The balance is credited to Purchase or Trading Account.

**Notes****Journal Entries**

1. (a) When the goods are sent on consignment at cost or at invoice price:
 

Consignment A/c	Dr.
To Goods sent on consignment A/c	

 (Being goods sent on Consignment at cost)
 

(b) If goods are sent at invoice price then one more entry is needed for making the adjustments. The amount of this entry is the difference between the invoice price and the cost price. The entry will be:

Goods sent on consignment A/c	Dr.
To Consignment A/c	
2. When expenses are incurred by the Consignor:
 

Consignment A/c	Dr.
To Bank A/c	

 (Being expenses incurred)
3. When the Account Sales is received from the Consignee :
  - (i) Consignee A/c Dr.

To Consignment A/c	
--------------------	--

 (Being the total sales by consignee)
  - (ii) Consignment A/c Dr.

To Consignee A/c	
------------------	--

 (Being the expenses incurred by consignee and with his Commission)
4. When the consignee remits the cash or bills:
 

Bank A/c/ Cash A/c/Bills receivable A/c	Dr.
To Consignee A/c	

 (Being Cash/B/R received)
5. When bills is discounted with Bank:
 

Cash A/c/ Bank A/c	Dr.
Discount A/c	
To Bills receivable A/c	

 (Being B/R discounted with the Bank)
6. For Stock remaining unsold:
 

Consignment stock A/c	Dr.
To Consignment A/c	

 (Being the value of stock plus proportionate expenses)

Notes

7. For Abnormal Loss of stock:

General Profit & Loss Account A/c Dr.  
 (with unrecoverable loss)  
 Insurance company A/c (with total recoverable loss) Dr.  
 To Consignment A/c (with total loss)

(For the abnormal loss of stock, amount recoverable and amount not recoverable)

8. For Profit or loss on Consignment:

(i) If there is profit on Consignment

Consignment A/c Dr.  
 To general Profit and Loss A/c

(Being the Profit on consignment transferred to Profit and Loss A/c)

(ii) If there is loss on Consignment

General Profit and loss Account Dr.  
 To Consignment A/c

(Being the loss on Consignment transferred to Profit & Loss Account)

9. For settlement of account with consignee:

Bank/Bills recoverable Dr.  
 To Consignee A/c

(Being amount sent for final settlement)

The Goods sent on Consignment Account' which shows credit balance will now be transferred to the Trading Account. Then the entry is :

Goods sent on consignment Account Dr.  
 To Trading A/c

(Being the goods sent on consignment account transferred to trading account).

**Ledgers**

(a) **Consignment Account** : Consignor prepares this account in his ledger. In it all transactions of a consignment are shown. This account discloses profit or loss incurred by each consignment. Debit side shows goods sent on consignment expenses incurred by consignor and consignee, consignees commission, bad debts etc. Credit side shows total sales (cash and credit), goods returned, and unsold stock etc. The difference between the debit and credit totals of Consignment Account is regarded as profit or loss which is transferred to the Profit and Loss Account and the Consignment Account stands closed. It is infact a nominal account and is just like Trading and Profit and Loss Account about which you must have studied earlier in final accounts. Therefore the principles applied to Trading and Profit and Loss Account hold good for this account also. Like Trading and Profit and loss Account all expenses and purchases are debited to this account and all sales and incomes are credited.

- (b) **Goods sent on consignment Account** : This account shows the goods transferred from the consignor to the consignee and goods returned by the consignee to the consignor. All the goods consigned by the consignor will be credited to this account and the goods returned by the consignee are debited to this account. The balance represents the cost of goods with consignee for sale, and is transferred to the Trading Account.
- (c) **Consignee's Account** : This account discloses what amount is due from the consignee. The consignee's account is debited with all cash and is credited by sales effected by the consignee. 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 a debit balance indicating the amount due from the consignee. At times it may show credit balance, if the advance given by the consignee is more than the sale affected by him. The balance revealed by this account is shown in the balance sheet of the consignor.

## Notes

**Illustration 1.** Vimal Mills Ltd. sent 100 pieces of suiting to Lal Garments House of Delhi on consignment basis. The consignees are entitled to receive 5 per cent commission plus expenses. The cost of Vimal Mills Ltd. is ₹ 200 per suiting. Lal Garments House pays following expenses :

Railway Freight	₹ 500
Godown Rent & Insurance	₹ 1,000

Vimal Mills Ltd. draw on the consignees a bill for ₹ 10,000 which is duly accepted. Subsequently it is discounted for ₹ 9,500. The consignees informed the consignor of the sale of the entire consignment for ₹ 28,500. Show journal entries and ledger accounts in the book of the consignor.

## Solution:

## Journal entries in the Book of Vimal Mills Ltd. (Consignor)

Date	Particulars	Dr.	Cr.
	Consignment A/c Dr. To goods sent on consignment A/c (100 pieces of suiting consigned to Lal Garments House at cost ₹ 200 per suiting)	20,000	20,000
	Bill receivable A/c Dr. To Lal Garment House (Being of the bills of exchange received from consignee)	10,000	10,000
	Cash Account Dr. Discount Account Dr. To bill receivable A/c (Being bill discounted with the bank)	9,500 500	10,000
	Lal Garment House Dr. To Consignment A/c (Being gross proceeds of the goods sold)	28,500	28,500

Notes

Consignment A/c	Dr.	1,500	
To Lal Garment House			1,500
(Being the expenses incurred by Lal Garment house)			
Consignment A/c	Dr.	1,425	
To Lal Garment House			1,425
(Being Commission @ 5% on sales)			
Consignment A/c	Dr.	5,575	
To Profit & Loss A/c			5,575
(Being profit on consignment transferred)			
Goods sent on Consignment A/c	Dr.	30,000	
To Trading A/c			30,000
(Being goods sent on consignment A/c transferred to trading A/c)			

Ledger Accounts

Consignment Account

Dr.		Cr.	
Particulars	(₹)	Particulars	(₹)
To goods sent on consignment A/c	20,000	By Lal Garment House (Sales)	28,500
To Lal Garments	1,500		
To Lal Garment House (commission)	1,425		
To Profit & Loss A/c (Profit on consignment)	5,575		
	28,500		28,500

Lal Garments House

Dr.		Cr.	
Particulars	(₹)	Particulars	(₹)
To consignment A/c	28,500	By bills receivable	10,000
		By Consignment A/c (Expenditure)	1,500
		By Consignment A/c (Commission)	1,425
		By Balance c/d	15,575
	28,500		28,500

## Goods Sent on Consignment Account

Particulars	(₹)	Particulars	₹
To Trading A/c (transferred)	20,000	By Consignment A/c	20,000
	20,000		20,000

**Notes**

### B. Books of the Consignee

Consignee need not pass any entry in his books on the receipt of goods by him or for expenses incurred by the consignor. He should, in principle, open the Consignor's Account in his books and route all the transactions through it in the following manner:

1. When cash is remitted or bill is accepted

Consignor A/c Dr.  
     To Cash A/c/Bills payable A/c  
 (Being cash remitted or bills accepted).

2. When expenses are incurred

Consignor A/c Dr.  
     To Cash A/c  
 (Being expenses incurred on consignment)

3. When sale is made on Consignment

(i) For cash sales

Cash a/c Dr.  
     To Consignor's A/c

(ii) For credit sales

Debtor's A/c Dr.  
     To Consignor A/c  
 (Being goods sold on credit)

4. On remitting balance to consignor after commission

Consignor's A/c Dr.  
     To Cash A/c/Bank A/c  
     To Commission A/c.  
 (Being cash remitted after commission)

**Note :** (A). For unsold stock lying with consignee, no entry is to be passed in his book of account.

(B) Consignee does not pass any entry for profit or loss in his books.

The consignee also prepares ledger accounts after passing all the journal entries. The Consignor's Account and Commission Account are the two important account prepared by the consignee in his books. Of course he will also do the postings to

the other accounts such as Consignment Debtor's Account, Consignment Expenses Account and Bills Payable Account etc.

**Notes**

(a) **Consignor's Personal Account** : It is the main account of Consignee's books which is prepared for working out the amount due to the consignor. Whatever amount he receives from sales of goods is credited to this account. All expenses incurred by the consignor in relation to consignment the commission due to him and the advance given by him to the consignor will be debited to this account. Further, if the consignee does not get del credere commission, the bad debts on account of credit sales are also debited to the Consignor's Account. The balance of this account indicates the amount payable to the consignor. This account is just the opposite of the Consignee's Account in the books of the consignor.

(b) **Commission Account** : It is nominal account. It shows the income earned by the consignee for the services rendered by him. All types of commission whether ordinary or special, due to the consignee is credited to this account. The commission account will be debited with bad debts if the consignee is to bear such loss because of del credere commission.

To continue with the same illustration No. 1, the consignee will have the following journal entries and ledger accounts:

**Journal Entries**

Date	Particulars	L.F.	Dr.	Cr.
	Vimal Mills Ltd. Dr. To Bills payable A/c (Being bill accepted)		10,000	10,000
	Vimal Mills Ltd. Dr. To Cash A/c (Being expenses incurred)		1,500	1,500
	Cash A/c Dr. To Vimal Mills (Being Sales proceeds received on consignment)		28,500	28,500
	Vimal Mills Ltd. Dr. To Commission A/c (Being 5% commission on total sales)		1,425	1,425
	B/P A/c Dr. To Cash A/c (Being bill met on maturity)		10,000	10,000

Vimal Mills Ltd. (Consignor)

Dr.

Cr.

Particulars	(₹)	Particulars	(₹)
To Bill payable A/c	10,000	By Cash (sale proceeds)	28,500
To Cash A/c (expenses)	1,500		
To Commission A/c	1,425		
To Balance c/d	15,575		
	28,500		28,500

Notes

**Illustration 2.** B. Ghosh of Bombay sent on consignment to Alok of Calcutta 300 cases @ ₹ 125 on 1st July 2006 to be sold on his account and at his risk for 10% commission. B. Ghosh incurred ₹ 3,000 expenses on dispatching the goods to Alok. On July 10, 2006 B. Ghosh received a bill for ₹ 20,000 at 2 months from Alok. On September 30, 2006 Alok sent on account sales disclosing that 200 cases have been sold for ₹ 160/- each and the remaining cases @ ₹ 150/- each. The account sales also discloses that Alok has incurred unloading expenses ₹ 600 and selling expenses ₹ 900. He sends a draft for the net amount due.

You are required to :

- Prepare the account sales; and
- Enter the transactions in the books of both the parties.

**Solution:** Account sales of 300 cases received from B. Ghosh to be sold on his account and risk.

200 cases @ ₹ 160	32,000	
100 cases @ ₹ 150	<u>15,000</u>	47,000
Less : Expenses		
Unloading expenses	600	
Selling expenses	900	1,500
Commission @ 10% on sales	<u>4,700</u>	6,200
₹ 47,000 (₹ 32,000 + ₹ 15,000)		
		40,800
Less Bill given as an advance on 10.7.2006		20,000
Balance (draft enclosed herewith)		<u>20,800</u>

E & O. E.

Alok

Calcutta 30th Sept., 2006

## Journal Entries in the Books of B. Ghosh (Consignor)

## Journal

Notes

Date	Particulars	L.F.	Dr.	Cr.
2006	Consignment A/c Dr.		37,500	
July 1	To goods sent on consignment A/c (Being 300 cases @ ₹ 125 sent on consignment to Alok)			37,500
July 1	Consignment A/c Dr. To Bank A/c (Being expenses incurred on account of goods sent on consignment)		3,000	3,000
Sep. 10	Bills receivable A/c Dr. To Alok (Being an acceptance for 2 months bill from Alok as an Advance)		20,000	20,000
Sep. 13	Bank Account Dr. To Bills Receivable A/c (Being the acceptance of Alok on the due date)		20,000	20,000
Sep. 30	Consignment A/c Dr. To Alok (Being unloading expenses) ₹ 600 and selling expenses ₹ 900 incurred by Alok		1,500	1,500
Sep. 30	Alok Dr. To Consignment A/c (Being goods sent on consignment sold by Alok-200 cases @ ₹ 160 and 100 case @ ₹ 150)		47,000	47,000
Sep. 30	Consignment A/c Dr. To Alok (Being commission payable to Alok @ 10% on ₹ 47,000)		4,700	4,700
Sep. 30	Bank A/c Dr. To Alok (Being amount due from Alok received)		20,800	20,800

Sep. 30	Consignment A/c To Profit & Loss A/c (Being profit on consignment transferred to Profit and Loss A/c)	Dr.		300	300
Sep. 30	Goods sent on consignment A/c To Trading A/c (Being goods sent on consignment transferred to Trading A/c)	Dr.		37,500	37,500

Notes

**Ledger**  
**Consignment Account**

<i>Dr.</i>			<i>Cr.</i>		
Date	Particulars	(₹)	Date	Particulars	(₹)
2006					
July 1	To goods sent on consignment A/c	37,500	Sep. 30	By Alok (Sales) 200 cases @ ₹ 160 = 32,000 100 case @ ₹ 150 = 15,000	47,000
July 1	To Bank A/c (Exp)	3,000			
Sep. 30	To Alok (Expenses)	1,500			
Sep. 30	To Alok (Commission)	4,700			
Sep. 30	To Profit transferred to profit & loss a/c	300			
		47,000			47,000

**Goods sent on Consignment Account**

<i>Dr.</i>			<i>Cr.</i>		
Date	Particulars	(₹)	Date	Particulars	(₹)
2006					
Sept 30	To Trading A/c	37,500	July 1	By Consignment to	37,500
Sept 30	To Trading A/c	37,500	July 1	By Consignment to Calcutta a/c	37,500
		37,500			37,500

**Bills Receivable Account**

<i>Dr.</i>			<i>Cr.</i>		
Date	Particulars	(₹)	Date	Particulars	(₹)
2006			2006		
July 10	To Alok	20,000	Sep. 13	By Bank A/c	20,000
		20,000			20,000

Notes

Dr.			Cr.		
Date	Particulars	(₹)	Date	Particulars	(₹)
2006			2006		
Sep. 30	To Consignment a/c (Sales)	47,000	July 10	By bills receivable	20,000
			Sep. 30	By consignment to Calcutta C/c (Exp)	1,500
			Sep. 30	By Consignment A/c (Commission)	4,700
			Sep. 30	By Bank a/c	20,800
		47,000			47,000

**Bank Account**

Dr.			Cr.		
Date	Particulars	(₹)	Date	Particulars	(₹)
2006			2006		
July 1	To balance b/c		July 1	By consignment a/c	3,000
Sep. 13	To Bills receivable	20,000	Sep. 30	By Bal. c/d	
Sep. 30	To Alok	20,800			

**Profit and Loss Account**

Dr.			Cr.		
Date	Particulars	(₹)	Date	Particulars	(₹)
			2006		
			Sep. 30	By Consignment to calculate a/c	300

**Entries in the Books of Alok (Consignee) Journal**

Date	Particulars	Dr.	Cr.
July 10	B. Ghosh Dr.	20,000	
	To Bills payable A/c		20,000
	(Being acceptance of bill for 2 months given)		
	Ghosh Dr.	1,500	
	To Bank A/c		1,500
	(Being unloading expenses ₹ 600 and selling expenses ₹ 900 incurred on account of B. Ghosh)		
Sep. 13	Bills payable A/c Dr.	20,000	
	To Bank A/c		20,000
	(Being bill met on the due date)		
	Bank A/c Dr.	47,000	

	To B. Ghosh (Being goods sold on behalf of B. Ghosh)		47,000
Sep. 30	B. Ghosh Dr.	4,700	
	To Commission A/c (Being 10% commission on sales charged to B. Ghosh).		4,700
Sep. 30	B. Ghosh Dr.	20,800	
	To Bank A/c (Being bank draft sent to B. Ghosh for the amount due)		20,800

Notes

**B. Ghosh**

<b>2006</b>				
July 10	To Bills payable A/c	20,000	By bank A/c (sales)	47,000
	To Bank A/c (expenses)	1,500		
Sep. 30	To commission A/c	4,700		
Sep. 30	To Bank A/c	20,800		
		47,000		47,000

**Bills Payable Account**

<b>2006</b>			<b>2006</b>		
Sep. 13	To Bank Account	20,000	July 10	B. Ghosh	20,000

**Commission Account**

			<b>2006</b>		
			Sep. 13	B. Ghosh	4,700

**Bank Account**

<b>2006</b>			<b>2006</b>		
July 1	To Balance b/d			Commission Payable	4700
	To B. Ghosh	47,000		By B. Ghosh	1,500
			Sep 13	By Bills payable	20,000
			Sep 30	By B. Ghosh	20,800
		47000			47000

**Illustration 3.** Suresh and Co. of Bombay sent on consignment to Mahesh & Co. of Delhi 60 cases cutlery goods costing ₹ 175 per case. Expenses incurred by the consignor at Bombay were : Freight ₹ 275, insurance ₹ 55 and loading charges ₹ 20.

Suresh & Co. draw on Mahesh & Co. 2 months bills at sight for ₹ 7,000 which the latter accepts. The charges paid by Mahesh & Co. at Delhi were unloading ₹ 30, Storage ₹ 85, insurance ₹ 15, Commission is payable to Mahesh & Co. at 2% on all sales in addition to 1½% del credere commission.

The consignee sells for prompt cash 30 cases @ ₹ 225 per case; 25 cases @ ₹ 250 per case and the balance @ ₹ 280 per case. The account was settled immediately by means of a bank draft.

Write up the transactions and ledger accounts in the books of both the parties.

Notes

Solution:

Consignor's Books Journal

Consignment to Delhi Account	Dr.	10,500	
To Goods sent on consignment Account			10,500
(60 cases consigned @ ₹ 175 per case)			
Consignment to Delhi Account	Dr.	350	
To Bank			350
(expenses on consignment paid)			
Bills receivable Account	Dr.	7,000	
To Mahesh & Co.			7,000
(Being Expenses incurred by consignee)			
Consignment to Delhi Account	Dr.	130	
To Mahesh & Co.			130
(Being Expenses incurred by consignee)			
Mahesh & Co.	Dr.	14,400	
To Consignment to Delhi Account			14,400
(Sales affected by consignee)			
Consignment to Delhi Account	Dr.	504	
To Mahesh & Co.			504
(Being Commission due to the consignee including del credere commission on sales i.e. 2% and 1½% of ₹ 14,400)			
Bank Account	Dr.	6,766	
To Mahesh & Co.			6,766
(Being Received bank draft in settlement of the accounts)			
Consignment to Delhi Account	Dr.	2,916	
To General Profit & Loss a/c			2,916
(Being Goods sent on consignment account closed)			

Ledger Account

Dr.		Consignment to Delhi Account		Cr.	
July 1	To goods sent to consignment a/c	10,500	By Mahesh & Co. (sales)	14,400	
	To Bank (expenses)	350			
	To Mahesh & Co. 130				

Notes

(Expenses)			
To Mahesh & Co. <u>504</u>	634		
(Commission)			
To General Profit & Loss A/c	2,916		
	14,400		14,400

**M/s Mahesh & Co's Account**

To consignment to Delhi A/c (sales)	14,400	By B/R A/c	7000
		By Consignment to Delhi Account	
		Expenses 130	
		Commission <u>504</u>	634
		By Bank a/c	6,766
	14,400		14,400

**Goods Sent on Consignment Account**

To Trading A/c (transfer)	10,500	By consignment to Delhi A/c	10,500
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**Consignee's Books**

**Journal**

Suresh & Co.	Dr.	7,000	
To Bills payable accepted			7,000
(Suresh & Co's bill accepted)			
Suresh & Co.	Dr.	130	
To cash A/c			130
(Being cash sent on expenses)			
Cash account	Dr.	14,400	
To Suresh & Co.			14,400
(Sales effected on consignor's behalf)			
Suresh & Co.	Dr.	504	
To Commission A/c			504
(Commission @ 2% and del credre commission @ 1.5% on ₹ 14,400)			
Suresh & Co.	Dr.	6,766	
To Bank A/c			6,766
(Balance remitted vide draft No. _____ dt. _____)			

## M/s Suresh &amp; Co's Account

Notes

To bills payable A/c	7,000	By cash (sales)	14,400
To cash (expenses)	130		
To Commission A/c	504		
To Bank A/c (draft)	6,766		
	14,400		14,400

Till now we have presumed that all the goods consigned are sold. But in practice we find that at the time of submitting the 'account sale', a part of goods consigned may still be unsold and may be lying with the consignee. In order to calculate the true profit or loss on consignment, the unsold stock should be valued and accounted for.

#### 4.6 VALUATION OF STOCK ON CONSIGNMENT

Valuations of unsold stock is usually done at cost. Cost, in case of consignment stock, would include the cost at which the goods are consigned plus, the proportionate non-recurring expenses. All the non-recurring expenses, whether incurred by the consignor or by the consignees, are to be taken into account. In the absence of details of expenditure incurred by the consignee, all expenses incurred by him are to be taken as recurring expenses and thus are not to be considered in the calculation of closing stock. In other words, while valuing the closing stock we add such proportionate expenses to the cost price that have been incurred upto the time the goods are brought to the place of the consignee. Any other expenses paid by the consignor or the consignee after this point will not be considered as these expenses do not add to the value of the goods. Such expenses are godown rent, selling expenses, carriage outwards, godown insurance, discount etc.

Usually following expenses are added for calculation of closing stock : Carriage and Freight, Loading Charges, Custom Duty, Clearing Charges, Dock Dues, Carriage paid upto the Godown, and Unloading charges.

Following are the expenses which are not considered for calculation of closing stock : Godown rent, Discount, Bad Debts, Insurance of the goods in the Godown, and Selling and Distribution expenses.

One can notice that all expenses incurred by the consignor are considered for valuation of the closing stock. The problem arises only selecting recurring expenses in case of consignee.

The value of unsold stock affects the profit or loss on any consignment so its valuation and recording in the books of consignor is very important. It is shown on the credit side of Consignment Account for which the journal entry passed would be as :

Stock on Consignment A/c	Dr.
To Consignment A/c	
(Being the values of sold stock)	

On the other hand the Consignee, will not pass any entry for the closing stock.

It is because he is not the owner of the goods and does not pass any entry even when the goods are received or he returns the goods.

## 4.7 ACCOUNTING FOR LOSS OF GOODS

Goods sent on consignment may be lost or damaged in transit. The loss of goods may be either (i) normal or (ii) abnormal. Treatment in the books of accounts will depend upon the nature of loss.

**Normal Loss :** Loss of goods is said to be normal when it is natural, unavoidable and is due to inherent characteristic of the goods despatched like evaporation, sublimation etc. The amount of stock to be carried down is the proportion of the total cost that the number of units on hand bears to be the total number units as diminished by loss.

**Deficiency of Stock :** When there is deficiency of stock at the time of stocktaking and the consignee is under a liability to account for the missing stock, the entry will be:

Consignee	Dr.
To Consignment a/c	
(Being the deficiency of stock charged to the consignee).	

If, on the other hand, he is not liable, the stock of the consignment will be shown at the gross figure and the consignment account will be debited with the loss in stock.

**Abnormal Loss :** There are the losses which are accidental and not natural like theft. Abnormal loss may occur in the godown of the consignee or in transit. Let us see the effect of abnormal loss on the closing stock under both situations.

When the abnormal loss occurs in the godown of the consignee the valuation of closing stock is not effected because the expenses incurred after they reach the godown of the consignee are not to be taken into account for the purpose. Hence, the normal formula will be followed for the valuation of closing stock. Look at illustration 4 and see how the abnormal loss and the value of closing stock is calculated when the abnormal loss occurs in the godown of the consignee.

The treatment in accounts will depend upon whether the unforeseen loss has been insured against or not. In case of insurance the consignment account will be credited but the insurance companies or underwriter's account will be debited with the amount of loss (which shall be calculated like valuation of stock on consignment i.e. including proportionate non-recurring expenses of both the consignor and the consignee). If the goods are not insured, instead of Insurance Company's or Underwriter's Accounts being debited, Profit and Loss Account will be debited and consignment account will be credited. In this way the final net profit on consignment is not adversely affected.

**Illustration 4.** X of Calcutta sent on 15th January, 2016, a consignment of 500 toys bicycles costing ₹ 100 each. Expenses of ₹ 700 met by the consignor. Y of Bombay spent ₹ 1,500 for clearance and the selling expenses were ₹ 10 per bicycle.

Y sold, on 4th April 2016, 300 pieces @ ₹ 160 per piece and again on 20th June 2016, 150 pieces @ ₹ 172.

Y was entitled to a commission of ₹ 25 per piece sold plus one fourth of the

Notes

amount by which the gross proceeds less total commission thereon exceeded a sum calculated at the rate of ₹ 125 per piece sold. Y sent the amount due to X on 30th June 2016.

You are required to show the Consignment Account and Y's Account in the books of X.

## Notes

Solution:

**Consignment Account**

2016	Particulars	(₹)	2016	Particulars	(₹)
Jan. 15	To goods sent on consignment a/c 500 @ ₹ 100	50,000	Apr. 4	By Y-sale of 300 pieces @ ₹ 160	48,000
Jan. 15	To Bank A/c - Exp.	700	June 20	By Y-sale of 150 Pieces @ 172	25,800
	To Y-Clearing Exp	1,500	June 30	By consignment stock A/c	5,220
Apr 4	To Y-selling Exp	3,000			
Jun 20	To Y- selling Exp	1,500			
Jun 30	To Commission A/c	12,510			
Jun 30	To Profit & Loss A/c Profit on Consignment	9,810			
		79,020			79,020

**Y Account**

2016	Particulars	(₹)	2016	Particulars	(₹)
Apr 4	To Consignment A/c	48,000	?	By consignment A/c (clearing exp.)	1,500
Jun 20	To Consignment A/c	25,800	Apr 4	By consignment A/c (selling exp.)	3,000
			June 20	By consignment A/c (selling exp.)	1500
			Jun 30	By consignment A/c commission (2)	12,510
				By Bank A/c	55290
		73,800			73,800

**Working Note**

(1) Valuation of Closing stock

50 pieces @ ₹ 100 each

₹ 5,000

Plus : Proportionate Expenses

Expenses incurred by X on 500 pieces = ₹ 700

Clearing expenses incurred by Y	= ₹ 1,500	
Total Expenses	₹ 2,200	
Therefore, expenses on 50 pieces	$2200 \times 50/500$	= ₹ 220
		₹ 5,220

**(2) Calculation of Commission**

Let Total Commission of Y be a

$$a = \text{No. of pieces sold} \times ₹ 25 + \frac{1}{4} [\text{Gross sale proceeds} - (\text{₹ } 125 \times \text{No. of pieces sold}) - (a)]$$

$$a = 450 \times ₹ 25 + \frac{1}{4} [₹ 73,800 - (\text{₹ } 125 \times 450) - a]$$

$$a = ₹ 45,000 + ₹ 17,500 - a$$

$$5a = ₹ 62,500$$

$$\text{Therefore : } a = 62,500/5 = ₹ 12,500$$

**Notes****4.8 INVOICING GOODS HIGHER THAN COST**

Sometimes the goods sent on consignment are priced not at cost but above cost i.e. at selling or near selling price. The purpose is to hide the real profit on the consignment from the competitive eye of the consignee. It does not affect the profits of the consignor. Here a few adjusting entries in respect of goods sent on consignment and stock are to be made at the end of the financial year. The entries are as follows :

To bring down the invoice of the goods sent on consignment to cost, debit goods sent on consignment account and credit consignment account with the difference in the invoice and the cost price.

(i) Goods sent on consignment A/c Dr.  
     To consignment A/c

(Being the excess of Invoice price written back)

To adjust the value of the stock lying unsold with the consignee, debit the consignment account and credit 'Stock Reserve Account' with the difference in prices.

(ii) Consignment A/c Dr.  
     To Consignment Stock Reserve A/c

(Being the excess of invoice price or value over cost Price of unsold stock adjusted).

The balance of the goods sent on consignment account will be transferred to the Trading Account as indicated earlier. The stock on consignment and Stock Reserve Account will be closed and the balance will be shown in Balance sheet.

Next year the stock on consignment account will be transferred to the debit of the 'Consignment Account' and Stock Reserve Account will be transferred to the Consignment Account (of course at the end of the next year.)

**Illustration 5.** B. Ltd. of Delhi consigned 1,000 cases of milk powder to S. of Bombay. The goods were charged at proforma invoice value of ₹ 10,000 including a profit of 25% on invoice price. The consignors paid ₹ 600 for freight and insurance. Consignee paid import duty ₹ 1,000, Dock Dues ₹ 200 and sent to the Consignors

a bank draft of ₹ 4,000 as advance. They sold 80 cases for ₹ 10,500 and sent for the balance due to the consignors after deducting commission of 5% on gross sale proceeds. Show ledger accounts in the books of the consignor.

Notes

**Consignment**

Dr.			Cr.		
2016	Particulars	(₹)	2016	Particulars	(₹)
	To goods sent on consignment A/c 25% over cost	10,000		By S of Bombay (consignee)	10,500
	To Bank Expenses	600		By Goods sent on consignment	2,500
	To S of Bombay (Exp)	1,200		By Consignment stock	2,360
	To consignment stock reserve A/c (25% of stock ₹ 200)	500			
	To commission paid of (5% 10,500)	525			
	To Profit transferred	2,535			
	To P & L A/c				
		15,360			15,360

**S of Bombay (Consignee)**

Dr.			Cr.		
2016	Particulars	(₹)	2016	Particulars	(₹)
	To Consignment A/c	10,500		By Bank	4,000
				By Consignment A/c Expenses 1200	
				Commission 525	1725
				By Bank	4,775
		10,500			10,500

**Goods sent on Consignment**

Dr.			Cr.		
2016	Particulars	(₹)	2016	Particulars	(₹)
	To consignment a/c	2,500		By Consignment a/c	10,000
	To Trading a/c	7,500			
		10,000			10,000

**Consignment Stock A/c**

Dr.			Cr.		
2016	Particulars	(₹)	2016	Particulars	(₹)
	To Consignment A/c	2,360		By balance c/d	2,360
		2,360			2,360

## Consignment Stock Reserves A/c

Consignment Accounts

Dr.

Cr.

2016	Particulars	(₹)	2016	Particulars	(₹)
	To balance c/d	500		By consignment A/c	500
					500

Notes

### Working Notes

Valuation of Stock

20 cases of Milk ₹ 100 = ₹ 2,000

Proportionate Expenses = Consignor expenses + Consignee

Expenses = ₹ 600 (freight and insurance + ₹ 1000 (Import duty) + ₹ 200 (Dock Dues) = ₹ 1800

Expenses on unsold Stock

$1800 \times 20/100 = 360$

Total value = ₹ 2000 + 360 = ₹ 2360

**Adjustment Entries-**

Excess of invoice price over cost price in case of goods sent on consignment =  $10,000 \times 25/100 = ₹ 2500$ .

### 4.9 SUMMARY

- Consignment is a specialised kind of transaction between consignor and consignee, whereby consignor sends goods to consignee to be sold by the latter on behalf of the former for a mutually agreed commission. The goods consigned to the agent cannot be treated as sales at the time of the consignment, they are treated as sales only when those are sold by the consignee. In a consignment transaction, the consignor sends goods to the consignee and makes a bill called Proforma Invoice. The value recorded in the proforma invoice may be the actual cost to the consignor or actual cost to the consignor plus mark-up. The objective of consignor in making accounts relating to consignment are to ascertain the results of consignment and to make final settlement with the consignee. To achieve this, he prepares consignment account and consignee account. The consignee makes accounts relating to consignment relating to consignment to effect the settlement with the consignor and to recognise his commission entitlement as consignee.

### 4.10 REVIEW QUESTIONS

1. Define 'Consignment'. What is the difference between a consignment and a sale of goods?
2. Why goods are sent to consignee at invoice price? What adjustment entries are recorded in the books of the consignor to find profit on consignment when goods are invoiced at proforma prices?
3. Give journal entries in respect of consignment transactions in the books of consignor and consignee.

Notes

4. Write short notes on:
- (a) Del Credere Commission
  - (b) Treatment of normal and Abnormal Losses in Consignment Account
  - (c) Valuation of Unsold Stock in Consignment

5. On 1st July, 2006 Radio House of Delhi consigned 200 Radios to Banerjee Bros. of the Calcutta. The cost of each radio was ₹ 400. Radio House paid ₹ 5,000 for freight and insurance. On 7 July, 2006 Banerjee Bros. accepted a 3 months bill drawn upon them by Radio House for ₹ 50,000, Banerjee Bros. paid ₹ 2,200 as rent and ₹ 1,300 for advertisement and upto 31st December, 2006 (on which date Radio House close their books) they sold 180 radios at ₹ 500 each. Banerjee Bros. were entitled to a commission of 5% on sales.

Give Journal entries and prepare necessary accounts to record the above transactions in the books of the parties.

6. Arun sends goods on consignment to Seemu. The terms are that Seemu will receive 10% commission on the price (which is cost plus 25%) and 20% of any price realised above the invoice price. Seemu will meet his expenses himself, goods to be sent freight paid.

Arun sent goods whose cost was ₹ 16,000 and spent ₹ 1,500 on freight, forwarding, etc. Seemu accepted a bill for ₹ 16,000 immediately on receiving the consignment. His expenses were ₹ 200 as rent and ₹ 100 as insurance. Seemu sold  $\frac{3}{4}$  of the goods for ₹ 19,500. Part of the sales were on credit and one customer failed to pay ₹ 400. Give Consignment Account and Seemu's Account in the books of Arun and Arun's Account in the books of Seemu.

7. Dutt of Delhi makes sewing machines at a cost of ₹ 120. On 1st January, 1994 he consigned 200 of them, invoice price ₹ 150 to Khan at Madras to be sold on behalf of Dutt, Khan receiving a commission of 8% on sales plus 2% del credere and 10% of any profit that may remain on the basis of invoice price. Khan was to bear all expenses after the machines reach his godown. Dutt incurred ₹ 500 as forwarding expenses and insurance.

10 machines were damaged during transit for which Dutt received ₹ 1,050 from insurers. Khan took delivery of remaining machines paying ₹ 1,140 as freight, octroi duty, cartage, etc. (Subsequently he also paid ₹ 500 as storage and other charges).

Khan sold 160 machines @ ₹ 180; 100 of them on credit out of which the proceeds of 5 machines could not be received because of the disappearance of the customer. Khan remitted the amount due to Dutt.

You are required to prepare the Consignment to Madras A/c and Khan's A/c in Dutt's Books.

## 5. Accounting for Joint Venture

**Notes**

### Structure

- 5.1 Introduction
- 5.2 Meaning of Joint Venture
- 5.3 Features of a Joint Venture
- 5.4 Differences between Joint Venture, Partnership and Consignment
- 5.5 Methods of Recording Joint Venture Transactions
- 5.6 Summary
- 5.7 Review Questions

### 5.1 INTRODUCTION

Complexities of a business as huge funds requirements, lack of technical expertise, sometimes make it difficult to undertake a business assignment individually like constructing a big building. The alternative available is that two or more persons join hand to take up that assignment. Joining hand may be for finance, for technical know-how, for sharing risk etc. When two or more persons join together to carry out a specific business and share the profits on predetermined basis, it is known as a *Joint Venture*. Joint venture is defined as a partnership confined to a particular adventure, speculation, course of trade or voyage, and in which partners, either latent or known use no firm or social name, and incur no responsibility beyond the limits of the adventure. For example, Mr. John and Mr. Ibrahim agreed to construct a bridge for municipal corporation. They pool their resources and technical know how. After they completed this project, the profits arising thereof will be shared by them in proportion to their contribution. When they are undertaking this project, they are free to carry on their own business as usual unless otherwise agreed. As the project ends, the relationship between the parties i.e. co-ventures ceases. So life of joint venture depends on the duration in which a project completes. Joint venture is neither a partnership nor it is consignment.

### 5.2 MEANING OF JOINT VENTURE

A joint venture is usually a temporary partnership without the use of a firm name, limited to carrying out a particular business plan in which the persons concerned agree to contribute capital and to share profits or losses. The parties in a joint venture are known as co-venturers and their liability is limited to the adventure concerned for which they agree to contribute capital and share profits or losses. A joint venture may consist of a joint consignment of goods, speculation in shares, underwriting of shares or debentures, construction of a building, or any similar form of enterprise.

### 5.3 FEATURES OF A JOINT VENTURE

The main features of a joint venture are specifically made clear.

Notes

- Two or more person are needed.
- It is an agreement to execute a particular venture or a project.
- The joint venture business may not have a specific name.
- It is of temporary nature. So the agreement regarding the venture automatically stands terminated as soon as the venture is complete.
- The co-ventures share profit and loss in an agreed ratio. The profits and losses are to be shared equally if not agreed otherwise.
- The co-ventures are free to continue with their own business unless agreed otherwise during the life of joint venture.

### 5.4 DIFFERENCES BETWEEN JOINT VENTURE, PARTNERSHIP AND CONSIGNMENT

In joint venture and partnership some business is carried on by two or more persons and the profits are shared by all of them. But there are some basic differences between the two which are given below:

Partnership Venture	Joint Venture
- A Partnership firm always has a name	There is no need of firm's name.
- It is of a continuous nature.	It comes to an end as soon as the work is complete.
- Separate set of books have to be maintained.	There is no need for a separate set of books, the account can be maintained even in one of the co-venturer's books only.
- No partner can carry on a similar business.	The co-venturers are free to carry on the business of a similar nature.
- Though the registration of partnership is not compulsory desirable	There no need for registration at all.
- A minor can also be admitted to the benefits of the firm.	A minor cannot be a co-venturer as he is incompetent to enter into a contract.

Consignment and joint venture are in the nature of an agreement between different parties but there are many points of differences between the two. Some of these are given below :

Joint Venture	Consignment
- Number of co-ventures is usually two but it can also be more than two.	Normally two persons are involved, the consignor and the consignee.
- The relationship between co-venturers is that of partnership. Co-venturers are the owners.	The relationship between the consignor and the consignee is that of principal and agent.

Notes

- The relationship comes to an end as soon as the venture is completed.	The arrangement may continue for a long time.
- All the co-venturers contribute funds to a common pool.	The funds are provided by the consignor.
- It may be for sale of goods or for carrying on any other activity like construction of building, investment in shares etc.	It is generally connected with sale of movable goods.
- The profit is shared by all the co-venturers.	The profit belongs to the consignor only. The consignee is entitled only to his commission.
- There is joint ownership	The consignor owns the goods.

Joint venturers as mentioned earlier are beneficial under the situations where there are limitations which can not be overcome by single party. By launching joint venture two or more parties can pool their financial resources to undertake a very big venture. Where experience or technical knowledge is a limitation co-venturers can also pool their expertise. Since joint ventures are normally big projects, if under unfavorable conditions there are losses then these losses are also shared thus loss to individual party is lessened.

### 5.5 METHODS OF RECORDING JOINT VENTURE TRANSACTIONS

Joint venture accounts can be kept under any of the following three methods :

- (a) Each co-venture records the transaction in his own books and opens "Joint Venture Account" and accounts of his fellow partners.
- (b) One common Joint Venture Account on memorandum basis is prepared to find the profit or loss made on trading. It is not a part of the double entry system. Under this system each one of the partners open only one account which is of the nature of personal account. The account is called. "Joint venture with .....a/c."
- (c) Venturers agree to keep a separate set of books and a person is made incharge of recording of all transactions. Generally this method is not adopted.

#### (A) Each co-venturer records the transactions

Under this system the "Joint Venture Account" is opened and debited with the value of goods bought and expenses incurred. Cash account or the party which has supplied the goods or incurred the expenses will be credited. When the sales proceeds are received, the party receiving it, will debit cash (for Debtors) account and credit the Joint Venture Account. The other parties will debit the recipient party and credit the Joint Venture Account.

Sometimes, a bill of exchange is drawn by one of the parties and is discounted. In such a case the discount on the bill should be charged to Joint Venture Account. Joint Venture Account will now show the profit or loss on trading. Under this system, each (Joint venturer) partner will open two accounts i.e. (i) Joint Venture Account (ii) The account of other parties.

**Journal Entries :** The following journal entries will be passed

- (1) For Investment in Joint Venture

Joint Venture A/c Dr.  
     To Cash/Good A/c

(Being the amount of goods supplied or cash put in for Joint Venture)

- (2) As goods are supplied by the Co-venturer or cash is invested in Joint Venture by him

Cash A/c (For cash sent) Dr.  
 Joint Venture A/c Dr.

    To Co-venturer A/c (for goods sent)

(Being goods supplied or cash invested by the other partner)

- (3) For recording sale of joint venture goods

Cash A/c Dr.  
     To Joint Venture A/c

(Being Sale of goods made)

- (4) On sale of joint venture goods by the other party

Co-Venturer A/c Dr.  
     To Joint Venture A/c

(Being Joint Venture goods sold by the other partner)

- (5) (a) For receipt of Bill of Exchange from the other partner

Bills receivable A/c Dr.  
     To Co-Venturer A/c

(Being bill receivable received)

- (b) For discounting the bill of exchange

Bank A/c Dr.  
 Joint Venture A/c Dr.

    To Bills Receivable A/c

(Being bill discounted and discounting charges debited to Joint Venture A/c).

- (6) Entries in the books of other partner Acceptor's books regarding acceptance of bills of exchange

Co-venturer A/c Dr.  
     To Bills Payable A/c

(Being acceptance given)

- (7) On discounting the bills of exchange by other party i.e. drawer

Joint venture A/c Dr.  
     To Co-Venturer A/c

- (8) On commission charged under Joint Venture

Joint Venture A/c Dr.  
     To commission A/c

**Notes**

(9) On Commission charged by other partner

Joint Venture A/c Dr.  
 To Co-Venturer A/c

(Being Commission on sale effected by other partners)

(10) When some products are left unsold and transferred to his own stock.

Purchase A/c Dr.  
 To Joint Venture A/c

(Being the unsold goods taken)

(11) If the other partner has taken the unsold goods, the entry will be:-

The Co-venturer A/c Dr.  
 To Joint Venture A/c

(Being the unsold goods taken by the other partner)

(12) Now Joint Venture Account will be closed. If it shows profit then the profit will be divided in the agreed ratio. The entry will be

Joint Venture A/c  
 To P & L A/c (own share)  
 To Co-venturers A/c (their share)

(Being the profit on Joint Venture shared by the parties)

**Notes**

**Format of Two accounts to be maintained**

**Joint Venture Account**

Dr.

Cr.

Particulars	Amount (₹)	Particulars	Amount (₹)
To Cash A/c (purchased)		By Cash A/c	
To Cash A/c (Expenses)		By Co-venturer A/c (Goods taken over)	
To Purchase A/c (Material supplied)			
To Outstanding Expenses A/c			
To Profit transferred to: Profit & Loss A/c Co-venturers A/c			

**Co-venturer's Personal Account**

Particulars	(₹)	Particulars	(₹)
To Joint Venture A/c (Good taken over)		By Bills Receivables	
To Cash a/c		By Joint Venture A/c	
	.....		.....

## Notes

**Illustration 1.** X and Y entered into Joint Venture to sell a consignment of timber sharing profits and losses equally. X provides timber from stock at mutually agreed value of ₹ 50000. He pays expenses amounting to ₹ 2500. Y incurs further expenses on cartage, storage and colliage of ₹ 6500 and receives cash for sales ₹ 30,000. He also takes over goods to the value of ₹ 10000 for his own use. At the close, X takes over the balance stock in hand which is valued at ₹ 11000.

Pass Journal Entries to record the above transactions and open the necessary ledger accounts in the books of X and Y.

## Journal entries in the Books of X

Particulars	L.F.	Dr. (₹)	Cr. (₹)
Joint Venture A/c	Dr.	52,500	
To Purchase A/c			50,000
To Bank A/c			2,500
(Being timber provided and expenses incurred)			
Joint Venture A/c	Dr.	6,500	
To Y			6,500
(Being expenses incurred by Y)			
Y	Dr.	30,000	
To Joint Venture a/c			30,000
(Being the sale proceeds by Y)			
Y	Dr.	10,000	
To Joint Venture A/c			10,000
(Y takes over the goods for his use)			
Purchase A/c	Dr.	11,000	
To Joint Venture A/c			11,000
(Being unsold goods taken)			
Y	Dr.	4,000	
Profit and Loss A/c	Dr.	4,000	
To Joint Venture A/c			8,000
(Being the loss on Joint Venture shared equally)			
Bank A/c	Dr.	37,500	
To Y			37,500
(Being draft received from Y)			

**Ledger Account**  
**Joint Venture A/c**

Particulars	(₹)	Particulars	(₹)
To Purchase	50,000	By Y (sale proceeds)	30,000
To Bank (expenses)	2,500	By Y (goods for his use)	10,000
To Y (expenses)	6,500	By Purchases (goods)	11,000

		By Y (loss)	4,000
		By Profit and Loss A/c (Ratio being 1:1)	4,000
	59,000		59,000

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Venture

Notes

**Y's Account**

Particulars	(₹)	Particulars	(₹)
To Joint Venture (Sale)	30,000	By Joint Venture (Expenses)	6,500
To Joint Venture (goods)	10,000	By Bank	37,500
To Joint Venture (goods)	4,000	(Final Settlement)	
	44,000		44,000

**Journal Entries in the Books of Y**

Particulars	L.F.	Dr. (₹)	Cr. (₹)
Joint Venture A/c	Dr.	52,500	
To X			52,500
(Being the goods supplied and expenses incurred)			
Joint Venture A/c	Dr.	6,500	
To Bank			6,500
(Being the expenses paid)			
Bank	Dr.	30,000	
To Joint Venture A/c			30,000
(Being the receipt of sale proceeds)			
Drawing A/c	Dr.	10,000	
To Joint Venture A/c			10,000
(Being the goods withdrawn for own use)			
X	Dr.	11,000	
To Joint Venture A/c			11,000
(Being the taking over the balance stock in hand by X)			
X	Dr.	4,000	
Profit and Loss A/c	Dr.	4,000	
To Joint Venture A/c			8,000
(For sharing of loss in equal ratio)			
X	Dr.	37,500	
To Bank			37,500
(Being the draft remitted X)			

Ledger A/cs



to it. All the items of personal accounts will also appear on the same side of 'Joint Venture Memorandum Account'. The balance of Joint Venture Memorandum Account shows profits or loss on joint venture and each party makes an entry for his share of profits or losses. The journal entry is as under:

Joint Venture with.....Account Dr.

To Profit and Loss Account

(Being profit earned on Joint Ventures)

Or

Profit and Loss Account Dr.

To Joint Venture with.....Account

(Being loss effected on Joint Venture)

**Illustration 2.** A and B entered into a Joint venture involving the buying and selling of old railway material with an agreement to share profit or loss equally. (The amount is in ₹ Hundreds). The cost of the material purchased was ₹ 30,000 which was paid by A, who drew bill of ₹ 20,000 on B at three months' period.

The bill was discounted by A at cost of ₹ 160. The transactions relating to the ventures were:

(i) A paid ₹ 200 for carriage, ₹ 600 for commission on sales and ₹ 100 for travelling expenses (ii) B paid ₹ 80 for travelling expenses and ₹ 120 for sundry expenses (iii) Sales made by A amounted to ₹ 21,400 less allowance for faulty goods ₹ 400 and (iv) Sales made by B were ₹ 15,000.

The remaining goods were retained by A and B for their private use and these were charged to them as ₹ 1600 and ₹ 2400 respectively. A was credited with sum of ₹ 300 to cover the cost for warehousing and insurance. The expenses in connection with the discounting to the bill were to be treated as a charge against the venture. Prepare the ledger accounts in the books of both the parties and also the memorandum joint venture account.

**Solution:**

**Memorandum Joint Venture A/c**

Dr.

(₹ In 000) Cr.

Particulars	(₹)	Particulars	(₹)
To Materials	30,000	By Sales	36,000
To discount on Bill	160	(21000 + 15000)	
To carriage	200	By stock taken by	
To Commission	600	A 1600	4,000
To Travelling (100 + 80)	180	B 2400	
To Sundry expenses	120		
To Warehousing expenses	300		
To Profit A : 4220	8,440		
B : 4220	40,000		40,000

**In the Books of A**  
**Joint Venture with B A/c**

(₹ in '000)

Dr.

Cr.

Notes

Particulars	(₹)	Particulars	(₹)
To Bank (material)	30,000	By Bank (sales)	21,000
To discount on bill	160	By Stock taken	1,600
To Bank		By Balance c/d	12,980
Carriage           200			
Commission       600			
Travelling exp.   100			
Warehousing <u>300</u>	1,200		
By Profit & Loss A/c	4,220		
	35,580		35,580
To Balance b/d	12,980		

**In the Books of B**  
**Joint Venture with A A/c**

(₹ in '000)

Dr.

Cr.

Particulars	(₹)	Particulars	(₹)
To Bank		By Bank (Sales)	15,000
Travelling Exp. 80		By Stock taken	2,400
Sundry Exp. 120	200		
To Profit & Loss A/c	4,220		
To Balance c/d	12,980		
	17,400		17,400
		By Balance b/d	12,980

Sometimes the co-venturers invest money in Joint venture business and receive back the amounts on different dates. It is quite usual for them to agree to calculate interest at a certain rate. Each co-venturers is entitled to receive interest on the amounts invested by him and pay interest on the amounts received by him. Only net interest receivable from or payable to the conventurer is recorded in the joint venture account. Thus, the net amount of interest is also taken into amount before ascertaining the profit or loss on joint venture.

**Illustration 3.** A and B enter into a joint venture sharing profits and losses equally. A purchased goods for ₹ 5,000 for cash on January 1, 1999. On the same day Bought goods for ₹ 10,000 on credit and spend ₹ 1,000 on freight etc. Further expenses were incurred as follows:

On 1.2.1999

Rs. 1,500 by B

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On 12.3.1999

Rs. 500 by A

Sales were made by each one of them as follows :

15.1.1999

₹ 3,000 by A

13.1.1999

₹ 6,000 by B

15.2.1999

₹ 3,000 by A

1.3.1999

₹ 4,000 by B

Creditors for goods were paid as follows

1.2.1999

₹ 5,000 by A

1.3.1999

₹ 5,000 by B

On March 31, 1999 the balance of stock was taken over by B at ₹ 9,000. The accounts between the co-venturers were settled by cash payment on this date. The co-venturers are entitled to interest at 12% per annum. Prepare necessary ledger accounts in the books of venturers as per Memorandum Joint Venture Account Method.

**Solution:**

### Memorandum Joint Venture Account

Dr.

Cr.

Particulars	(₹)	Particulars	(₹)
To A (cost of goods)	5,000	By A (sales)	6,000
To B (Cost of goods)	10,000	By B (sales)	10,000
To B (Freight etc.)	1,000	By B (interest)	50
To A (expenses)	500	By B (stock taken)	9,000
To B (expenses)	1,500		
To A (interest)	135		
Profit transferred			
A : 3457			
B : 3458	6,915		
	25,050		25,050

### Joint Venture with B Account

Dr.

Cr.

Date	Particulars	(₹)	Date	Particulars	(₹)
1999			1999		
Jan. 1	To Bank A/c (Purchase)	5,000	Jan. 15	By Bank A/c (Sales)	3,000
Feb. 1	To Bank A/c (Creditors)	5,000	Feb. 15	By Bank A/c (Sales)	3,000
Mar. 1	To Bank A/c (Expenses)	500	Mar. 15	By Bank A/c (Final settlement)	8,902

Mar. 31	To Interest a/c	135			
Mar. 31	To Profit & Loss A/c	3,457			
		14,092			14,092

Notes

**B's Books**  
**Joint Venture with A Account**

*Dr.* *Cr.*

Date	Particulars	(₹)	Date	Particulars	(₹)
<b>1999</b>			<b>1999</b>		
Jan. 1	To Bank A/c (Freight)	1,000	Jan. 31	By Bank (Sales)	6,000
Feb. 1	To Bank A/c (Exp)	1,500	Mar. 31	By Bank (sales)	4,000
Mar. 1	To Bank A/c (Crs)	5,000	Mar. 31	By Goods A/c Stock taken over.	9,000
Mar. 31	To Profit & Loss A/c	3,458	Mar. 31	By Interest A/c	50
Mar. 31	To Bank A/c (Amt. Paid in Final Statement)	8,092			
		19,050			19,050

**Calculation of Interest :**

**Payment by A**

Date	Amount	Month	Product (₹)	
1.1.99	₹ 5,000	3	15,000	(5,000 × 3)
1.3.99	₹ 500	1	500	(500 × 1)
1.2.99	₹ 5,000	2	10,000	(5,000 × 2)
			25,000	

$$\text{Interest} = 25,500 \times \frac{12}{100} \times \frac{1}{12} = ₹ 255$$

**Receipts by A**

15.1.99	₹ 3,000	2.5	7,500	(3,000 × 2 ½)
15.2.99	₹ 3,000	1.5	4,500	(3,000 × 1 ½)
			12,000	

$$\text{Interest} = 12,000 \times 12/100 \times 1/12 = 120$$

$$\text{Net Interest due} = 255 - 120 = ₹ 135$$

**Payment by B**

1.1.99	₹ 1,000	3	3,000
1.2.99	₹ 1,500	2	3,000
1.3.99	₹ 5,000	1	5,000
			11,000

$$\text{Interest} = 11,000 \times 12/100 \times 1/12 = \times 110$$

		<b>Receipts by B</b>	
31.1.99	₹ 6,000	2	12,000
1.3.99	₹ 4,000	1	4,000
			16,000

**Notes**

$$\text{Interest} = 16,000 \times 12/100 \times 1/12 = ₹ 160$$

$$\text{Net Interest due from B} = 160 - 110 = ₹ 50$$

**(C) Separate Books**

Recording of transactions is done not in books of parties but in a separate set of books. Co-venturer first contributes to a common bank account and then all payments are made through it. Accounts of parties are also opened. Profit or Loss on Joint Venture is transferred to the respective partner's accounts in due ratios. Finally, the books are closed with the close of the venture.

Three main accounts opened under separate set of accounts are:

1. Joint Venture Account
2. Joint Bank Account, and
3. Personal Capital Accounts of Joint Venturers.

The following entries will be passed under this system

- (1) When cash is invested by Joint Venturer

Joint Bank A/c Dr.  
To Capital Accounts of Joint Venturers.

(Being cash invested by Joint Venturers and deposited into the Bank)

- (2) When purchases are made for joint venture out of bank A/c

Joint Venture A/c Dr.  
To Joint Bank A/c

(Being Purchase made for Joint Venture)

- (3) When expenses are incurred for joint venture out of Bank A/c

Joint Venture A/c Dr.  
To Joint Bank A/c

(Being expenses incurred for Joint Venture Account)

- (4) When sales are made

Joint Bank A/c Dr.  
To Sales

(Being sales made and receipts from sales deposited into Bank)

- (5) When some products are left unsold and are taken away by Joint Venturers

Capital accounts of Joint Venturer A/c Dr.  
To Joint Venture A/c

(Being unsold stock taken by Joint Venturers)

(6) (a) For Profit on Joint Venture account

Joint Venture A/c

Dr.

To capital accounts of Joint Venturers A/c

(Being profit earned on Joint Venturers)

(b) The reverse entry will be passed in cases of losses on Joint Venture.

Notes

**Illustration 4.** X and Y enter into joint venture to underwrite public issue of Reliance Ltd. They agree to guarantee the subscription at par on 1,00,000 shares of ₹ 10 each of Reliance Ltd. and sharing profits and losses in the ratio of 2:3. The terms with the company are 4.5 % commission payable in cash and 6,000 fully paid shares of the company. They agreed to pay expenses in connection with the issue of shares. The expenses incurred are advertisement ₹ 5,000; Printing and stationery ₹ 2,000 and postage ₹ 600. All expenses are paid by X. The public subscribed to 88,000 shares only. The remaining shares under the agreement were duly taken by X and Y who provided the necessary cash equally. The commission is received in cash and is shared by the co-venturers in the ratio of 4:5. The entire holding of the joint venture is then sold in the market through brokers as follows : 25% at a price of ₹ 9 per share, 50% at a price of ₹ 8.75 per share, 15% at a price of ₹ 8.50 per share and the remaining 10% is taken over by A and B equally at an agreed price of ₹ 8 per share. Prepare the Joint Venture Account, Joint Bank Account, Shares Account and the Accounts of X and Y showing the final statement.

**Solution:**

**Joint Venture Account**

Dr.

Cr.

Particulars	(₹)	Particulars	(₹)
To		By Joint A/c	45,000
Advertisement	5000	(commission)	
Printing	2000	By shares a/c	60,000
Postage	600	(commission)	
To Shares A/c	23,400		
(Loss on sale)			
To profit transferred to			
X: 29,600			
Y: 44,400	74,000		
	1,05,000		1,05,000

**Joint Bank Account**

Dr.

Cr.

Particulars	(₹)	Particulars	(₹)
To X (contribution)	60,000	By Shares A/c	1,20,000
To Y (contribution)	60,000	By X (commission)	20,000
To Joint Venture	45,000	By Y (commission)	25,000

## Notes

(Commission)		By X (final settlement)	70,000
To Shares A/c (sale for cash)		By Y (final settlement)	72,000
25%      40,500			
50%      78,750			
15% <u>22,950</u>	1,42,200		
	3,07,200		3,07,200

## Share Account

Particulars	(₹)	Particulars	(₹)
To Joint Bank a/c	1,20,000	By Joint Bank A/c (Sale of Shares)	40,500
To Joint Venture (commission)	60,000	By Joint Bank A/c (sale of shares)	78,750
		By Joint Bank A/c (Sale of shares)	22,950
		By X (shares taken over)	7,200
		By Y (shares taken over)	7,200
		By Joint Venture A/c	23,400
	1,80,000		1,80,000

## X's Account

Particulars	(₹)	Particulars	(₹)
To Joint Bank A/c (Commission)	20,000	By Joint Venture A/c (Expenses)	7,600
To Shares A/c	7,200	By Joint Bank A/c (Commission)	60,000
To Joint bank A/c (Final Settlement)	70,000	By Joint Venture A/c (Profit)	29,600
	97,200		97,200

## Y's Account

Particulars	(₹)	Particulars	(₹)
To Joint Bank A/c (Commission)	25,000	By Joint Bank A/c (Commission)	60,000
To Shares A/c	7,200	By Joint Venture A/c (Profit)	44,400
To Joint Bank A/c (Final Settlement)	72,200		
	1,04,400		1,04,400

## Notes

## 1. Distribution of commission received in cash

4.5 % of ₹ 10,00,000 = ₹ 45,000

Xs shares  $4/9 \times 45,000 = ₹ 20,000$

Y's shares  $5/9 \times 45,000 = ₹ 25,000$

## 2. Treatment of shares received

Shares received by way of commission

6,000

Shares not subscribed by public

12,000

Total Number of shares received

18,000

**(a) Sold for cash**

25% of 18,000 i.e. 4,500 shares sold @ ₹ 9 per share ₹ 40,500

50% of 18,000 i.e. 9,000 shares sold @ ₹ 8.75 per share ₹ 78,750

15% of 18,000 i.e. 2,700 shares sold @ ₹ 8.50 per share ₹ 22,950.

**(b) Dividend amongst X and Y**

10 % of the remaining shares i.e. 1,800 shares are taken over equally by

X and Y at an agreed price of ₹ 8 per share.

X : 900 shares @ ₹ 8 per share = ₹ 7200

Y : 900 shares @ ₹ 8 per share = ₹ 7200

**5.6 SUMMARY**

- A joint venture is a contractual arrangement between two or more parties to undertake an economic activity, which is subject to joint control, i.e., agreed sharing of power to govern the financial and operating policies of an economic activity, so as to obtain benefits from it. A joint venture arises because of the limitations of a person due to constraint of available time, money expertise to execute a job etc. Despite broad similarities between joint venture and partnership, the two types of business differ considerably. A joint venture can also be distinguished from the consignment although both forms of business arise because of inherent limitations of a person to undertake a business effectively on his own. It is necessary to maintain proper accounts of all transactions of joint venture so that correct profit or loss on joint venture may be ascertained. The main methods of recording joint venture transactions are by creating an independent set of books of the joint venture which do not form part of the accounting system of an co-venturer, to record all the transactions of the joint venture, whether, entered by himself or by his co-venturer and to record only those transactions of the joint venture in which he himself features.

## 5.7 REVIEW QUESTIONS

1. Define a joint venture and give its various features. Name the different methods used to record joint venture transactions.
2. Distinguish joint venture from consignment and partnership.
3. Give the various journal entries to be passed in case where separate set of books are maintained for recording joint venture transactions.
4. What is a Memorandum Joint Venture Account? Give the various journal entries when accounts are maintained under this method.
5. Give the various journal entries to be passed in case where no separate set of books are maintained for recording joint venture transactions.
6. Ramesh and Suresh entered into a joint venture to purchase and sell hosiery goods. Profit and losses were to be shared equally. Ramesh financed the venture and Suresh undertook the sales on a commission of 5% on the sales proceeds. Ramesh purchased goods to the value of ₹ 50,000 less 5% trade discount, paid freight ₹ 1,500 and advanced ₹ 1,200 to Suresh to meet expenses. Suresh expended for carriage ₹ 300, rent ₹ 450, advertisement ₹ 200 and sundries ₹ 150. Sales made by Suresh amounted to ₹ 67,500. It was agreed that Ramesh should receive ₹ 2,500 as interest.

Remaining unsold goods costing ₹ 2,500 were retained by Suresh and those were charged to him at a price to show the same rate of gross profit (without charging any expenditure) as that made on the total sales (excluding those goods taken).

Give journal entries in the books of Ramesh and Suresh and also prepare the necessary ledger accounts in their books.

7. Vikas and Vishal entered into a joint venture of underwriting 1,00,000 shares of ₹ 10 each at par issued by a joint stock company. The consideration for underwriting the shares was 2,500 other shares of ₹ 10 each fully paid to be issued to them.

The public took up 90,000 shares and the remaining 10,000 shares of the guaranteed issued were taken up by Vikas and Vishal who provide cash equally for the purchase of remaining shares. The entire share holding of the joint venture was then sold through other brokers: 50% at a price of ₹ 10 less brokerage 50 paise per share; 20% at ₹ 9.50 less brokerage 50 paise per share and the balance were taken up by Vikas and Vishal equally at ₹ 9 per share. Expenses on account of joint venture were: advertisement ₹ 750 and other expenses ₹ 250. You are required to prepare; (a) Joint Venture Account; (b) Joint Bank Account; and (c) Accounts of Vikas and Vishal.

8. A and B entered into a joint venture for the purchase and sale of materials auctioned by the Government. A agreed to provide funds for the purchase of materials, and B to devote his time. The profit and loss was to be shared equally, subject to a credit of ₹ 500 to A by way of interest on his capital. A purchased materials worth ₹ 50,000; and drew a bill at two months for ₹ 20,000 on B which was duly accepted by the latter.

### Notes

Notes

The bill was discounted at a cost of ₹ 260. The various expenses relating to the venture were:

- (a) A paid ₹ 250 for carriage, ₹ 100 for brokerage, and ₹ 50 for miscellaneous expenses.
- (b) B paid ₹ 300 for commission, ₹ 200 for insurance, and ₹ 100 for miscellaneous expenses.

The total sales amounted to ₹ 72,000 (cash). There was, however, some stock of unsold goods which was taken over by both the parties, at ₹ 200 by A and at ₹ 300 by B. B paid the amount due to A. The expenses in connection with the discounting of the bill were to be treated as a charge against the venture. Prepare Joint Venture Account in the books of A and B separately and a Memorandum Joint Venture Account.

9. C of Calcutta and D of Delhi entered into a joint venture for the purpose of buying and selling second-hand motor cars, C to make purchases and D to effect sales. The profit or loss was to be shared as to C two-fifths and D three-fifths. A sum of ₹ 10,000 was remitted by D to C towards the venture.

C purchased 10 cars for ₹ 8,000, paid ₹ 4,350 for their reconditioning and sent them to Delhi. His other expenses were -Buying Commission 2½ per cent and Sundry Expenses ₹ 350.

D took delivery of the cars by paying ₹ 750 for railway freight and ₹ 375 for octroi. He sold four cars at ₹ 1,600 each, two at ₹ 1,800 each and three at ₹ 2,250 each. He retained the remaining car for himself at an agreed value of ₹ 2,100. His expenses were-Insurance ₹ 150; Garage Rent ₹ 250; Brokerage ₹ 685; Sundries ₹ 450.

Each party's ledger contains a record of his own transactions on joint account. Prepare a statement showing the result of the venture and the account of the venture in each party's ledger as it will finally appear, assuming that the matter was finally settled between the parties.

## 6. Branch Accounts

Notes

### Structure

- 6.1 Introduction
- 6.2 Need for Branch Accounting
- 6.3 Types of Branches
- 6.4 Accounting for Dependent Branches
- 6.5 Debtors System
- 6.6 Final Accounts System
- 6.7 Stock and Debtors System
- 6.8 Summary
- 6.9 Self Assessment Questions

### 6.1 INTRODUCTION

A business may be split up into a number of divisions. The divisions are known as departments if located under the same roof and branches if located at different places of the same town, country or world. For example, Cottage Emporium has various divisions like garments, furniture, gift items, jewellery, etc. They are located in the same building and so are called departments. Snowwhite has its showrooms in Connaught Place, Nehru Place, Karol Bagh, South Extension and Kamlanagar. These are all branches of Snowwhite. Similarly, Bata has its branches all over the country and Leventies all over the world. Each branch is treated as a separate profit centre and hence the profit or loss is to be worked out separately for each branch. Moreover, the firm has to keep strict control over various activities of each branch and ensure its smooth functioning. The accountants, therefore, have developed some specialised accounting methods for the recording of transactions at branch level and for incorporating the net effect of all branch transactions in a firm's books,

From accounting point of view, the branches are divided into three categories: (i) dependent branches, (ii) independent branches, and (iii) foreign branches. In this unit you will learn how the accounts of dependent branches are maintained and how their profit or loss is worked out.

### 6.2 NEED FOR BRANCH ACCOUNTING

As stated earlier, each branch is treated as a separate profit centre. Hence it should record various transactions in such a manner that its profit or, loss can be worked out and incorporated in the firm's overall results at the end of the accounting year. Moreover, the branches conduct all activities under the direction and control of

the head office which may need a variety of information from time to time about the functioning of each branch. This becomes possible only if the branches keep proper books of account. Thus, the main reasons of keeping branch accounts can be summarised as follows:

**Notes**

- (i) to find out the profit or loss of each branch for the accounting period;
- (ii) to ascertain the financial position of each branch at the end of the accounting year;
- (iii) to incorporate the net effect of branch transactions and their assets and liabilities in a firm's final accounts;
- (iv) to estimate requirements of cash and stock for each branch;
- (v) to evaluate the progress and performance of each branch;
- (vi) to calculate the commission for payment to the managers, if based on profit of branch;
- (vii) to assess the prospects for expansion of business in each branch; and
- (viii) to meet audit requirements.

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### 6.3 TYPES OF BRANCHES

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From accounting point of view the branches can be divided into the following categories:

- (1) Branches not keeping full system of accounting;
- (2) Branches keeping full system of accounting;
- (3) Foreign branches,

Let us have an idea about their main characteristics.

**Branches not Keeping Full System of Accounting:** The branches not keeping full system of accounting are also called dependent branches. The main features of such branches are:

- (i) They sell only those goods which are received from the head office and are not usually allowed to make purchases in the open market except with the permission of the head office.
- (ii) Goods are supplied by the head office to such branches either at cost price or at invoice price.
- (iii) All major expenses of the branch are paid by the head office. The branch manager is allowed to incur only petty expenses like cartage, postage, etc. out of the petty cash provided to him for which he is required to maintain a simple petty cash book.
- (iv) The amount received from cash sales and debtors is either remitted to the head office daily or deposited in the account of head office in some local bank.
- (v) The branch manager is normally expected to sell the goods for cash, but he may be authorised to sell goods on credit in certain cases.
- (vi) Such branches do not keep complete account books. They simply maintain record of sales and prepare debtors accounts, if necessary.

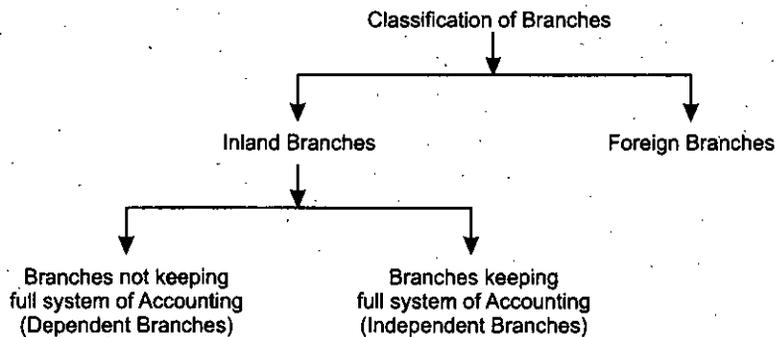
They are also required to maintain a stock register and furnish weekly or monthly statements giving complete information about stock position and movement of goods to the head office. This enables the head office to keep proper control over stock at branches.

**Branches Keeping Full System of Accounting:** Branches keeping full system of accounting are called independent branches. They are allowed to **purchase goods** from the market and also supply to the head office, if necessary. They can incur expenses from the cash **realised** and operate the bank account in their own names. Thus, they operate as independent units for all practical **purposes**. Their only **link** with the head office is that they are **owned** by the head office and whatever profit they earn or loss they incur ultimately belongs to the head office.

Such branches keep a complete set of books on the double entry system and prepare their own Trial Balance, Trading and Profit & Loss Account and Balance Sheet. Such branches open Head Office Account in their books and record all **transactions** between the branch and the head office in this account.

**Foreign Branches:** When a branch is **located** in a foreign country, it is called a foreign branch. Such branches will keep their books of account in foreign currency. The distinctive feature of foreign branches is that financial information received from them will be in foreign currency which has to be converted into the currency of the country of the head office before it can be incorporated in the head office books. For example, if an Indian company has a branch in Nairobi, the branch Trial Balance will be in Kenyan shillings. The Trial Balance must be converted into rupees before it can be incorporated in head office books. For all practical purposes, however, foreign branches are treated as independent branches.

Look at Figure 5.1 for complete classification of branches.



## 6.4 ACCOUNTING FOR DEPENDENT BRANCHES

You know that the dependent branches do not keep a complete set of books. Most of their transactions are recorded at the head office level. The accounting system adopted by head office for a branch depends up on the size of a branch and the degree of control to be exercised by the head office. The following are the various methods by which the head office usually keeps branch accounts in its books:

- (i) **Debtors System:** This system is adopted generally for those branches which are fairly small in size. Under this system, the head office simply opens a Branch Account for each branch in which it records all transactions

## Notes

## Notes

relating to the branch. The Branch Account is prepared in such a manner that it also helps in ascertaining the branch profit or loss.

- (ii) **Final Accounts System:** Under this system, the head office prepares a Trading and 'Profit and Loss Account' in order to find out profit or loss of each branch and a Branch Account to find out the amount due to, or due from, that branch, in this case, the Branch. Account simply acts as a personal account.
- (iii) **Stock and Debtors System:** Under this system, the head office does not open any Branch Account. For each branch, it prepares a Branch Stock Account, a Branch Expenses Account, a Branch Adjustment Account and Goods sent to Branch Account in order to find out the profit or loss of each branch.

## 6.5 DEBTORS SYSTEM

As stated earlier, under debtors system, the head office simply opens a Branch Account for each branch in which it records all transactions relating to the branch. The Branch Account also helps in ascertaining the profit or loss of the branch.

Good be invoiced to a branch at cost or at selling price (also called invoice price). Accordingly, there are two methods of preparing the Branch Account: (i) Cost Price Method, and (ii) Invoice Price Method. Let us now study the preparation of Branch Account under both of these methods.

### Cast Price Method

When goods are invoiced at cost, the following journal entries are passed in the books of the head office to record various transactions relating to the branch.

- (1) For goods sent to branch

Branch A/c	Dr.
To Goods Sent to Branch A/c	
(Being goods sent to branch)	

- (2) For return of goods to head office

Goods Sent to Branch A/c	Dr
To Branch A/c	
(Being goods returned by the branch)	

- (3) For amount sent to branch for expenses

Branch A/c	Dr.
To Bank A/c	
(Being cheque sent to branch for expenses)	

- (4) For amount received from branch

Bank A/c	Dr.
To Branch A/c	
(Being cash or cheque received from branch)	

- (5) For closing goods sent to branch account

Goods Sent to Branch A/c Dr.  
 To Purchases/Trading A/c  
 (Being balance transferred to Trading Account)

- (6) For closing balances of assets at the branch

Branch Assets A/c Dr.  
 (Individually)  
 To Branch A/c  
 (Being closing balances of assets brought into account)

- (7) For closing balances of liabilities at the branch

Branch A/c Dr.  
 To Branch Liabilities A/c  
 (Individually)  
 (Being closing balances of liabilities brought into account)

- (8) For transferring profit or loss to the General Profit and Loss Account

- (i) If profit

Branch A/c Dr.  
 To General Profit and Loss A/c  
 (Being branch profit transferred to General P & L Ac)

- (ii) If loss

General Profit and Loss A/c Dr.  
 To Branch A/c  
 (Being branch loss transferred to General P & L A/c)

The closing balances of branch assets and liabilities are shown in the Balance Sheet of the head office. At the beginning of the next year, the entire numbers 6 and 7 are reversed so as to show opening balances in the Branch Account.

The Branch Account will appear as given in Figure 5.2.

### Branch Account

Dr.

Particulars	Amount (₹)	Particulars	Amount (₹)
To Opening Balances		By Opening Balances	
Stock		Creditors	
Debtors		Outstanding expenses	
Petty Cash		By Bank	
Furniture		Cash Sales	

Notes

Notes

Prepaid expenses or any payment made by the H.O. on behalf of the Branch) To Closing Balances Outstanding expenses Creditors To Profit (transferred to General Profit & Loss A/c)		Collections from Debtors (for remittances) (to head office) By Closing Balances Petty Cash Stock Debtors Furniture (at depreciated value) Prepaid expenses By Loss, if any (transferred to General Profit & Loss A/c)	
--	--	--	--

Look at **Illustrations 1 and 2** and study how Branch Account is prepared with the help of the given information.

*Illustration 1. From the following particulars relating to Delhi Branch for the year ending December 31, 1988 prepare Branch Account in the books of head office.*

Particulars	Amount (₹)	Particulars		Amount (₹)
Stock at Branch on 1-1-1988	15,000	Cheques sent to Branch for		
Debtors at Branch on 1-1-1988	30,000	Salaries	9,000	
Petty Cash at Branch on 1-1-1988	300	Rent and Taxes	1,500	
Goods sent to Branch	2,52,000	Petty Cash	1,100	11,600
Cash sales	60,000	Goods returned by the branch		2,000
Received from Debtors	2,10,000	Stock at Branch on 31-12-1988		25,000
Credit Sales	2,28,000	Petty cash at Branch on 31-12-1988		200
		Debtors at Branch on 31-12-1988		48,000

**Solution:**

*Branch Accounts*

**Head Office Ledger  
Delhi Branch Account**

**Notes**

Dr.		Cr.	
Particulars	Amount (₹)	Particulars	Amount (₹)
To Balance b/d		By Cash :	
Branch Stock	15,000	Cash Sales	60,000
Branch Debtors	30,000	Received from	
Branch Petty Cash	300	Debtors	2,10,000
To Goods sent to			2,70,000
Branch A/c	2,52,000	By Goods sent to	
To Bank A/c		Branch A/c	2,000
Salaries	9,000	By Balance dd	
Rent & Taxes	1,500	Branch Stock	25,000
Petty Cash	1,100	Branch Debtors	48,000
	11,600	Branch Petty Cash	200
To Profit (Transferred to			
General P & L A/c	36,300		
	<b>3,45,200</b>		<b>3,45,200</b>

*Illustration 2. Sankat Mochan Ltd., Varanasi, opened a branch at Madras on January 1, 1988. The following particulars are available in respect of the branch for the year 1988.*

Particulars	Amount (₹)	Particulars	Amount (₹)
Goods sent to branch	75,000	Cash remittance to branch towards Petty Cash	6,000
Cash sales at branch	50,000	Petty Cash at branch on 31-12-1988	500
Credit sales at branch	60,000	Debtors at branch on 31-12-1988	5,000
Salaries of branch staff paid by head office	15,000	Stock at branch on 31-12-1988	27,000
Office expenses of branch paid by head office	12,000		

Prepare Branch Account to show the profit/loss from the branch for the year 1988.

## Books of Sankat Mochan Ltd.

## Madras Branch Account

Notes

Dr.			Cr.	
Particulars		Amount (₹)	Particulars	Amount (₹)
To Goods sent to Branch A/c		75,000	By Bank A/c	
To Bank A/c			Cash Sales	50,000
Salaries	15,000		Received from Debtors	55,000
Office expenses	12,000	27,000	By Balance c/d	
Branch A/c			Branch Petty Cash	500
To Bank A/c		6,000	Branch Debtors	5,000
(for petty expenses)			Branch Stock	27,000
To Profit (transferred to General P & L A/c)		29,500		
		<b>1,37,500</b>		<b>1,37,500</b>

**Note:** The amount of cash received from debtors is not given. It has been found by preparing the Memorandum Branch Debtors Account as follows:

Particulars	Amount (₹)	Particulars	Amount (₹)
To Credit Sales	60,000	By Cash Received	55,000
		(balancing figure)	
		By Balance c/d	5,000
	<b>60,000</b>		<b>60,000</b>

**Some Peculiar Items**

**Petty cash expenses:** No entry is made in respect of petty cash expenses incurred by the branch out of its petty cash. As per practice, the Branch Account is debited with the opening balance of petty cash and the amount of petty cash sent by head office, and it is credited with the closing balance of petty cash. This amounts to a net debit to Branch Account which is equal to the amount of petty expenses incurred by branch. For example, the opening balance of petty cash with a branch was ₹ 200, the cash sent by head office for petty expenses was ₹ 300, and the petty expenses incurred by branch were ₹ 400. When we debit the Branch Account with ₹ 200 (opening: petty cash balance) and ₹ 300 (amount sent by head office) and credit it with ₹ 100 (closing petty cash balance), the Branch Account stands debited by a net amount of ₹ 400 (₹ 200 + ₹ 300 – ₹ 100) which is equal to the amount of petty cash expenses (₹ 400) incurred by the branch.

Credit sales, sales returns, bad debts, discount allowed to debtors, etc. : All these items relate to branch debtors and will not be shown in the Branch Account. The reasoning is similar to that of petty cash expenses. When the Branch Account is

debited with the opening balance of branch debtors and credited with cash received from debtors and the closing balance of branch debtors, the amount of credit sales etc. automatically stand accounted for.

**Shortage or surplus of stock:** It is possible that, at the time of checking the stock of a branch, certain amount of shortage or surplus is detected. These are not to be shown in the Branch Account because the closing stock credited to the Branch Account is the actual amount of stock and thus the shortage or surplus is automatically covered.

**Depreciation of fixed assets:** This is also not shown in the Branch Account because, as per practice, the closing balance of the fixed asset after deducting the amount of depreciation is shown on the credit side of the Branch Account.

Thus you should note that while preparing the Branch Account for dependent branches, the following items will be ignored:

- (1) Petty Cash Expenses
- (2) Credit Sales
- (3) Sales Returns
- (4) Bad Debts
- (5) Discount Allowed to Debtors
- (6) Shortage or Surplus of Stock
- (7) Depreciation

Look at **Illustration 3** and see how Branch Account is prepared without specifically showing the above items, if given.

*Illustration 3. Pratap Tractors Ltd., Allahabad, has a branch at Hissar. From the following particulars relating to the branch for the year ending December 31, 1988, prepare the Branch Account in the head office books:*

Particulars	Amount (₹)	Particulars	Amount (₹)
Stock at Branch on 1-1-1988	10,000	Discount Allowed to Debtors	100
Branch Debtors on 1-1-1988	4,000	Cash sent to Branch	
Petty Cash on 1-1-1988	500	Rent	2,000
Furniture on 1-1-1988	2,000	Salaries	2,400
Prepaid Insurance on 1-1-1988	150	Petty Cash	1,000
Salaries Outstanding on 1-1-1988	100	Insurance (up to 31-3-1989)	600
Goods sent to Branch	80,000	Goods Returned by Branch	1,000
		Goods Returned by Debtors	2,000
		Stock Branch	

Notes

Notes

Cash Sales	1,30,000	on 31-1-1988	5,000
Credit Sales	40,000	Petty Expenses paid	
Cash received from Debtors	35,000	by Branch	850
Cash paid by Debtors (direct to head office)	2,000		

Provide depreciation on furniture @ 10% p.a.

**Solution.**

**Hissar Branch Account**

Dr.			Cr.	
Particulars		Amount (₹)	Particulars	Amount (₹)
To Balance b/d			By Balance b/d	
Branch Stock		10,000	Branch Outstanding	
Branch Debtors		4,000	Salaries	1,00,000
Branch Petty Cash		500		
			By Cash	
Branch Furniture		2,000	Cash Sales	30,000
Branch prepaid insurance		150	Cash Received	
To Goods sent to			from Debtors	37,000
Branch	80,000			1,67,000
Less: Return from			By Balance c/d	
Branch	1,000	79,000	Branch Stock	5,000
			Branch Petty Cash	650
To Bank			Branch Debtors	4,900
Rent	2,000		Branch Furniture	1,800
Salaries	2,400		Branch Prepaid	
Petty Cash	1,000		Insurance	150
Insurance	600	6,000		
To Profit (transferred to General P & L A/c)		77,950		
		<b>1,79,600</b>		<b>1,79,600</b>

**Notes:**

- (1) Cash received from debtors include ₹ 2,000 which the debtors directly paid to the head office.
- (2) Branch petty cash balance at the end is not given. It is ascertained as follows :

Petty dish at the beginning	500
Add amount sent by head office	1,000
	<u>1,500</u>

Less petty cash expenses

850

Branch Accounts

650

- (3) Furniture at the end has been shown after deducting ₹ 200 for depreciation.
- (4) Prepaid insurance on 31-12-1988 is one-fourth of ₹ 600.
- (5) The closing balance of branch debtors is not given. It has been worked out by preparing that Memorandum Branch Debtors Account as follows:

Notes

#### Memorandum Branch Debtors Account

Particulars	₹	Particulars	₹
To Balance b/d	4,000	By Cash Received from Debtors	37,000
To Sales (Credit)	40,000	By Sales Returns	2,000
		By Discount Allowed	100
		By Balanced c/d (balancing figure)	4,900
	44,000		44,000

#### Invoice Price Method

As in the case of consignment (you have studied about it in the elective course ECO.02), the goods may be invoiced to branches at a price higher than the cost (termed as invoice price). This is done primarily to have an effective control over stock with branches and keep the margin of profit secret from the branch manager. In such a situation, all entries relating to goods are made in the Branch Account at invoice price and necessary adjustments for loading (difference between I.P. and C.P.) are recorded at the end by passing the following additional journal entries:

- (1) For adjustment of loading in opening stock at branch

Stock Reserve A/c Dr.  
    To Branch A/c

- (2) For adjustment of loading in goods sent to branch less returns

Branch A/c Dr.  
    To Goods Sent to Branch A/c

- (3) For adjustment of loading in closing stock at branch

Branch A/c Dr.  
    To Stock Reserve A/c

Look at Illustration 4 and see how Branch Account is prepared when goods are invoiced at a price higher than cost.

**Illustration 4.** The Mukund Gas Co., Varanasi have a sales branch at Ghaziabad and invoiced goods to the branch at cost price plus  $33\frac{1}{3}$  per cent. It is arranged that all cash received by the branch is to be paid daily to the Head Office Account with the Banaras State Bank Ltd. and the necessary advice sent to the Head Office. From the following particulars, prepare Branch Account and Goods sent to Branch Account

**Notes**

	₹		₹
Stock on 1-1-1988		Rent, Rates and Taxes	3,200
(at invoice price)	12,000	Salaries and Wages	4,800
Goods Sent to Branch		Debtors on 31-12-1988	1,600
(at invoice price)	96,000	Goods Returned to	
Debtors on 1-1-1988	1,500	Head Office	
Cash Sent to Head Office	77,100	(at invoice price)	16,000
Sales	77,000	Shortage of stock	
		(at invoice price)	200

**Solution.**

**Ghaziabad Branch Account**

<i>Dr.</i>			<i>Cr.</i>	
Particulars		₹	Particulars	₹
To Balance b/d			By Cash Received	77,000
Branch Stock		12,000	By Goods Returned by	
Branch Debtors		1,500	Branch A/c	16,000
To Goods sent to			By Stock Reserve A/c	
Branch A/c		96,000	(loading in op. stock)	3,000
To Bank			By Goods sent to	
Rent, Rates &			Branch A/c	
Taxes	3,200		(loading in goods	
			sent less return)	20,000
Salaries & Wages	4,800	8,000	By Balance c/d	
To stock Reserve A/c			Branch Stock	14,800
(loading in cl. stock)		3,700	Branch Debtors	1,600
To Profit (transferred to				
General P & L A/c)		11,300		
		1,32,500		1,32,500

**Goods Sent to Branch Account**

Particulars	₹	Particulars	₹
To Ghaziabad Branch A/c	16,000	By Ghaziabad Branch A/c	96,000
To Ghaziabad Branch A/c			
(loading ₹ 80,000)	20,000		

To Trading A/c (transfer)	60,000		
	96,000		96,000

Notes:

- (1) The branch stock at the end has not been given. It can be worked out by preparing Memorandum Branch Stock Account as follows.
- (2) Loading is 25% of invoice price

Notes

Particulars	₹	Particulars	₹
To Balance hold	12,000	By Goods returned to head office	16,000
To Goods received from head office	96,000	By Sales	77,000
To Goods returned by Customers	-	By Shortage of Stock	200
		By Balance hold	14,800
	<b>1,08,000</b>		<b>1,08,000</b>

It should be noted that all figures in Memorandum Branch Stock Account have been recorded at the invoice price.

**Check Your Progress A**

1. What do you mean by dependent branch?

.....  
 .....  
 .....

2. Fill in the blanks:

- (i) The branch expenses paid by the head office are.....to the Branch Account.
- (ii) The balance in Goods sent to Branch Account is transferred to..... Account.
- (iii) If the cost price is ₹ 100 and the invoice price is cost plus 20% on invoice price, the invoice price is ₹.....
- (iv) Loading is the.....between cost price and invoice price.
- (v) If opening or closing stock is not given, the same can be worked out by preparing.....Account at.....price.

3. List the items which are not to be shown in Branch Account prepared under the Debtors System.

.....  
 .....  
 .....

## 6.6 FINAL ACCOUNTS SYSTEM

**Notes**

The profit or loss of a dependent branch can also be worked out by preparing a Memorandum Branch Trading and Profit & Loss Account. This account is prepared on the basis of cost of goods sent to the branch (not the invoice price). Apart from the Branch Trading and Profit & Loss Account, the Head Office also maintains the Branch Account. But, under this system, the Branch Account is in the nature of a personal account which shows only the mutual transactions between the head office and the branch. The balance of Branch Account, therefore, represents the net assets of the branch.

Look at Illustration 5 and study how profit or loss is ascertained and how Branch Account is maintained under the final accounts system.

*Illustration 5. A-one Ltd., Bhopal has a branch at Madras to which the goods are sent at cost plus 25%. The Madras branch keeps its own Sales Ledger and remits all cash received to the head office every day. All expenses are paid by the head office. The transactions for Madras Branch during the year ending December 31, 1988 were as follows:*

	₹		₹
Stock (1-1-1988)	11,000	Return Inwards	500
Debtors (1-1-1988)	100	Cheques sent to Branch	
Petty Cash	100	Rent	600
Cash Sales	2,650	Wages	200
		Salary and other expenses	900
Credit Sales	23,950	Stock (31-12-1988)	13,000
Goods sent to Branch	20,000	Debtors (31-12-1988)	2,000
Collection on Ledger A/c	21,000	Petty Cash (31-12-1988)	
Goods returned to H.O.	300	(including miscellaneous income	
Bad Debts	300	₹ 25 not remitted.)	125
Allowances to Customers	250		

Prepare the Memorandum Branch Trading and Profit & Loss Account and Madras Branch Account for the year ending December 31, 1988.

**Solution:**

**Memorandum Branch and Profit & Loss Account for the year ending 31-12-1988**

Dr.		Cr.	
Particulars	₹	Particulars	₹
To Opening Stock (11,000-2,200)	8,800	By Sales	
To Goods sent to Branch (20,000-4,000)	16,000	Cash	2,650
To Wages	200	Credit	23,950
To Gross Profit c/d	11,740		26,600
		Less Returns	500
		By Goods sent to 1-1.0. (300 - 60)	26,100
			240

		By Closing Stock (13,000–2,600)	10,400
	36,740		36,740
To Bad Debts	300	By Gross Profit b/d	11,740
To Allowances	250	By Misc, Income	25
To Rent	600		
To Salaries and other expenses	900		
To Profit transferred to General Profit & Loss A/c	9,715		
	11,765		11,765

Notes

**Madras Branch Account**

Particulars	₹	Particulars	₹
To Balance b/d		By Bank A/c	
Stock	8,800	Cash Received from	
Debtors	100	Debtors	21,000
Petty Cash	100	Cash Sale	2,650
To Goods sent to		By Goods sent to Branch	
Branch A/c	16,000	(return to H.O.)	240
To Bank A/c		By Balance c/d	
Rent	600	Stock	10,400
Wages	200	Debtors	2,000
Salaries and other expenses	900	Petty Cash	125
To Profit as per Branch Trading and P & L A/c	9,715		
	36,415		36,415

**6.7 STOCK AND DEBTORS SYSTEM**

Under Stock and Debtors System, the head office does not open a Branch Account in its books. It maintains a few control accounts for recording the various branch transactions. These accounts usually are : (i) Branch Stock Account, (ii) Branch Debtors Account, (iii) Branch Expenses Account, (iv) Branch Cash Account, (v) Goods sent to Branch Account, and (vi) Branch Fixed Assets Account. At the end of the accounting year, it prepares the Branch Adjustment Account and the Branch Profit & Loss Account. This system is used only when goods are invoiced at selling price which the branch is not allowed to vary.

Let us now study the working of each account opened by the head office when such a system is followed.

**Branch Stock Account:** This is the most important account which helps the head office in controlling the branch stock. It shows all branch transactions relating to goods. The goods sent to branches and the sales returns are shown on its debit side,

## Notes

and the sales (both cash and credit) and the goods returned to head office on the credit side. All these items are recorded at the invoice price. Hence, if the figure of any of these items is given at cost, the same should be converted into invoice price before recording it in the Branch Stock Account. The balance of this account would show the unsold goods (stock) lying with the branch. If it is found that the actual stock with the branch is less than the balance shown by the Branch Stock Account, it means that there is a 'shortage' in the stock with the branch. Similarly, if the actual stock with the branch is more than the balance shown by the Branch Stock Account, it would reflect 'surplus'. Both situations warrant investigation. But, so far as their recording goes, the shortage will be shown on the credit side of the Branch Stock Account and if there is surplus, the same will be recorded on its debit side. Then, the balance of the Branch Stock Account will be the exact amount of actual stock with the branch. In other words, while preparing the Branch Stock Account, you will show the actual stock with branch as the balance in this account, and then if the totals of both sides do not tally, you will show the difference as shortage or surplus as the case may be.

**Branch Debtors Account:** This account shows all transactions relating to branch debtors. The credit sales are shown on its debit side, and cash received from debtors, sales returns, bad debts, discount allowed, etc. on the credit side. The balance of this account represents the closing debtors of the branch.

**Branch Expenses Account:** This account shows all expenses incurred by the branch. In addition, the items like bad debts, discount allowed, depreciation on branch fixed assets, etc. are also debited to this account. This account is closed by transfer to the Branch Adjustment Account.

**Branch Cash Account:** This account shows all cash transactions of the branch where the branch is not required to remit all collection of cash immediately to the head office but use it for branch expenses and remit the balance to the head office from time to time. This account helps the head office to keep control over branch cash. Normally, the dependent branch is not allowed the freedom to retain cash collections. Hence, this account need not be maintained.

**Branch Fixed Assets Account:** The head office maintains separate account for each type of branch asset such as furniture, equipment, building, etc. These accounts are prepared in the usual manner. The depreciation on branch fixed assets is, however, debited to Branch Expenses Account and credited to the respective account.

**Goods Sent to Branch Account:** This account is prepared in the same manner as in case of branches to which the goods are sent at the invoice price (Sub-section 1.5.2).

**Branch Adjustment Account:** This account is like a Trading Account of the branch. It is prepared to ascertain the gross profit or gross loss made at the branch by recording the loading (difference between invoice price and cost price) on various items. The loading on branch closing stock and shortage is shown on its debit side while the loading on branch opening stock, goods sent to branch (less returns) and surplus on the credit side. The balance of this account reflects the gross profit or gross loss which is transferred to Branch Profit & Loss Account.

**Branch Profit & Loss Account:** This account is prepared to ascertain the net profit or net loss made at the branch. As stated earlier, the gross profit or gross loss

ascertained by the Branch Adjustment Account is transferred to this account. It is debited with branch expenses as per the Branch Expenses Account and the loss on account of shortage being the cost of such shortage. In case the Branch Stock Account reveals some surplus, the amount equal to the cost of such surplus will be shown on the credit side of the Branch Profit & Loss Account. The balance of the Branch Profit & Loss Account represents the net profit or net loss made at the branch which is transferred to the General Profit & Loss Account.

## Notes

The following journal entries are passed in the head office books for opening the, above accounts relating to the various branch transactions:

1. When goods are sent to the branch (at invoice price)

Branch Stock A/c	Dr.
To Goods Sent to Branch A/c	

2. When goods are returned by the branch to the H.O. (at invoice price)

Goods Sent to Branch A/c	Dr.
To Branch Stock A/c	

3. When sales are made by the branch

(i) For Cash Sales

Cash A/c	Dr.
To Branch Stock A/c	

(ii) For Credit Sales

Branch Debtors A/c	Dr.
To Branch Stock A/c	

4. When cash is received from debtors

Cash A/c	Dr.
To Branch Debtors A/c	

5. For sales returns

Branch Stock A/c	Dr.
To Branch Debtors A/c	

6. For discount allowed, bad debts, etc.

Branch Expenses A/c	Dr.
To Branch Debtors A/c	

7. For shortage of stock

Branch Adjustment A/c	Dr.
(with amount of loading)	

Branch P & L A/c	Dr.
(with cost of shortage)	

To Branch Stock A/c	
---------------------	--

For surplus at branch, the reverse entry will be passed.

8. For Branch expenses paid in Cash

Notes

- Branch Expenses A/c Dr.
- To Cash A/c
- 9. For closing branch expenses account
- Branch P & L A/c Dr.
- To Branch Expenses A/c
- 10. For adjustment of loading on the opening stock
- Stock Reserve A/c Dr.
- To Branch Adjustment A/c
- 11. For adjustment of loading on the closing stock
- Branch Adjustment A/c Dr.
- To Stock Reserve A/c
- 12. For adjustment of loading on net goods sent to branch
- Goods Sent to Branch A/c Dr.
- To Branch Adjustment A/c
- 13. For transfer of gross profit
- Branch Adjustment A/c Dr.
- To Branch P & L A/c
- 14. For transfer of net profit to General Profit & Loss Account
- Branch Adjustment A/c Dr.
- To General P & L A/c

The entry will be reversed if there is net loss.

- 15. For closing the Goods Sent to Branch Account
- Goods Sent to Branch A/c Dr.
- To Trading A/c

Look at Illustration 6 and see how the accounts for various branch transactions are prepared under Stock and Debtors System.

**Illustration 6.** Indiana Traders, Jaipur opened a branch at Jodhpur on 1-7-1987. The goods were sent by the head office to the branch invoiced at selling price of the branch which was 125% of the cost price of the head office.

The following are the particulars relating to the transactions of Jodhpur Branch.

	₹			₹
Goods sent to branch		Cash sent to branch for :		
(at cost to head office)	2,80,000	Wages	3,000	
Sales—Cash	1,24,000	Freight	11,000	
Sales—Cash	1,75,500	Other expenses including		
Cash Collected from debtors	1,56,000	godown rent	6,000	
Discount allowed	4,000			20,000
Spoiled cloth in bales written		Stock on June 30, 1988		55,500
off at invoice price	500	(at invoice price)		

Ascertain the profit or loss for the Jodhpur Branch for the year ended June 30, 1988 by preparing accounts under the Stock and Debtors System.

Branch Accounts

Solution:

### Branch Stock Account

Dr.		Cr.	
Particulars	₹	Particulars	₹
To goods Sent to Branch A/c	3,50,000	By Cash A/c	
To Branch Debtors A/c	5,000	(cash sales)	1,24,000
(sales returns being balancing figure)		By Branch Debtors A/c	
		(credit sales)	1,75,000
		By Branch Adjustment A/c	
		(spoilage-loading)	100
		By Branch P & L A/c	
		(Spoilage-cost)	400
		By Balance c/d	55,550
	3,55,000		3,55,000

Notes

Note: Total of the credit side of Branch Stock A/c exceeds the debit side by ₹ 5,000. It is assumed to-be on account of returns by customers.

### Goods Sent to Branch Account

Particulars	₹	Particulars	₹
To Branch Adjustment A/c	70,000	By Branch Stock A/c	3,50,000
(loading)			
To Trading A/c	2,80,000		
	3,50,000		3,50,000

### Branch Debtors Account

Particulars	₹	Particulars	₹
To Branch Stock A/c	1,75,000	By Cash A/c	1,56,000
		By Branch Stock A/c	
		(returns)	5,000
		By Branch Expenses A/c	
		(discount allowed)	4,000
		By Balance c/d	10,000
	1,75,000		1,75,000

**Branch Expenses Account**

Notes

Particulars	₹	Particulars	₹
To Cash A/c		By Branch P & L A/c	24,000
Wages	3,000		
Freight	11,000		
Other Expenses	6,000		
To Branch Debtors A/c (discount)	4,000		
	24,000		24,000

**Branch Adjust Account**

Particulars	₹	Particulars	₹
To Branch Stock A/c (loading on spoilages)	100	By Goods Sent to Branch A/c (loading)	70,000
To Stock Reserve A/c (loading on closing stock)	11,100		
To Branch Profit & Loss A/c	58,800		
	70,000		70,000

**Branch Profit & Loss Account**

Particulars	₹	Particulars	₹
To Branch Expenses A/c	24,000	By Goods Sent to Branch A/c	58,800
To Branch Stock A/c (Spoilage-cost)	400		
To Net Profit transferred to General P & L A/c	34,400		
	58,800		58,800

It should be noted that if there is any theft or spoilage of goods at the branch, or some goods are lost in transit, these are to be treated in accounts in the same way as the shortage of goods. If, however, some amount is received from the insurance company for such abnormal losses of stock, the same will be credited to the Branch Profit and Loss Account.

**Check Your Progress B**

1. How is the Branch Account prepared under the Debtors System different from the Branch Account prepared under the Final Accounts System.

.....

.....

.....

## 2. Fill in the blanks:

- (i) The closing balance of Branch Account under the Final Accounts System represents.....at the branch.
- (ii) Branch Expenses Account under the Stock and Debtors System is closed by transfer to.....Account.
- (iii) Under Stock and Debtors System, all figures in Branch Stock Account are recorded at.....price.
- (iv) Under Stock and Debtors System,.....Account is credited when the branch returns goods to the head office.
- (v) Under the Stock and Debtors System, Bad Debts are credited to Branch Debtors Account and debited to.....Account.
- (vi) If the balance shown by Branch Stock Account is different from actual stock with the branch, the difference reflects.....

Notes

## 6.8 SUMMARY

- From accounting point of view, each branch is treated as a separate profit centre. Hence, accounting for branch transaction is designed in such a way that profit or loss made at each branch can be correctly worked out and proper control can be exercised over their financial activities. For this purpose, the branches are divided into three categories: (i) branches not keeping full system of accounting (dependent branches), (ii) branches keeping full system of accounting (independent branches), and (iii) foreign branches.
- Where branches do not keep full system of accounting, the head office has to maintain proper record of branch transactions. There are three methods that can be followed for this purpose: (i) Debtors System, (ii) Final Accounts System, and (iii) Stock and Debtors System.
- Debtors System is usually adopted for small branches which merely act as sales depots. Under this system, the head office simply opens a Branch Account for each branch in which it records all related transactions. The Branch Account is maintained like a Consignment Account which also helps in ascertaining the profit or loss made by the branch.
- Under the Final Accounts System of maintaining branch accounts, the head office prepares, a Memorandum Trading and Profit & Loss Account for each branch from the data provided by the branch and ascertains its profit or loss for the accounting period. Then it also maintains a Branch Account for recording mutual transactions between the head office and the branch which finally reveals the amount due to, or due from, the branch. Its balance, in fact, will be equal to the net assets with the branch.
- Stock and Debtors System is followed where the goods are invoiced to the branch at selling price. Under this system, no Branch Account is opened. The head office maintains (i) Branch Stock Account, (ii) Branch Expenses Account, (iii) Goods Sent to Branch Account, and (iv) Branch Fixed Assets Account. At the end of the accounting period, it prepares Branch Adjustment Account and Branch Profit and Loss Account for ascertaining the branch gross profit/gross loss and the net profit/net loss respectively. This system also enables the head office to exercise effective control on branch stock.

## 6.9 REVIEW QUESTIONS

### Questions

1. What are the objectives of keeping branch accounts?
2. Name the three systems of maintaining the accounts of a dependent branch and describe how profit is ascertained under each system.
3. Explain how Branch Stock Account helps in keeping effective control over the branch stock.

### Exercises

1. Kabir & Co. of Moradabad have their branch, at Kanpur. The following are the transactions relating to the branch for the year ending December 31, 1988:

	₹
Opening Stock on January 1, 1988	20,000
Goods supplied to Branch	50,000
Cash sent to Branch for :	
Rent	200
Other Expenses	100
	300
Cash received from Branch during the year	60,000
Closing Stock on December 31, 1988	15,000
Closing balance of Petty Cash on December 31, 1988	10

From the above information, pass the necessary journal entries and prepare Kanpur Branch Account and other necessary accounts in the books of the Head Office.

(Answer: Branch Net Profit ₹ 4,710)

2. A Meerut Company has a retail branch in Kota which is supplied with all goods from Meerut. The branch keeps its own Sales Ledger, receives cash against the ledger accounts and remits the whole of the cash received daily to the head office. All wages and branch expenses are drawn by cheque weekly from the Head Office upon the imprest system. From the under mentioned particulars supplied by the Branch Manager, show how the Branch Account would appear in the Head Office books as on December 31, 1988.

Particulars	₹	Particulars	₹
Six month's credit sales	2,387	Stock December 31, 1988	1,121
Return inwards	20	Debtors July 1, 1988	1,227
Cash received on Ledger accounts	2,384	Goods received from Head Office	2,178
Cash Sales	1,214	Rent, Taxes etc. paid	375

Notes

Stock July 1, 1988	720	Sundry Expenses	396
Bad Debts	100		

(Answer: Net Profit ₹ 933; Missing Figure; Closing Debtors ₹ 1,110)

3. Royal Store of Kanpur opened a selling branch at Madras on July 1, 1988. Goods are sent to branch from the head office at cost plus 25%. The branch is advised to deposit cash every day in the bank in head office account. From the following particulars, prepare Branch Account in the books of head office for the period ending December 31, 1988. Petty Cash at branch is maintained on imprest system.

Notes

Particulars	₹	Particulars	₹
Cash sent to branch for meeting petty expenses	1,500	Cash sales by the branch	80,000
Furniture purchased for the branch	12,000	Credit sales during 6 month	30,000
Goods sent to branch at invoice price	1,60,000	Cash received from the debtors	22,000
Expenses paid by the Head Office:		Discount allowed to debtors	400
Rent	2,200	Goods returned by debtors (at invoice price)	800
Advertisement	800	Bad debts written off	100
Salaries	4,600	Petty expenses paid by the branch	1,000
Insurance (up to June 30, 1989)	400	Stock at invoice price on December 31 (excluding stock received from debtors)	40,000

Provide depreciation on furniture at 10% p.a.

(Answer: Profit ₹ 3,940; Debtors at the end ₹ 6,700)

4. X Ltd. of Bombay has a branch in Delhi. The head office sends goods to the branch at cost plus 50%. From the following data, prepare the necessary accounts in the books of head office under Stock and Debtors System.

Goods sent from Head Office (at invoice price)	₹ 50,000	Credit Sales	₹ 8,000
Returns to Head Office	1,000	Opening Stock	10,000
Cash Sales	35,500	Closing Stock	11,000

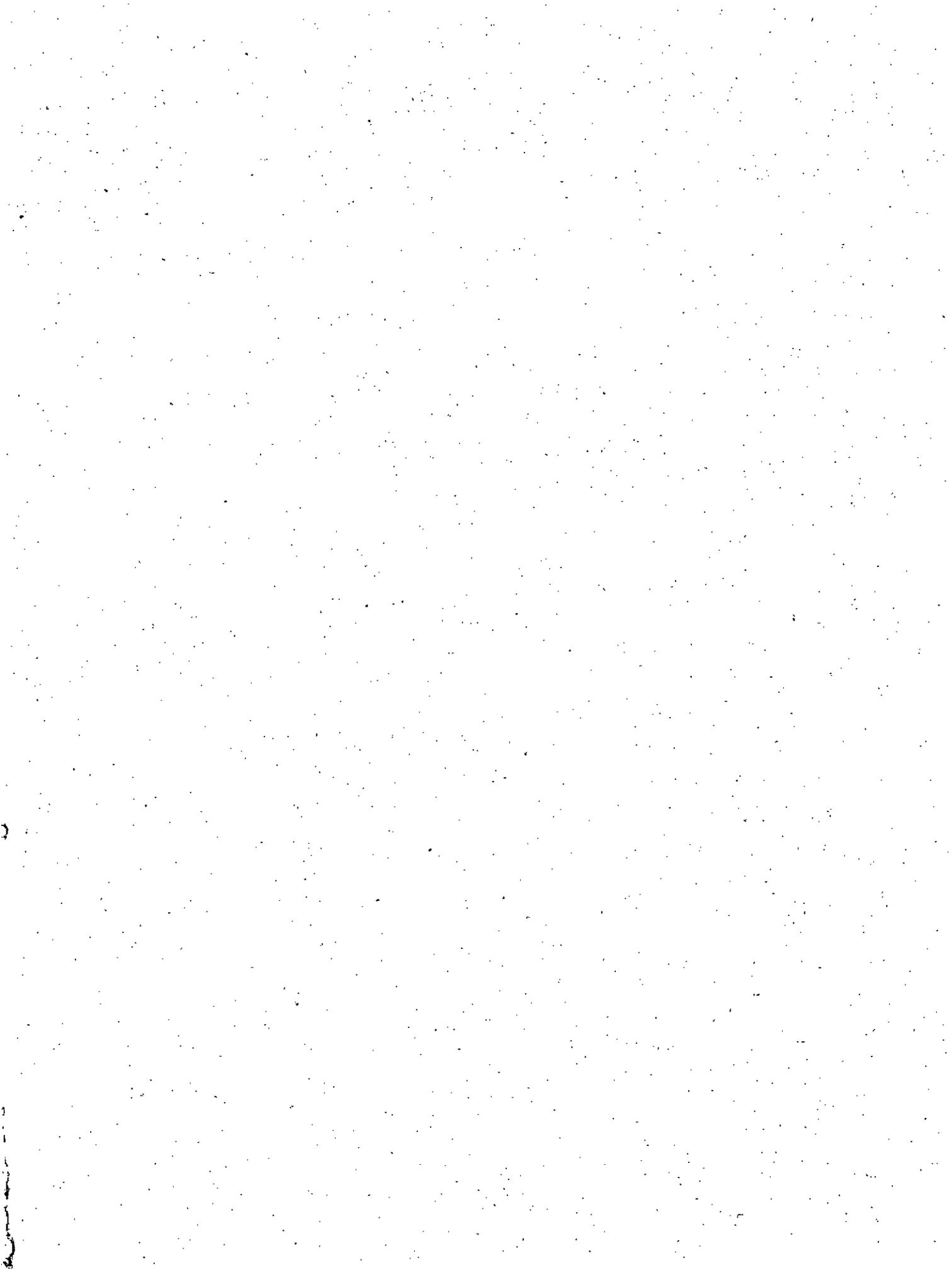
(Answer: Profit ₹ 11,500; Shortage of Goods ₹ 4,500)

5. Shyam Brothers of Delhi has a branch at Hyderabad. In order to maintain strict control over stocks, it invoices goods to the branch at selling price including profit of 25% on selling price. From the following particulars, prepare Branch Stock Account, Branch Debtors Account, Goods Sent to Branch Account, Branch Adjustment Account, and Branch Profit and Loss Account.

Notes

	₹
Stock January 1, 1989	30,000
Debtors on January 1, 1989	22,800
Goods invoiced to Branch at invoice price	1,34,000
Sales at the branch	
Cash	62,000
Credit	74,800
Cash received from Debtors	80,000
Bad Debts written off	500
Discount allowed to customers	600
Expenses at the branch	13,400
Stock on December 31, 1989.	26,800

(Answer: Gross Profit ₹ 34,200; Net Profit ₹19,400)



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