STUDY MATERIAL

FOUNDATION PROGRAMME

FUNDAMENTALS OF ACCOUNTING AND AUDITING

PAPER 4

THE INSTITUTE OF
Company Secretaries of India
IN PURSUIT OF PROFESSIONAL EXCELLENCE
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FOUNDATION PROGRAMME – IMPORTANT NOTE

The study material has been written in lucid and simple language and conscious efforts have been made to explain the fundamental concepts and principles of accounting and auditing. This study material is divided into two main parts –

Part-A Fundamentals of Accounting, and

Part-B Fundamentals of Auditing

There is computer based examination for the Foundatian Programme. Where Student are required to answer multiple choice questions.

For supplementing the information contained in the study material, students may refer to the economic and financial dailies, commercial, legal and management journals, Economic Survey (latest), CS Foundation Course e-Bulletin, Suggested Readings and References mentioned in the study material and relevant websites.

The objective of the study material is to provide students with the learning material according to the syllabus of the subject of the Foundation Programme. In the event of any doubt, students may write to the Directorate of Studies in the Institute for clarification at **academics@icsi.edu**

Although due care has been taken in preparing and publishing this study material, yet the possibility of errors, omissions and/or discrepancies cannot be ruled out. This publication is released with an understanding that the Institute shall not be responsible for any errors, omissions and/or discrepancies or any action taken on the basis of contents of the study material.

Should there be any discrepancy, error or omission noted in the study material, the Institute shall be obliged if the same are brought to its notice for issue of corrigendum in the e-Bulletin CS Foundation Course.

SYLLABUS

PAPER 4: FUNDAMENTALS OF ACCOUNTING AND AUDITING

Level of Knowledge: Basic Knowledge

Objective: *To familiarize and develop an understanding of the basic aspects of accounting, auditing concepts and their principles.*

PART A: FUNDAMENTALS OF ACCOUNTING (70 MARKS)

1. **Theoretical Framework**
   - Meaning and Scope of Accounting; Accounting Concepts; Accounting Principles, Conventions and Standards
   - Concepts, Objectives, Benefits; Accounting Policies; Accounting as a Measurement Discipline
   - Valuation Principles, Accounting Estimates
2. **Accounting Process**
   - Documents & Books of Accounts: Invoice, Vouchers, Debit & Credit Notes, Day books, Journals, Ledgers and Trial Balance
   - Capital and Revenue: Expenditures and Receipts; Contingent Assets and Contingent Liabilities
   - Rectification of Errors
3. **Bank Reconciliation Statement**
   - Meaning; Causes of difference between Bank Book Balance and Balance as per Bank Pass Book/Bank Statement; Need of Bank Reconciliation Statement; Procedure for Preparation of Bank Reconciliation Statement
4. **Depreciation Accounting**
   - Brief of various Methods, Computation and Accounting Treatment of Depreciation (Straight line and Diminishing Balance Method); Change in Depreciation Methods
5. **Preparation of Final Accounts for Sole Proprietors**
   - Preparation of Profit & Loss Account, Balance Sheet
6. **Partnership Accounts**
   - Goodwill
   - Nature of Goodwill and Factors Affecting Goodwill
   - Methods of Valuation: Average Profit, Super Profit and Capitalization Methods
   - Treatment of Goodwill
   - Final Accounts of Partnership Firms
   - Admission of a Partner
   - Retirement/Death of a Partner

- Dissolution of a Partnership Firm

7. **Joint Venture and Consignment Account**
8. **Introduction to Company Accounts**
   - Issue of Shares and Debentures; Forfeiture of Shares; Re-Issue of Forfeited Shares; Redemption of Preference Shares
9. **Accounting for Non-Profit Organisations**
   - Receipt and Payment Accounts
   - Income and Expenditure Accounts
10. **Computerized accounting environment:**

    Basic Utility of SAP, TALLY, ERP

PART B: FUNDAMENTALS OF AUDITING (30 MARKS)

11. **Auditing**
    - Concepts and Objectives
    - Principles of Auditing
    - Types of Audit
    - Evidence in Auditing
    - Audit Programmes
12. **Audits and Auditor's Reports**
    - Internal Audit
    - Statutory Auditor: Appointment, Qualification, Rights and Duties
    - Secretarial Audit: An Overview
    - Cost Audit: An Overview
    - Reporting: Types, Meaning, Contents, Qualifications

LIST OF RECOMMENDED BOOKS*

PAPER 4 : FUNDAMENTAL OF ACCOUNTING AND AUDITING

READINGS

1.	M. C. Shukla, T. S. Grewal & S. C. Gupta	Advanced Accounts Vol. I, S. Chand & Company Ltd., Ram Nagar, New Delhi-55.
2.	R. L. Gupta & V. K. Gupta	Financial Accounting, Sultan Chand & Sons, New Delhi - 2.
3.	J. R. Monga	Financial Accounting – Concepts & Applications; Mayoor Paperbacks, A-95, Sector 5, Noida (U.P.)
4.	S. N. Maheshwari & S. K. Maheshwari	Advanced Accounting, Volume I; Vikas Publishing House (Pvt.) Ltd., Jangpura, New Delhi-14.
5.	S. P. Jain & K. L. Narang	Advanced Accounting, Volume I; Kalyani Publishers, Daryaganj, New Delhi - 2.
6.	Ashok Sehgal & Deepak Sehgal	Advanced Accounting (Financial Accounting); Taxmann's, New Delhi.
7.	Aruna Jha	Student's Guide to Auditing & Assurance, Taxmann Publications Pvt. Ltd., New Rohtak Road, New Delhi.
8.	S. D. Sharma	Auditing Principles & Practice, Taxmann Publications Pvt. Ltd., New Rohtak Road, New Delhi.
9.	Anand G. Srinivasan	Auditing, Taxmann Publications Pvt. Ltd., New Rohtak Road, New Delhi.
10.	S. Sundharababu,	A Handbook of Practice Auditing, S. Chand, S. Sundharsanam, B.N. Tondon & Company, New Delhi
11.	A K Nadhani & K K Nadhani	Real Accounting Software:Link With Tally, BPB Publication

REFERENCES

1.	T. P. Ghosh, A. Banerjee & K.M. Bansal	Principles and Practice of Accounting, Galgotia Publishing Company, New Delhi-5.
2.	P. C. Tulsian	Financial Accounting, Sultan Chand & Company, New Delhi.
3.	R. Narayanaswamy	Financial Accounting – A Managerial Prospective; PHI Learning Pvt. Ltd.
4.	Ashish K. Bhattacharyya	Essentials of Financial Accounting; PHI Learning Pvt. Ltd.

*This study material sufficient from the point of view of syllabus. The students may refer latest edition of these books for further knowledge and study of the subject.

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PART A
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LEARNING OBJECTIVES

In today's business world, accounting is considered as 'the universal language of business', because it is the vehicle for reporting financial information about a business entity to users such as shareholders and managers. A proper accounting system is essential to any business, whether big or small, in order to manage its daily functions and run it successfully. The main obligation of any business is to maximize profits, minimize losses and at the same time maintain its position as a responsible entity within the society.

So, in the current business world, everybody should have the knowledge of accounting discipline irrespective of the job one is doing. Due to the rapid advancement in business activities due to industrialization and globalization, the need for people having knowledge of accounts have increased manifold. It is impossible to survive in today's advanced business environment without adequate knowledge of basic accountancy.

Especially all business students should have some background in accounting to understand and interpret and present the results of business.

Lesson 1
Theoretical Framework

LESSON OUTLINE

- Accounting
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LEARNING OBJECTIVES

Accounting is a very old concept – as old as money. A description of proper keeping of accounts is also found in 'Arthashastra" written by Kautilya. However, it has developed with the passage of time to meet the requirements and challenges of ever – growing society. The modern-day accounting concept based on double entry system was originated by Luca Pacioli in Italy. Though the act of accounting is very old, in recent times it has acquired special significance because of rapidly growing economy, cut-throat competition, expanding markets, increasing production and changes in technology.

In this lesson, we will throw light on the basic concepts of accounting, types of accounts, accounting principles, conventions, concepts & standards, meaning of double entry system and the rules of debit & credit on which the entire concept of accounting is based.

The system of book keeping by double entry is, perhaps the most beautiful one in the wide domain of literature or science.

Edwin T. Freedley

ACCOUNTING

Accounting is used by business entities for keeping records of their monetary or financial transactions. A businessman who has invested money in his business would like to know whether his business is making a profit or incurring a loss, the position of his assets and liabilities and whether his capital in the business has increased or decreased during a particular period.

Definition

The definition given by the American Institute of Certified Public Accountants ('AICPA') clearly brings out the meaning of accounting. According to it, accounting is "*the art of recording, classifying and summarizing in a significant manner and in terms of money, transactions and events which are, in part at least, of a financial character and interpreting the results thereof*". The definition brings out the following attributes of accounting :

(i) Accounting is classified as an art, as it helps us in attaining our aim of ascertaining the financial results, that is to know the operating profit and financial position through analysis and the interpretation of financial data which requires special knowledge, experience and judgment.

(ii) It involves recording, classifying and summarizing. Recording means systematically writing down the transactions in accounting books soon after their occurrence. Classifying is the process of accounting grouping transactions or entries of the same type at one place. This is done by opening accounts in a book called ledger. Summarizing involves the preparation of reports and statements from the classified accounts (ledger),that are understandable and useful to the management and other interested parties. This involves preparation of final accounts namely profit and loss account and balance sheet.

(iii) It records transactions in terms of money. All transactions are recorded in terms of common measure i.e. money.

(iv) It records only those transactions and events which are of financial character. If an event has no financial character then it will not be capable of being measured in terms of money ; it will not be, therefore, recorded.

(v) It is the art of interpreting the results of operations to determine the financial position of the enterprise, the progress it has made and how well it is getting along.

Stages of Accounting

Accounting has the following stages:

(i) The transactions of a business that have, at least in part, a financial character are identified and recorded.

(ii) The recording is done in a manner which identifies the different classes and types of transactions.

(iii) The resulting records are summarized in such a way that the owners or other interested parties in the business can see the overall effects of all the transactions. The statements prepared by the summarizing process are known as financial statements which will show the profit or loss made by the business over a period of time and the position of its the assets and liability on a particular data. Such financial statements are used by management to make business decisions.

Branches of Accounting

Accounting has three main forms or branches viz. financial accounting, cost accounting and management accounting.

(i) *Financial Accounting*: It is concerned with record-keeping directed towards the preparation of trial balance, profit and loss account and balance sheet.

(ii) *Cost Accounting*: Cost accounting is the process of accounting for costs. It is a systematic procedure for determining the unit cost of output produced or services rendered. The main functions of cost accounting are to ascertain the cost of a product and to help the management to adopt measure to control cost.

(iii) *Management Accounting:* Management accounting is primarily concerned with the supply of information which is useful to the management in decision-making, increasing efficiency of business and maximizing profits.

Functions of Accounting

The following are the main functions of accounting:

(i) *Keeping Systematic Records*: Accounting is done to keep a systematic record of financial transactions.

(ii) *Protecting and Controlling Business Properties*: Accounting helps to see that there is no unauthorized use or disposal of any assets or property belonging to the firm, because proper records are maintained. Accounting will furnish information about money due from various persons and money due to various parties. The firm can see that all amounts due to it are recovered in due time and that no amount is paid unnecessarily.

(iii) *Ascertaining the Operational Profit/Loss*: Accounting helps to determine the results of the activities in a given period, usually a year, i.e. to show how much profit has been earned or how much loss has been incurred during the year. This is done by keeping a proper record of revenues and expenses of a particular period and then matching the revenues with the corresponding costs.

(iv) *Ascertaining the Financial Position of the Business*: Balance sheet is prepared to ascertain the financial position of the firm at the end of a particular period. It shows the values of the assets and the liabilities of the business entity.

(v) *Facilitating Rational Decision Making:* Accounting facilitates collection, analysis and reporting of information at the required point of time to the required levels of authority in order to facilitate rational decision making.

Advantages of Accounting

The following are the advantages of accounting:

(i) *Maintenance of Business Records*: All financial transactions are recorded in a systematic manner in the books of accounts so that there is no need to depend upon on memory. It is impossible to remember the business transactions which have grown in size and complexity.

(ii) *Preparation of Financial Statements*: Proper recording of transactions facilitates the preparation of financial statements i.e. the trading and profit and loss account and balance sheet.

(iii) *Comparison of Results*: Accounting information when properly recorded can be used to compare the results of one year with those of earlier years so that the significant changes can be analyzed.

(iv) *Decision Making*: Accounting information helps the management to plan its future activities by preparing budgets and coordination of various activities in different departments.

(v) *Evidence in Legal Matters*: Properly recorded accounting information can be produced as evidence in a court of law.

(vi) *Provides Information to Interested Parties*: Interested parties like owners, creditors, management, employees, customers, government, etc. can get financial information about the organisation.

(vii) *Helps in Taxation Matters*: Income tax and/sales tax authorities depend for taxation matter on the accounts maintained by the business.

(viii) *Valuation of Business*: When the business is to be sold, the accounting information can be utilized to determine the proper value of business.

(ix) *Replacement of memory*: No need to remember transaction as it is recorded.

Limitations of Accounting

The following are the limitations of accounting:

(i) *Accounting information is expressed in terms of money*: The accountant measures only those events that are of financial nature i.e. capable of being expressed in terms of money. Non-monetary items or events which cannot be measured are not recorded in accounting.

(ii) *Accounting information is based on estimates*: Some accounting data are based on estimates and some estimates may be inaccurate.

(iii) *Accounting information may be biased*: Accounting information is not without personal influence or bias of the accountant. In measuring income, accountant has a choice between different methods of inventory valuation, deprecation methods, treatment of capital and revenue items etc. Hence, due to the lack of objectivity income arrived at may not be correct in certain cases.

(iv) *Fixed assets are recorded at the original cost*: The values of fixed assets change over time and so there may be a great difference between the original cost and current replacement cost. Balance sheet may not show true and fair view of the financial position on a particular date.

(v) *Accounting can be manipulated*: Accounting information may not be used as the only test of managerial performance as profits can be manipulated or misrepresented.

(vi) *Money as a measurement unit changes in value*: The value of money does not remain stable. Unless price level changes are considered in measurement of income, the accounting information will not show true financial results.

REVIEW QUESTIONS

1. Accounting records only those transactions and events which are of __________character.

(a) Qualitative (b) Quantitative (c) Both (d) None

2. ____________ is concerned with record-keeping directed towards the preparation of trial balance, profit and loss account and balance sheet.

(a) Financing Accounting (b) Cost Accounting

(c) Management Accounting (d) Human Resource Accounting

3. The main function of cost accounting is to ascertain the _____________ of a product.

(a) Cost (b) Price (c) Profit (d) Cost control

4. Fixed assets are recorded at _______________.

(a) Book value (b) Market value (c) Historical cost (d) Replacement cost

5. Accounting information is expressed in terms of ___________.

(a) Money (b) Goods

BOOK-KEEPING

Book-keeping is mainly concerned with recording of financial data relating to the business operations in a significant and orderly manner. It is concerned with the permanent recording of all transactions in a systematic manner to show its financial effect on the business. It covers procedural aspects of accounting work and includes record keeping function. It is the science and art of correctly recording in books of account all those business transactions that result in the transfer of money or money's worth. It is mechanical and repetitive. This work of book–keeping is of clerical nature and usually entrusted to junior employees of accounts section of a business house. Now-a-days, most of the book-keeping work is done through computers and other electronic devices. In fact, accounting is based on a systematic and efficient book-keeping system. The main purpose behind book-keeping is to show correct position regarding each head of income and expenditure as well as assets and liabilities. Further, book-keeping is meant to show the effect of all the transactions made during the accounting period on the financial position of the business.

Book-Keeping and Accounting

Book-keeping and accounting are often used interchangeably but they are different from each other. Accounting is a broader and more analytical subject. It includes the design of accounting systems which the book-keepers use, preparation of financial statements, audits, cost studies, income-tax work and analysis and interpretation of accounting information for internal and external end-users as an aid to making business decisions. This work requires more skill, experience and imagination. The larger the firm, the greater is the responsibility of the accountant. It can be said that accounting begins where book-keeping ends. Book-keeping provides the basis for accounting.

The following are the points of distinction between book-keeping and accounting:

DIFFERNCE BETWEEN BOOK-KEEPING AND ACCOUNTING

Book-keeping	***Accounting***
(i) It is concerned with the recording of transactions.	(i) It is concerned with the summarizing of the recorded transactions.
(ii) The work of book-keeping is mainly routinal and clerical in nature and is increasingly being done by computers.	(ii) The work of accountant requires higher level of knowledge, conceptual understanding and analytical skill.
(iii) Book-keeping constitutes the base for accounting.	(iii) Accounting starts where book keeping ends.
(iv) Book-keeping is done in accordance with basic accounting concepts and conventions.	(iv) The methods and procedures for accounting for analysis and interpretations for financial reports may vary from firm to firm.
(v) Financial statements do not form part of book-keeping.	(v) Financial statements are prepared in accounting process from the book-keeping records.
(vi) Financial position of the business cannot be ascertained through book-keeping records.	(vi) Financial position of the business is ascertained on the basis of accounting reports.

SYSTEMS OF ACCOUNTING

Basically there are two systems of accounting:

Cash System of Accounting: It is a system in which accounting entries are made only when cash is received or paid. No entry is made when a payment or receipt is merely due. In other words, it is a system of accounting in which revenues and costs and assets and liabilities are reflected in the accounts in the period in which actual payments or actual receipts are made in cash. It may not treat any revenue to have been earned or even sales to have taken place unless cash is actually paid by customers. It has no relevance whether the receipts pertain to previous period or future period. Similarly, expenses are restricted to the actual payments in cash during the current year and it is immaterial whether the payments have been made for previous period or future period.

Cash basis of accounting is incompatible with the matching principle of income determination. Hence, the financial statements prepared under this system do not present a true and fair view of operating results and financial position of the organization. However, cash system of accounting is suitable in the following cases:

(i) Where the organization is very small or in the case of individuals, where it is difficult to allocate small amounts between accounting periods; and

(ii) Where credit transactions are almost negligible and collections are uncertain e.g. accounting in case of professionals i.e. doctors, lawyers, firms of chartered accountants/company secretaries. But while recording expenses, they take into account the outstanding expenses also. In such a case, the financial statement prepared by them for determination of their income is termed as Receipts and Expenditure Account.

Accrual System of Accounting: This is also known as mercantile system of accounting. It is a system in which transactions are recorded on the basis of amounts having become due for payment or receipt. Accrual basis of accounting attempts to record the financial effects of the transactions, events, and circumstances of an enterprise in the period in which they occur rather than recording them in period(s) in which cash is received or paid by the enterprise. It recognizes that the buying, selling and other economic events that affect enterprise's performance often do not coincide with the cash receipts and payments of the period. The purpose of accrual basis accounting is to relate the revenue earned to cost incurred so that reported net income measures an enterprise's performance during a period instead of merely listing its cash receipts and payments. Accrual basis of accounting recognizes assets, liabilities or components of revenues and expenses received or paid in cash in past and expected to be received or paid in cash in the future. The following are the essential features of accrual basis:

- Revenue is recognized as it is earned irrespective of whether cash is received or not;
- Costs are matched against revenues on the basis of relevant time period to determine periodic income, and
- Costs which are not charged to income are carried forward and are kept under continuous review. Any cost that appears to have lost its utility or its power to generate future revenue is written off as a loss.

ACCOUNTING AS INFORMATION SYSTEM

Accounting, being the language of business, is used to communicate financial and other information to individuals, organizations, governments etc. about various aspects of business and non-business entities. For example, when a firm applies for a loan from a bank, it will have to submit details of its business activities in terms of operating results (profit or loss) and the financial position (assets and liabilities). Similarly, the shareholders or prospective investors must have financial information in order to evaluate the performance of the management. Many laws require that extensive financial information be reported to various government departments such as income-tax department, sales tax department, company law board and so on. Accounting is a discipline that collects reports and interprets financial information about the activities of different organizations. Hence, actual accounting is concerned with communicating the results of an organization.

Users of Accounting Information

Accounting is of primary importance to the proprietors and the managers. However, other persons such as creditors, prospective investors, etc. are also interested in the accounting information.

(i) *Owners/Shareholders*: The primary aim of accounting is to provide necessary information to the owners related to their business.

(ii) *Managers*: In large business organizations and in corporations, there is a separation of ownership and management functions. The managers of such business houses are more concerned with the accounting information because they are answerable to the owners.

(iii) *Prospective Investors*: The persons who are contemplating an investment in a business will like to know about its profitability and financial position. They derive this information from the accounting reports of the concern.

(iv) *Creditors, Bankers and other Lending Institutions*: Trade creditors, bankers and other lending institutions would like to be satisfied that they will be paid on time. The financial statements help them in judging such position. Banks and other lending agencies rely heavily upon accounting statements for determining the acceptability of a loan application.

(v) *Government*: The Government is interested in the financial statements of business enterprise on account of taxation, labour and corporate laws.

(vi) *Employees*: Employees are interested in financial statements because increase in their salaries and wages and payment of bonus depends on the size of the profit earned.

(vii) *Regulatory Agencies*: Various Government departments and agencies such as Company Law Board, Registrar of Companies, Tax Authorities etc. use accounting reports not only as a basis for tax assessment but also in evaluating how well various businesses are operating under regulatory legislation.

(viii) *Researchers*: Accounting data are also used by the research scholars in their research in accounting theory as well as business affairs and practices.

(ix) *Customers*: Customers may also have either short-term or long-term interest in the business entity to know the profitability, liquidity and solvency position of the company.

Characteristics of Accounting Information

The various characteristics of accounting information are as follows:

(i) *Relevance*: The information should be relevant in order to influence the economic decisions of users by helping them to evaluate the events at all times. Accounting information has a bearing on decision making by helping investors, creditors and other users to evaluate past and future events. It confirms or corrects prior expectations. The relevance of information is affected by its nature and materiality.

(ii) *Reliability*: Reliability relates to the confidence in the accounting information in the sense that the information must faithfully represent what it intends to present; it must be factual. Information should be free from material errors and bias. The key aspects of reliability are faithful representation, substance over form, neutrality, prudence and completeness.

(iii) *Comparability*: Accounting information of an enterprise is useful when it is comparable with similar information for the same enterprise in other periods of time and similar information regarding other enterprises at the same time. Thus, the information should be presented in a consistent manner over time and consistent between entities to evolve users to make significant comparisons.

(iv) *Understandability*: Information should be readily understandable by users who are expected to have a reasonable knowledge of business, economics and accounting and a willingness to study the information with reasonable diligence.

(v) *Timeliness*: The more quickly the information is communicated or provided to the users, the more likely it is to influence their decisions. Hence, for prompt decision-making accounting information should be made available at appropriate time without delays.

(vi) *Cost-benefit*: The accounting information must be useful to most of the people who want to use it and preparation of that useful information must not be a costly and time consuming process. The emphasis is on cost-benefit consideration and the benefit derived from information should normally exceed the cost of providing it.

(vii) *Verifiability*: Verifiability ensures the truthfulness of the recorded transactions, which can be checked by persons other than the accountant himself.

(viii) *Neutrality*: Accounting information is neutral in the sense that it should be free from bias and it should not favour one group over another. Neutrality is significant especially for the external users of accounting information.

(ix) *Completeness*: Completeness means that all material information that is necessary to investors, creditors or other users for assessing the financial position and operating results of the organization has been disclosed in the financial statements.

ROLE OF ACCOUNTANT

The role of accountant may be summarized as under:

(i) *Maintenance of Books of Accounts*: The primary role of an accountant is to offer his services for maintaining systematic records of financial transactions in order to ascertain the net profit or loss for the accounting period and the financial position as on a particular date.

(ii) *Statutory Audit*: Every limited company is required to appoint a chartered accountant as an auditor who is statutorily required to report each year whether the financial statements have been prepared in accordance with the generally accepted accounting principles, accounting standards and legal requirements and that they show a true and fair view of the financial position and profit and loss.

(iii) *Internal Audit*: In addition to statutory audit, a big company employs its own staff to conduct internal audit to ensure that the transactions are recorded, classified and summarized in accordance with the established accounting procedures to ensure that instructions of the management are being followed throughout the company.

(iv) *Budgeting*: Budgeting means the planning of business activities before they occur. On completion of the actual activities for a given period, the planned activities are compared with the actual activities to find out the variation, if any.

(v) *Taxation*: An accountant can handle the taxation matters of a business and can represent before the tax authorities and settle the tax liability under the prevailing statute. He also assists in reducing the tax burden by proper tax planning.

(vi) *Investigation*: Accountants are often called upon to carry out investigation to ascertain the financial position of the business for the information of interested parties.

(vii) *Management Advisory Service*: An accountant is largely responsible for internal reporting to the management for planning, controlling, decision-making on matters for long-term plans. He provides management consultancy services in the areas of management information systems, expenditure control and evaluation of appraisal techniques.

(viii) *Other Activities*: Accountants among many other duties perform duties of arbitrator for settling of disputes, liquidators, cost accountants, etc.

ACCOUNTING PRINCIPLES, CONCEPTS AND CONVENTIONS

Accounting Principles

Accounting is often called the language of business through which a business house communicates with the outside world. In order to make this language intelligible and commonly understood by all, it is necessary that it should be based on certain uniform scientifically laid down standards. These standards are termed as accounting principles.

Accounting principles have been defined as "the body of doctrines commonly associated with the theory and procedure of accounting, serving as an explanation of current practices and as a guide for the selection of conventions or procedures where alternatives exist".

In short, accounting principles are guidelines to establish standards for sound accounting practices and procedures in reporting the financial status and periodic performance of a business. These principles can be classified into two categories (i) Accounting concepts; and (ii) Accounting conventions.

Accounting Concepts

Accounting concepts are defined as basic assumptions on the basis of which financial statements of a business entity are prepared. They are used as a foundation for formulating various methods and procedures for recording and presenting the business transactions. The important accounting concepts are given below:

(i) *Business Entity Concept*: According to this concept, business is treated as an entity separate from its owners. It is treated to have a distinct accounting entity which controls the resources of the concern and is accountable thereof. Accounts are kept for a business entity as distinguished from the person(s) owning it. All transactions of the business are recorded in the books of the business from the point of view of the business. Transactions are also recorded between the owner and the business, for instance, when capital is provided by the owner, the accounting record will show the business as having received so much money and as owing to the proprietor. This concept is based on the sense that proprietors entrust resources to the management and the management is expected to use these resources to the best advantage of the firm and to account for the resources placed at its disposal. Hence, in accounting for every type of business organization, be it sole tradership or partnership or joint stock company, business is treated as a separate accounting entity.

The failure to recognize the business as a separate accounting entity would make it extremely difficult to evaluate the performance of the business since the private transactions would get mixed with business transaction. The overall effect of adopting this concept is:

- Only the business transactions are recorded and reported and not the personal transactions of the owners.
- Income or profit is the property of the business unless distributed among the owners.
- The personal assets of the owners or shareholders are not considered while recording and reporting the assets of the business entity.

(ii) ***Money Measurement Concept***: Money measurement concept holds that accounting is a measurement and communication process of the activities of the firm that are measurable in monetary terms. Thus, only such transactions and events which can be interpreted in terms of money are recorded. Events which cannot be expressed in money terms do not find place in the books of account though they may be very important for the business. Non-monetary events like, death, dispute, sentiments, efficiency etc. are not recorded in the books, even though these may have a great effect. Accounting therefore, does not give a complete account of the happenings in a business or an accurate picture of the conditions of the business. Thus, accounting information is essentially in monetary terms and quantified.

The system of accounting treats all units of money as the same irrespective of their time dimension. This has created doubts about the utility of the accounting data, leading to the introduction of inflation accounting.

(iii) ***Cost Concept***: According to cost concept, the various assets acquired by a concern or firm should be recorded on the basis of the actual amounts involved or spent. This amount or cost will be the basis for all subsequent accounting for the assets. The cost concept does not mean that the assets will always be shown at cost. The fixed asset will be recorded at cost at the time of its purchase but it may systematically be reduced in its value by charging depreciation. These assets ultimately disappear from the balance sheet when their economic life is over and they have been fully depreciated and sold as scrap. It may be noted that if nothing has been paid for acquiring something, it would not be shown in the accounting books as an asset.

Cost concept is not much relevant for investors and other users because they are more interested in knowing what the business is actually worth today rather than the original cost.

(iv) ***Going Concern Concept***: Business transactions are recorded on the assumption that the business will continue for a long-time. There is neither the intention nor the necessity to liquidate the particular business venture in the foreseeable future. Therefore, it would be able to meet its contractual obligations and use its resources according to the plans and pre-determined goals. It is on this concept that a clear distinction is made between assets and expenses. Transactions are recorded in such a manner that the benefits likely to accrue in future from money spent now or the future consequences of the events occurring now are also taken into consideration. It is because of this concept that fixed assets are valued on the basis of cost less proper depreciation keeping in mind their expected useful life ignoring fluctuations in the prices of these assets.

However, if it is certain that a business will continue for a limited period, then the accounting records will be kept on the basis of expected life of the business and there will be no need for such detailed accounting information as to revenue and capital expenditure.

When an enterprise liquidates a branch or one segment of its operations, the ability of the enterprise to continue as a going concern is not impaired. But the enterprise will not be considered as a going concern if it goes into liquidation or it has become insolvent. If the assumption of the going concern is not valid, the financial statements should clearly state this fact.

(v) ***Dual Aspect Concept***: This concept is based on double entry book-keeping which means that accounting system is set up in such a way that a record is made of the two aspects of each transaction that affects the records. The recognition of the two aspects to every transaction is known as dual aspect concept. Modern financial accounting is based on dual aspect concept. One entry consists of debit to one or more accounts and another entry consists of credit to some other one or more accounts. However, the total amount debited is always equal to the total amount credited. Therefore, at any point of time total assets of a business are equal to its total liabilities. Liabilities to outsiders are known as liabilities, but a liability to owners is referred to as capital. Thus, this concept expresses the relationship that exists among assets, liabilities and the capital in the form of an accounting equation which is as follows:

Assets = Liabilities + Capital, or

Capital = Assets – Liabilities

Since accounting system requires recording of the two aspects of each transaction, this concept shows the effect of each transaction on them. Assets and liabilities are two independent variables and capital is the dependent variable, for it is the difference between assets and liabilities. Any change in any one of these three, must lead to a change in any of the other two.

(vi) *Realisation Concept*: According to this concept revenue is recognised only when a sale is made. Unless money has been realised i.e., cash has been received or a legal obligation to pay has been assumed by the customer, no sale can be said to have taken place and no profit can be said to have arisen. It prevents business firms from inflating their profits by recording incomes that are likely to accrue i.e. expected incomes or gains are not recorded.

(vii) *Accrual Concept*: Every transaction and event affects, one or more or all the three aspects viz., assets, liabilities and capital. Normally all transactions are settled in cash but even if cash settlement has not taken place, it is proper to record the transaction or the event concerned into the books. This concept implies that the income should be measured as a difference between revenues and expenses rather than the difference between cash received and disbursements. Business transactions are recorded when they occur and not when the related payments are received or made. This concept is called accrual basis of accounting and it is fundamental to the usefulness of financial accounting information.

It is not necessary that there is an immediate settlement in cash for any transaction or event therefore accrued revenues and costs are recognized as they are earned and incurred and recorded in the financial statements of the period. On the basis of this concept, adjustment entries relating to outstanding and prepaid expenses and income received in advance etc. are made. They have their impact on the profit and loss account and the balance sheet.

(viii) *Accounting Period Concept*: It is customary that the life of the business is divided into appropriate parts or segments for analyzing the results shown by the business. Each part or segment so divided is known as an accounting period. It is an interval of time at the end of which the income or revenue statement and balance sheet are prepared in order to show the results of operations and changes in the resources which have occurred since the previous statements have been prepared. Normally, the accounting period consists of twelve months.

(ix) *Revenue Match Concept*: This concept is based on accounting period concept. In order to determine the profit earned or loss suffered by the business in a particular defined accounting period, it is necessary that expenses of the period should be matched with the revenues of that period. The term ‘matching’ means appropriate association of related revenues and expenses. Therefore, income made by the business during a period can be ascertained only when the revenue earned during a period is compared with the expenditure incurred for earning that revenue. According to this concept, adjustments should be made for all outstanding expenses, accrued incomes, unexpired expenses and unearned incomes etc. while preparing the final accounts at the end of the accounting period.

Accounting Conventions

The term ‘convention’ denotes custom or tradition or practice based on general agreement between the accounting bodies which guide the accountant while preparing the financial statements. It is a guide to the selection or application of a procedure. In fact financial statements, namely, the profit and loss account and balance sheet are prepared according to the following accounting conventions:

(i) *Consistency*: The consistency convention implies that the accounting practices should remain the same from one year to another. The results of different years will be comparable only when accounting rules are continuously adhered to from year to year. For example, the principle of valuing stock at cost or market price whichever is lower should be followed year after year to get comparable results. Similarly, if depreciation is charged on fixed assets according to diminishing balance method, it should be done year after year. The rationale behind this principle is that frequent changes in accounting treatment would make the financial statements unreliable to the persons who use them.

The consistency convention does not mean that a particular method of accounting once adopted can never be changed. When an accounting change is desirable, it should be fully disclosed in the financial statements along with its effect in terms of rupee amounts on the reported income and financial position of the year in which the change is made.

(ii) *Disclosure*: Apart from statutory requirements good accounting practice also demands all significant information should be fully and fairly disclosed in the financial statements. All information which is of material interest to proprietors, creditors and investors should be disclosed in accounting statements. This convention is gaining more importance because most of big business units are in the form of joint stock companies where ownership is divorced from management. The Companies Act makes ample provisions for disclosure of essential information so that there is no chance of any material information being left out.

(iii) *Conservatism*: Financial statements are usually drawn up on a conservative basis. There are two principles which stem directly from conservatism.

(a) The accountant should not anticipate income and should provide for all possible losses, and

(b) Faced with the choice between two methods of valuing an asset, the accountant should choose a method which leads to the lesser value.

Examples:

– Making provisions for bad debts in respect of doubtful debts.

– Amortizing intangible assets like, goodwill, patents, trade marks, etc. as early as possible.

– Valuing the stock in hand at lower of cost or market value.

(iv) *Materiality*: According to the convention of materiality, accountants should report only what is material and ignore insignificant details while preparing the final accounts. The decision whether the transaction is material or not should be made by the accountant on the basis of professional experience and judgment.

An item may be material for one purpose while immaterial for another. For the items appearing in the profit and loss account, materiality should be judged in relation to the profits shown by the profit and loss account. And for the items appearing in the balance sheet, materiality may be judged in relation to the groups to which the assets or liabilities belong e.g. for any item of current liabilities, it should be judged in relation to the total current liabilities.

DISTINCTION BETWEEN ACCOUNTING CONCEPTS AND CONVENTIONS

(i) A concept is a theoretical idea forming a set of practices while a convention is a method or procedure accepted by general agreement.

(ii) Accounting concepts are not based on accounting conventions whereas accounting conventions are based on accounting concepts.

(iii) Accounting concepts are not internally inconsistent while accounting conventions are internally inconsistent.

(iv) Personal judgment has no role in the adoption of accounting concepts. But for accounting conventions, personal judgment may play a crucial role.

(v) Accounting concepts are established by law while accounting conventions are established by common accounting practices.

(vi) There is uniform application of accounting concepts in different organizations while it may not be so in a case of accounting conventions.

ACCOUNTING STANDARDS

Accounting as a “language of business” communicates the financial results of an enterprise to various interested parties by means of financial statements, which have to exhibit a “true and fair” view of its state of affairs. Like any other language, accounting, has its own complicated set of rules. However, these rules have to be used with a reasonable degree of flexibility in response to specific circumstances of an enterprise and also in line with the changes in the economic environment, social needs, legal requirements and technological developments. Therefore, these rules cannot be absolutely rigid nor they can be applied arbitrarily.

Accounting standards (ASs) are written policy documents issued by expert accounting body or by government or any other regulatory body. Accounting Standards cover the aspects of recognition, measurements, presentation and disclosure of accounting transactions in the financial statements. These are set in the form of general principles and left to the professional judgment for application.

An accounting standard may be regarded as a sort of law - a guide to action, a settled ground or basis of conduct or practice. The objective of setting standards is to bring about uniformity in financial reporting and to ensure consistency and comparability in the data published by enterprises. The Institute of Chartered Accountants of India (ICAI) constituted the Accounting Standards Board (ASB) on 21st April, 1977, with a view to harmonising the diverse accounting policies and practices in use in India. The ICAI has issued 32 Accounting Standards and 29 Accounting Standards has been interpreted so.

ACCOUNTING POLICIES

Accounting policies refer to the specific accounting principles and the methods of applying those principles adopted by the enterprise in the preparation and presentation of financial statements. Policies are based on various accounting concepts, principles and conventions.

The accounting standards issued by professional accounting bodies limit and reduce alternatives out of which accounting policies are to be selected by an enterprise for measurement and reporting of business transactions. Thus, the specific accounting policies are selected by an enterprise in conformity with generally accepted accounting principles and the accounting standards. For example, as per matching concept, depreciation should be treated as cost of doing business and matched with revenue of the same period. As per Accounting Standard-6 depreciation can be calculated by straight line method, written down value method etc. So, the organization has to make a policy as to which method it wants to follow. Similarly, valuation of inventory, treatment of goodwill, valuation of investments, valuation of fixed assets etc. are the significant areas which require standardization of accounting policies to ensure relevance and reliability of accounting information.

ACCOUNTING - A MEASUREMENT DISCIPLINE

Accounting is a measurement discipline as it deals with the monetary measurement of inputs and outputs and as a result, it provides a basis for measuring the efficiency or performance of enterprise. Measurement means assignment of numerical values to specific attributes or characteristics of selected objects or events. It means that asset, liability or change in capital must have a relevant attribute that can be expressed in monetary units with sufficient reliability.

Value refers to the benefits to be derived from objects, abilities or ideas. Valuation is essentially an economist’s concept. Value is the utility of an economic resource to the person enjoying its use. In accounting, monetary unit is used for the value of an object, ability or idea. Value is measured in terms of money. If the value of the machine is taken as ₹2,00,000, it is only one type of value popularly called acquisition cost or historical cost. Measurement is a broader concept than valuation. The concept of measurement includes valuation.

Generally, four measurement bases are usually accepted in accounting parlance i.e. (i) Historical Cost; (ii) Current Cost; (iii) Realizable Value; and (iv) Present Value.

(i) *Historical Cost*: It means acquisition price, i.e., the amount of cash paid to acquire an asset. Liabilities are recorded at the amount of proceeds received in exchange of the obligation.

(ii) *Current Cost*: Assets are carried at the amounts of cash or cash equivalent that would have to be paid if the same or equivalent assets were acquired currently. Liabilities are carried at the undiscounted amount of cash or cash equivalents that would be required to settle the obligation currently.

(iii) *Realisable Value*: As per this valuation basis, assets are recorded at the amount of cash or cash equivalent that would be realized by selling the assets in a routine manner. Similarly, liabilities are recorded at their settlement values.

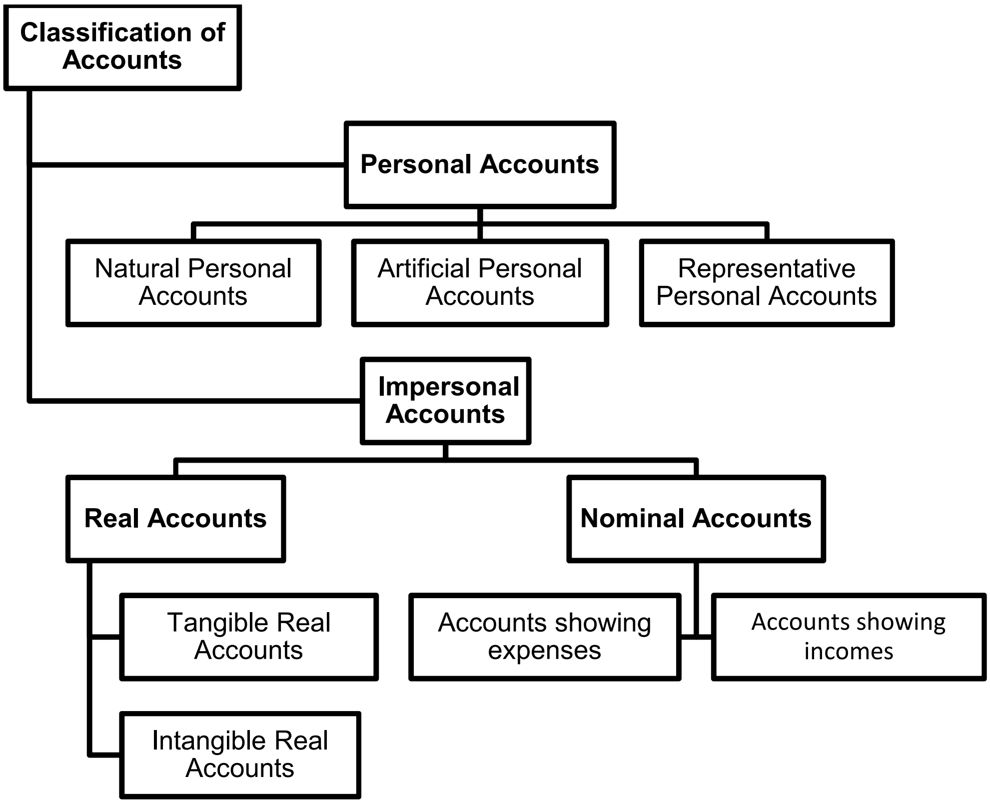
(iv) *Present Value*: As per present value concept, an asset is shown in the balance sheet at the sum of present discounted net cash inflows that the asset is expected to generate in the normal course of business activities. Similarly, liabilities are disclosed at the present discounted value of future net cash outflows that are expected to be required to satisfy the liability in normal or due course of business activities.

ACCOUNTS AND ITS CLASSIFICATION

The business transactions are recorded in accounts. An account is an individual record of a person, firm, or thing, an item of income or an expense.

An account is prepared for each type of asset, liability, owner(s) equity, revenue and expense. For example, the account of cash would show the cash receipts, cash payments and balance of cash in hand. An account of a person would show the business transactions that have taken place with that person and net position in respect of money owed by or to him.

According to Kohler's Dictionary for Accountants, an account has been defined as a formal record of a particular type of transactions expressed in money.



Classification of Accounts

(I) PERSONAL ACCOUNTS: These accounts show the transactions with customers, suppliers, money lenders, the banks and the owner. Personal accounts can take the following forms:

(a) ***Natural Personal Accounts***: The term natural persons means human beings who are the creation of God. For example, Naresh a customer or supplier.

(b) ***Artificial Personal Accounts***: These accounts include accounts of corporate bodies or institutions which are recognized as persons in business dealings. For example, any limited company's account, bank account, insurance company's account, any firm's account, any club's account, etc.

(c) ***Representative Personal Accounts***: These are accounts which represent a certain person or group of persons. In books, the names of the parties will appear. Since these accounts are many in number but are of the same nature, they are added and put under a common title. For example, salary is outstanding towards 15 employees, the amount may be shown against one name 'Salary Outstanding' representing all the 15 employees. Interest outstanding, capital account, rent receivable, prepaid expenses and income received in advance are other such examples.

(II) REAL ACCOUNTS: Real account normally belongs to the property of the business and may be of the following types:

(a) ***Tangible Real Accounts***: These are accounts of such things as are tangible i.e. can be seen, touched or felt physically. Examples– land, building, furniture, cash etc.

(*Note: please note that bank account is a personal account and is not a real account because bank account is the account of some banking company which is an artificial person*).

(b) ***Intangible Real Accounts***: These accounts represent such things as cannot be touched but can be measured in terms of money. Example are, goodwill, trade marks, patent rights etc.

(III) NOMINAL ACCOUNTS: Nominal accounts are opened in the books to explain the expenses and incomes. For example, in a business- salary is paid to the employees, rent is paid to the landlord, wages are paid to the workers, commission is paid to the salesmen, wherein cash goes. Example are salary account, rent account, commission account etc. Nominal accounts include accounts of all expenses, losses, income and gains. They are known as nominal as at the end of year these accounts transferred to Trading or P/L Account.

Valuation Accounts: In addition to the traditional classification of accounts - personal and impersonal - valuation accounts are also being recognized e.g. provision for depreciation account, provision for doubtful debts account, stock reserve account etc.

REVIEW QUESTIONS

1. Classify the following into personal, real and nominal accounts:

Stationery Account, Depreciation Account, Cash Account, Bank Current Account, Goodwill Account, Interest Account, Patents and Trade Marks Account, Capital Account, Bank Loan Account, Freight Account, Drawings Account, Rent Account and Account of Govind, a customer.

2. A firm spends money for the following. Mention whether they are assets, expenses or losses :

– Purchasing computers
– Acquiring trade marks
– Paying salaries
– Acquiring a lease of land for 15 years
– Paying interest
– Purchasing furniture
– Paying compensation to injured workers
– Theft by burglars

DOUBLE ENTRY SYSTEM

There are two systems of keeping records- Single Entry System and Double Entry System. The single entry system appears to be time-saving and economical but it is unscientific as under this system, some transactions are not recorded at all whereas some other transactions are recorded only partially. On the other hand, the double entry system is based on scientific principles and is, therefore, used by most of the business houses. The system recognises the fact that every transaction has two aspects and records both aspects of each and every transaction. Under this system, in every transaction an account is debited and other account is credited. The crux of accountancy lies in finding out which of the two accounts are affected by a particular transaction and out of these two accounts which account is to be debited and which account is to be credited.

Merits of Double Entry System

(i) It keeps a complete record of business transactions. Both personal accounts and impersonal accounts are kept. The entire information regarding the values of assets and profits earned during the year can be easily obtained.

(ii) It provides a check on the arithmetical accuracy of accounts, since every debit has corresponding credit to it and vice-versa.

(iii) The detailed profit and loss account can be prepared to show profit earned or loss suffered during any given period.

(iv) The system makes possible the comparison of purchases as well as sales, expenditure, income etc. of current year with those of the previous years, thus enabling a businessman to control its business activities. The balance sheet can be prepared at any specified point of time or any date showing the actual amounts of assets, liabilities and capital.

(vi) It significantly reduces the chances of a fraud and if a fraud is committed it can be easily detected.

(vii) The accurate details with regard to any account can be easily obtained.

RULES OF DEBIT AND CREDIT

The left hand side of an account is called the debit side; while the right hand side is called the credit side. An entry on the left side of an account is called a debit entry, or merely a debit, an entry on the right side is called a credit entry or credit. The act of recording an entry on the left side of an account is called debiting the account; and recording an entry on the right side of an account is called crediting the account. The difference between the total debits and total credits in an account is the account balance. If the credit side is greater than the debt side of an account, if would have credit balance written on the debt side and vice-versa. Double entry system means the recording of both the aspects i.e. debit and credit.

GOLDEN RULES

Personal Accounts: 'Debit the receiver and credit the giver'

Real Accounts: 'Debit what comes in and credit what goes out'

Nominal Accounts: 'Debit all expenses and losses and credit all incomes and gains'

Explanation:

Personal Accounts: 'Debit the receiver and credit the giver', i.e. debit the account of the person who receives something and credit the account of the person who gives something. For example, if you purchase goods from Ram on credit, the two accounts involved are Goods (Purchase) Account and Ram's Account. The latter account is a personal account. Since, Ram is the giver in this transaction, his account will be credited. Similarly, if cash is paid to Ram, Ram's Account will be debited since he is the receiver. Thus, the account of a person is debited with any benefit such person receives and is credited with any benefit such person imparts.

Real Accounts: 'Debit what comes in, and credit what goes out', i.e. debit the account of the thing which comes in and credit the account of the thing which goes out. For example, where furniture is purchased for cash, furniture account is debited while cash account is credited.

Nominal Accounts: 'Debit all expenses and losses and credit all incomes and gains' i.e. debit the accounts of expenses and losses and credit all incomes and gains. For example, if firm/business pays salary to its clerk, the two accounts involved are salary account and cash account. Salary account is a nominal account. Salary paid is an expense of the business and therefore this account will be debited. Similarly if interest is received, interest account will be credited, since interest is an income item.

Significance of Debit and Credit

(a) ***Debit in Personal Accounts***

(i) If the account is new, debit implies that the person whose account is being debited has become debtor of the business.

(ii) If the account is already there and the person whose account is being debited is already a debtor of the business, the new debit implies that the sum due from that person has increased.

(iii) If the account of a person who is a creditor of the business is debited, the debit implies that the amount due to that person has decreased by the amount of debit. It is also conceivable that the creditor may become a debtor after the debit entry; it will happen when the amount of the debit exceeds the amount for which the person was a creditor immediately before the debit.

(b) ***Credit in Personal Accounts***

(i) If the account is new, credit implies that the person whose account is being credited has become creditor of the business.

(ii) If the account of a creditor of the business is credited, it will mean that the amount which is due to that person has increased by the amount of the fresh credit. Credit in the account of a debtor of the business signifies that the amount for which the debtor was liable to the business has diminished by the amount of the credit entry. It is also possible that a debtor may become a creditor after the credit.

(c) ***Debit in Real Accounts***: A debit in real account means that either the value of the asset whose account is being debited has increased or the business has acquired more of that asset.

(d) ***Credit in Real Accounts***: A credit in the real account implies that either the value of the asset whose account is being credited has decreased or the business has disposed of a part or the whole of the asset for the amount of the credit.

(e) ***Debit in Nominal Accounts***: A debit in nominal account signifies that there has been an expense or loss of the amount of the debit or some income or profit has diminished by the amount of the debit.

(f) ***Credit in Nominal Accounts***: A credit in a nominal account implies that there has been an income or a profit of the amount of credit or some expense or loss has diminished by the amount of the credit.

IMPORTANT NOTE: ANALYSING TRANSACTIONS FOR RECORDING

If the three fundamental rules described above are kept in mind, it would be possible to record all the transactions correctly. Follow these simple steps to record all the transactions:

- *Identify the two accounts involved in the transaction.*
- *Find out the type of account for both the accounts involved in the transaction.*
- *Apply the rules of debit and credit.*

For example, payment of salary is a transaction. It involves Salary Account and the Cash Account. Salary Account is a nominal account whereas the Cash Account is a real account. Salary is an Expense. Rule of Nominal Accounts says "Debit all expenses and losses". So, Salary Account will be debited. Whereas rule of real accounts says credit what goes out. Here cash is going out. So, Cash Account will be credited

Illustration 1: From the following transactions, identify the nature of accounts involved and state which account will be debited and which account will be credited?

S. No.	TRANSACTION	ACCOUNTS INVOLVED	TYPE OF ACCOUNT	DEBIT/ CREDIT
1.	Mr. Anil started business with ₹ 60,000.	Cash Account Capital Account	Real Personal	Debit Incomings Credit Giver
2.	Purchased goods for cash ₹ 25,000.	Purchases A/c Cash Account	Nominal Real	Debit Expenses Credit Outgoings
3.	Sold goods for cash ₹ 20,000.	Cash Account Sales	Real Nominal	Debit Incomings Credit Income
4.	Purchased goods from Mr. Bansal for cash ₹ 10,000.	Purchases i.e. good the A/c Cash Account	Nominal Real	Debit Exp Credit Outgoings

5.	Sold goods to Mr. Charles ₹ 8,000 on credit.	Charles Sales A/c	Personal Nominal	Debit Receiver Credit Income
6.	Purchased furniture for ₹ 6,000	Furniture A/c Cash Account	Real Real	Debit Incomings Credit Outgoings
7.	Paid rent ₹ 1,500	Rent Account Cash Account	Nominal Real	Debit Expenses Credit Outgoings
8.	Paid wages	Wages A/c Cash Account	Nominal Real	Debit Expenses Credit Outgoings
9.	Purchased goods from Ajit on credit	Purchases A/c Ajit	Nominal Personal	Debit Expenses Credit giver
10.	Dividend received	Cash Account Dividend A/c	Real Nominal	Debit incomings Credit Income
11.	Machinery sold	Cash Account Machinery A/c	Real Real	Debit incomings Credit Outgoings
12.	Outstanding for salaries	Salaries A/c Outstanding Salaries A/c	Nominal Personal	Debit Expenses Credit given

ACCOUNTING EQUATION

All business transactions are recorded as having a dual aspect. At any point of time, a firm will possess things which may either be sold or converted into cash or which may be later used for a fairly long time. All these things are called assets. Building, land, machinery, furniture, stock, debtors, bills receivable, cash at bank, cash in hand etc. are a few examples of assets. The proprietor of the business brings capital into the business out of which the business (a separate entity) purchases assets for its use. Thus, the amount of the assets of a business is equal to the amount of capital contributed by the proprietor of the business. Thus, Capital = Assets.

In case the capital contributed by the proprietor is insufficient, the business takes borrowing from other parties or outsiders. These parties may give loan or allow credit facilities at the time of purchase of goods. The amounts which are owed to outsiders and which have to be paid, sooner or latter are called liabilities. For example: Loans, Bank Overdraft, Creditors, Bills Payable, and Outstanding Expenses etc. On the one hand, the loan given by the outside parties increases the assets of the business, on the other hand, claims of creditors and lender of money on the assets of the business increase.

Hence, the sum of resources (assets) = obligations (capital + liabilities)

Therefore, Capital + Liabilities = Assets; or

Capital = Assets — Liabilities.

This equation is known as accounting equation. This equation is based on the concept that for every debit, there is an equivalent credit. The entire system of double entry book-keeping is based on this concept.

Example: Suppose A starts a business with a capital of ₹ 50,000, immediately the firm will have ₹ 50,000 as cash as asset and at the same time the firm will owe to the owner ₹ 50,000 which is taken as the proprietor's capital. Thus,

Capital (₹ 50,000) = Assets ₹ 50,000 (Cash).

If the firm purchases furniture worth ₹ 10,000 out of the money provided by A, the situation will be:

Capital (₹ 50,000) = Cash (₹ 40,000) + Furniture (₹ 10,000).

Subsequently, if the business borrows ₹ 15,000 from a bank, the position will be as follows:

Capital (₹ 50,000) + Bank loan (₹ 15,000) = Cash (₹ 55,000) + Furniture (₹ 10,000).

BILL OF EXCHANGE

"A Bill of Exchange is an instrument in writing containing an unconditional order signed by the maker, directing a certain person to pay a certain sum of money only to, or to the order of, a certain person or to the bearer of the instrument." Section 5 of the Negatibale Instrument Act, 1881

Features of a Bill of Exchange are :

1. A Bill of Exchange must be in writing.
2. It must contain an order (and not a request) to make payment.
3. The order of payment must be unconditional .
4. The amount of bill of exchange must be certain.
5. The date of payment should be certain.
6. It must be signed by the drawer of the bill.
7. It must be accepted by the drawee by signing on it.
8. The amount specified in the bill of exchange is payable either on demand or on the expiry of a fixed period.
9. The amount specified in the bill is payable either to a certain person or to his order or to the bearer of the bill.
10. It must be stamped as per legal requirements.

PARTIES TO A BILL OF EXCHANGE

1. DRAWER :

Drawer is the person who makes or writes the bill of exchange. Drawer is a person who has granted credit to the person on whom the bill of exchange is drawn. The drawer is entitled to receive money from the drawee (acceptor).

2. DRAWEE :

Drawee is the person on whom the bill of exchange is drawn for acceptance. Drawee is the person to whom credit has been granted by the drawer. The drawee is liable to pay money to the creditor/drawer.

3. PAYEE :

Payee is the person who receives the payment from the drawee. Usually the drawer and the payee are the same person. In the following cases. drawer and payee are two different persons :

(i) When the bill is discounted by the drawer from his bank- payee is the bank.

(ii) When the bill is endorsed by the drawer to his creditors : payee is the endorsee.

CONTENTS OF BILL EXCHANGE :

1. **DATE** – The date on which a bill is drawn, is written on the top right corner of the bill. It helps in determining the date of maturity of the bill.
2. **Term/Tenure** – Term specifies the time period for which a bill is written. It should be specified in the body of the bill.
3. **Amount** – Amount in figure should be mentioned in the top lelf corner and amount in words should be mentioned in body of the bill.
4. **Stamp** – Stamp of proper value depending upon the amount of bill must be affixed on the bills of exchange.
5. **Name of parties** - The name and addresses of the drawer and the drawee should be mentioned in the bill of exchange.
6. **For Value Received** – It means the bill has been issued in exchange of some consideration. These words are very important because law does not consider those agreements which have been made without consideration.

LESSON ROUND UP

– Accounting is the art of recording, classifying and summarizing transactions and events which are of a financial character in terms of money, and interpreting the results thereof.

– Three main branches of accounting are financial accounting, cost accounting and management accounting.

– Accounting functions are: keeping systematic records; protecting and controlling business properties; ascertaining the operational profit/loss; ascertaining the financial position of the business; and facilitating rational decision-making.

– Accounting is the language of business and used to communicate financial and other information to different interested parties like owners, manager, creditors, investors, researchers, government etc.

– Accounting information should be relevant, reliable, comparable, understandable, timely, neutral, verifiable and complete.

– Accounting can be based on cash or accrual system. In cash system, accounting entries are passed only when cash is received or paid while in accrual system, transactions are recorded on the basis of amounts having become due for payment or receipt.

– Book keeping is different from accounting. Book keeping is concerned with the permanent recording or maintaining of all transactions in a systematic manner to show its financial effect on the business. Accounting is concerned with its summarizing of the recorded transcations.

– Accounting principles are guidelines to establish standards for sound accounting practices and procedures in reporting the financial status of a business. These principles can be accounting concepts and accounting conventions.

– Accounting concepts are defined as basic assumptions on the basis of which financial statements of a business entity are prepared. While ‘convention’ denotes custom or tradition or practice based on general agreement between the accounting bodies which guide accountant while preparing the financial statements.

– Some of the important accounting concepts are: business entity concept, money measurement concept, cost concept, going concern concept, dual aspect concept, realization concept, accrual concept, accounting period concept and revenue match concept.

– Accounting conventions are consistency, disclosure, conservatism and materiality.

– Accounting standards (ASs) are written policy documents issued by expert accounting body or by government or any other regulatory body.

– Two classes of accounts are personal accounts and impersonal accounts. Impersonal accounts can be further classified into real and nominal accounts.

– Accounting Equation represents that sum of resources (assets) is equal to the obligations (capital and liabilities) of the business.

GLOSSARY

Book Keeping	The permanent recording or maintaining of all transactions in a systematic manner to show its financial effect on the business.
Accounting	Summarizing of the recorded transactions to prepare various reports
Accounting Principles	Guidelines to establish standards for sound accounting practices and procedures in reporting the financial status of a business.
Accounting Concepts	Basic assumptions on the basis of which financial statements of a business entity are prepared.
Accounting Standards	Written policy documents issued by expert accounting body or by government or any other regulatory body.

SELF-TEST QUESTIONS

Theory Questions

1. Define accounting and state its characteristics.
2. Name the users of accounting information.
3. Discuss the system of accounting.
4. What are the functions of accounting?
5. Distinguish between book-keeping and accounting
6. State the difference between accounting concepts and conventions.
7. Explain important accounting conventions.
8. What are accounting standards?
9. Discuss the merits of double entry system of accounting.
10. Explain the basic rules of debit and credit in accounting.
11. What do you mean by accounting equation?
12. Define the term ‘account’ and name the types of accounts? Also explain with examples.

Practical Questions

1. Point out the accounts which will be debited and credited for each one of the following transactions:
   – Cash received from X and discount allowed to him.
   – Cash paid to Y and discount received from him.
   – Credit Sales to Z.
   – Cash Sales to A.
   – Purchases from B on credit.

- Salary paid to clerk by means of cheque.
- Payment of cash to landlord for rent.
- Depreciation on furniture.
- Interest due but not yet paid.
- Interest provided on capital.

2. Give Accounting Equation for the following transactions of Jitesh:
   - Started business with cash ₹ 36,000
   - Paid rent in advance ₹800
   - Purchased goods for cash ₹10,000 and on credit ₹4,000
   - Sold goods for cash ₹8,000
   - Rent paid ₹2000 and rent outstanding ₹400
   - Bought cycle for personal use ₹16,000
   - Purchased equipments for cash ₹10,000
   - Paid to creditors ₹1,200
   - Some business expenses paid ₹1,800
   - Depreciation on equipment ₹2,000
3. Aman had the following transactions. Use accounting equation to show their effect on his assets, liabilities and capital.
   - Brought ₹ 20,00,000 in cash to start business.
   - Purchased Government Bonds for cash ₹ 1,06,000.
   - Purchased an office building for ₹ 9,00,000 giving ₹ 6,00,000 in cash and the balance through a loan.
   - Sold Government Bonds costing ₹ 6,000 for ₹ 6,500.
   - Purchased an old car for ₹1,68,000.
   - Received cash for rent ₹ 21,600.
   - Paid cash ₹ 3,000 for loan and ₹ 1,800 for interest.
   - Paid cash for office building expenses ₹ 1,800.
   - Received cash for Interest on Government Bonds ₹1,200.
4. Prepare the Accounting Equation on the basis of the following transactions:
   - Sohan commenced business with ₹10,00,000
   - Withdrew for private use ₹ 1,700
   - Purchased goods on credit ₹ 14,000
   - Purchased goods for cash ₹ 10,000
   - Paid salaries ₹6,000
   - Paid to creditors ₹10,000
   - Sold goods on credit for ₹15,000
   - Sold goods for cash (cost price was ₹3,000) ₹ 4,000
   - Purchased machinery for ₹ 45,000

MULTIPLE CHOICE QUESTIONS

1. Which accounting principle is violated by including personal expenses of the owner in the business expenses?

   (A) Cost principle (B) Going concern concept (C) Entity concept (D) Conservatism

2. Realisation account is a:

   (A) Personal a/c (B) Real a/c (C) Nominal a/c (D) Memorandum a/c

3. Financial accounting is concerned with –

   a) Recording of business expenses and revenue b) Recording of costs of products and services c) Recording of day to day business transactions d) None of the above

4. Amortization of intangible Asset Such as Goodwill which has indefinite life is an example of accounting concept

   a) Conservatism Concept b) Continuity Concept c) Realisation Concept d) Measurement Concept

5. Accounting principles are generally based upon:

   a) Practicability b) Subjectivity c) Convenience in recording d) None of the above

6. According to which concept business is treated as a unit apart from owner

   a) Dual concept b) Divider concept c) Entity concept d) Landlord concept

7. Under which concept it is assumed that the enterprises has neither the intention nor the necessity of liquidation or of curtailing materiality the scale of operation

   a) Revenue realization concept b) Matching cost concept c) Going concern concept d) None of these

8. Making the provision for doubtful debts and discount on debtors in anticipation of actual bad debts and discount is an example for which concept

   a) Conservatism concept b) Continuity concept c) Realization concept d) All of these

9. Journal Entries are known as book of ………………Entry.

   a) Original b) Duplicate c) Personal d) Nominal

10. Which of the following is time span into which the total life of a business is divided for the purpose of preparing financial statements?

    a) Fiscal year b) Calendar year c) Accounting period d) Accrual period

Lesson 2
Accounting Process–I
(Recording of Transactions)

LESSON OUTLINE

- Accounting Cycle
- Journal
  - Procedure of Journalising
  - Compound Journal Entry
- Ledger
  - Features of Ledger Account
  - Difference between Journal and Ledger
  - Ledger Posting
  - Balancing Ledger Accounts
- Subsidiary Books of Account
  - Purchases Book
  - Sales Book
  - Purchases Returns Book
  - Sales Returns Book
  - Bills Receivable Book
  - Bills Payable Book
  - Cash Book
- Review Questions
- Petty Cash Book
- General Journal
- Trial Balance
  - Features of Trial Balance
  - Objectives of Trial Balance
  - Methods of Preparing of Trial Balance
- Lesson Round Up
- Glossary
- Self Test Questions

LEARNING OBJECTIVES

Accounting process involves identification and analysis of financial transactions. These transactions are recorded, classified and summarised in a systematic manner to provide useful information. Thus, accounting process starts with the recording of business transactions in monetary terms, in the primary books of accounts. For recording business transactions, it is necessary that these transactions are evidenced by proper source documents like cash memoes, purchase bills, sales bills, couterfoils of cheques issued, salary slips etc. From these source documents, transactions are recorded in the books of accounts which is the first and major step in accounting. It is the basis of accounting as entire future process would depend upon this recording of transactions. In this lesson, we will know about recording transactions in primary book journal proper and other subsidiary books, posting in ledger and then preparation of counter foils of trial balance.

Accounting is the language of business.

Warren Buffet

ACCOUNTING CYCLE

Accounting cycle or accounting process includes the following:

1. Identifying the transactions from source documents like purchase orders, loan agreements, invoices, etc.
2. Recording the transactions in the journal proper and other subsidiary books as and when they take place.
3. Classifying all entries posted in the journal or subsidiary books and posting them to the appropriate ledger accounts.
4. Summarising all the ledger balances and preparing the trial balance and final accounts with a view to ascertaining the profit or loss earned during a particular period and ascertaining the financial position of the business on that particular date.

JOURNAL

Journal is the book of primary entry in which every transaction is recorded before being posted into the ledger. It is that book of account in which transactions are recorded in a chronological (day to day) order. In modern times, besides the main journal, specialized journals are maintained to record different types of transactions. The process of recording transactions in a journal is termed as journalising. A journal is generally kept in a columnar from.

SPECIMEN OF JOURNAL

Name of Item

Journal

Date (i) a – b	*Particulars (ii)*	*L.F. (iii)*	*Debit Amount (₹) (iv)*		*Credit Amount (₹) (v)*	

(i) ***Date***: The date on which the transaction has taken place is recorded here. The year is written at the top of the date column of each page of the journal. On the next line of the date column, the month & day of the first entry are written. Unless the month or year changes or until a new page is begun, neither the month nor the year is repeated on the page. Year and month are written in the under left hand sub-column and date is written is right hand smaller sub-column.

(ii) ***Particulars***: The two aspects of a transaction are recorded in this column i.e. However, mostly there are no sub-column and year, month and date in one column of Date. the accounts which have to be debited and credited. The name of the account(s) to be debited is entered at the extreme left of the particulars column next to the date column. The abbreviation 'Dr.' is written at the right end of the particulars column on the same line of the account debited. The name of the account to be credited is entered in the next line with a prefix 'To'. A brief explanation of the transaction known as narration is written below the account titles of the transaction. Finally, a thin line is drawn all through the particulars column to indicate that the entry of the transaction has been completed.

(iii) ***L.F. (Ledger Folio)***: This column records the page number in the ledger in which the accounts in the particulars column are posted.

(iv) ***Debit Amount (Debit)***: The debit amount is recorded in the debit amount column opposite to the title of the account being debited.

(v) ***Credit Amount (Credit)*****:** The credit amount is recorded in the credit amount column opposite to the title of the account being credited.

Procedure of Journalising

The following procedure is followed for passing journal entries –

- Analyze each transaction in terms of accounts affected. As a rule every transaction has its effect on at least two accounts.
- Find out the type of accounts affected in a transaction i.e. personal, real or nominal.
- Apply the rules of debit and credit to each type of accounts involved.
- The debit and credit accounts must be equal. Sometimes, a journal entry may have more than one debit or/and more than one credit. This type of journal entry is called compound journal entry. Regardless of the number of debits or credits in a compound journal entry, the aggregate amount of debits should be equal to the aggregate amount of credits.
- For a business, journal entries generally extend to several pages, hence, totals of debit and credit amount columns are cast at the end of each page. Against the debit and credit total at the end of a page, the words, 'Total c/f' (c/f - indicates carried forward) are written in the particulars column. The debit and credit totals are then written in the beginning of the next page in the amount columns and against them the words 'Total b/f' (b/f - indicates brought forward) are written in the particulars column. On the last page 'Grand Total' is written.

Compound Journal Entry

Transactions which are inter-connected and have taken place simultaneously are recorded by means of a compound or combined journal entry. For example receipt of cash from a debtor and allowance of discount to him are recorded by means of a single journal entry. Similarly transactions of the same nature are recorded by means of a combined entry provided they take place the same day. For example, if amount is spent on the same day for salaries, wages, stationery, rent, etc. a combined entry can be passed debiting all the relevant nominal accounts with respective amounts and crediting cash account with the total amount spent.

Salary account	Dr.
Wages account	Dr.
Stationery account	Dr.
Rent account	Dr.
To cash account	

Illustration 1:

Journalise the following transactions:

2016			₹
Mar.,	2	Commenced business with cash	2,50,000
”	4	Purchased furniture for cash	20,000
”	4	Cash purchases	1,45,000
”	5	Deposited with bank	30,000
”	6	Purchase from Patil	40,000
		Sold to Natarajan for cash	14,300
”	7	Stationery purchased	1,050
”	7	Purchase from Salil	26,000
”	7	Sold to Mukherjee	8,080
”	9	Rent for two years paid in advance	24,000
”	9	Drawings by the proprietor for household expenses	4,000
		Goods taken out by the proprietor for domestic use	500
”	9	Cash withdrawn from Bank	25,000
”	10	Sold to Mathur on credit	9,850

"	11	Purchases made, payment through cheque	2,900
"	14	Cash received from Patil on account	10,000
"	14	Cash paid to Salil after deduction of discount ₹ 1300	24,700
"	17	Cash received from Mathur in full settlement of his account	9,750
"	18	Mukherjee becomes insolvent. A dividend of 50 paise in a rupee is received	4,040
"	18	Purchase of a Scooter for cash	30,000
"	20	Sold goods to Aggarwal	8,640
		Sales to Nayak	3,780
"	24	Cartage paid in cash	150
"	24	Repairs to Scooter, payment not yet made	170
"	26	Payment of cash for petrol	550
"	26	Purchases of goods for cash	12,000
"	26	Purchases of Office Equipment for cash	12,100
"	27	Repairs bill paid in cash	170
"	28	Aggarwal returns goods	400
"	31	Depreciation on furniture	100
		Depreciation on Scooter	200
"	31	Salary to clerk outstanding	1,800
"	31	Adjustment for the month's outstanding rent	1,000
"	31	Bank charges for the month	50
"	31	Interest on capital for the month	1,250
		Salary to be credited to proprietor	2,000
"	31	Salil agrees to take some defective goods purchased from him and immediately refunds the money	700

Solution:

JOURNAL

Date	*Particulars*		*L.F.*	*Debit* ₹	*Credit* ₹
2016					
Mar., 2	Cash Account	Dr.		2,50,000	
	To Capital Account				2,50,000
	(For cash brought in by proprietor as capital)				
" 4	Furniture Account	Dr.		20,000	
	To Cash Account				20,000
	(For purchase of furniture for cash)				
" 4	Purchases Account	Dr.		1,45,000	
	To Cash Account				1,45,000
	(For purchase of goods-in-trade for cash)				
" 5	Bank	Dr.		30,000	
	To Cash Account				30,000
	(For cash deposited with bank)				
" 6	Purchases Account	Dr.		40,000	
	To Patil				40,000
	(For credit purchases of goods in trade, Patil being the supplier)				
" 6	Cash Account	Dr.		14,300	
	To Sales Account				14,300
	(For cash sales made to Natarajan)				
	Total c/f			4,99,300	4,99,300

Date	*Particulars*		*L.F.*	*Debit* ₹	*Credit* ₹
	Total b/f			4,99,300	4,99,300
2016					
Mar. 7	Stationery Account	Dr.		1,050	
	To Cash Account				1,050
	(For purchase of stationery for cash)				
" 7	Purchases Account	Dr.		26,000	
	To Salil				26,000
	(For credit purchases of goods from Salil)				
" 7	Mukherjee	Dr.		8,080	
	To Sales Account				8,080
	(For credit sales of goods to Mukherjee)				
" 9	Pre-Paid Rent A/c	Dr.		24,000	
	To Cash Account				24,000
	(For rent paid in advance)				
" 9	Drawings Account	Dr.		4,500	
	To Cash Account				4,000
	To Purchases Account				500
	(For drawings in cash and goods taken by the proprietor for personal use)				
" 9	Cash	Dr.		25,000	
	To Bank Account				25,000
	(For cash withdrawn from Bank)				
" 10	Mathur	Dr.		9,850	
	To Sales Account				9,850
	(For sales to Mathur on credit)				
" 11	Purchases Account	Dr.		2,900	
	To Bank				2,900
	(For purchases of goods, payment being made by means of a cheque)				
" 14	Cash Account	Dr.		10,000	
	To Patil				10,000
	(For cash received from Patil)				
" 14	Salil	Dr.		26,000	
	To Cash Account				24,700
	To Discount Account				1,300
	(For cash paid to Salil and discount received from him)				
" 17	Cash A/c	Dr.		9,750	
	Discount Account	Dr.		100	
	To Mathur				9,850
	(For cash received from Mathur and discount allowed to him)				
" 18	Cash Account	Dr.		4,040	
	Bad Debts Account	Dr.		4,040	
	To Mukherjee				8,080
	(For cash received from Mukherjee on his insolvency and amount written off as bad debt)				
	Total c/f			6,54,610	6,54,610

Date	*Particulars*		*L.F.*	*Debit* ₹	*Credit* ₹
2016	Total b/f			6,54,610	6,54,610
Mar. 18	Scooter Account	Dr.		30,000	
	To Cash Account				30,000
	(For purchase of a scooter for cash)				
" 20	Aggarwal	Dr.		8,640	
	Nayak	Dr.		3,780	
	To Sales Account				12,420
	(For credit sales made to Aggarwal and Nayak)				
" 24	Cartage Account	Dr.		150	
	To Cash Account				150
	(Cartage paid)				
" 24	Repairs Account	Dr.		170	
	To Repairs Outstanding A/c				170
	(For repairs charges)				
" 26	Petrol Expense Account	Dr.		550	
	To Cash Account				550
	(For petrol expenses paid in cash)				
" 26	Purchases Account	Dr.		12,000	
	To Cash Account				12,000
	(For cash purchases)				
" 26	Office Equipment Account	Dr.		12,100	
	To Cash Account				12,100
	(For purchase of office equipment)				
" 27	Repairs Outstanding A/c	Dr.		170	
	To Cash Account				170
	(Repairs outstanding paid)				
" 28	Sales Returns Account	Dr.		400	
	To Aggarwal				400
	(Sales returns from Aggarwal)				
" 31	Depreciation Account	Dr.		100	
	To Furniture Account				100
	(For depreciation on furniture)				
" 31	Depreciation Account	Dr.		200	
	To Scooter Account				200
	(For depreciation on scooter)				
" 31	*Salary Account	Dr.		1,800	
	To Salary Outstanding A/c				1,800
	(For salary outstanding)				
" 31	*Rent Account	Dr.		1,000	
	To Rent Outstanding A/c				1,000
	(For rent outstanding)				
	Total c/f			7,25,670	7,25,670

* A combined entry may be passed.

Salary account	Dr.	1800	
Rent Account	Dr.	1000	
To salary outstanding a/c			1800
To rent outstanding a/c			1000

Date	*Particulars*	*L.F.*	*Debit* ₹	*Credit* ₹
	Total b/f		7,25,670	7,25,670
2016				
Mar., 31	Bank Charges Account Dr. To Bank Account (For bank charges)		50	50
” 31	Interest on Capital Account Dr. Salary to Proprietor Account Dr. To Capital Account (For interest on capital, Rs. 1250 and salary for the proprietor credited with Rs. 2,000)		1,250 2,000	3,250
”	Cash Account Dr. To Purchase Returns A/c (For cash received from Salil on return of some defective goods sold to him)		700	700
	Total		7,29,670	7,29,670

LEDGER - PRINCIPAL BOOK OF ACCOUNTS

Ledger is the principal book of accounts where similar transactions relating to a particular person or property or revenue or expense are recorded. It is a set of accounts. It contains all accounts of the business enterprise whether real, nominal or personal. The main function of a ledger is to classify or sort out all the items appearing in the journal or other subsidiary books under their appropriate accounts so that at the end of the accounting period each account will contain the entire information of all the transactions relating to it in a summarised or condensed form.

For instance, all the transactions that have taken place with Mr. Mathur will be entered in Mathur’s Account. Similarly, all items relating to cash, sales, purchases, salaries, discount, etc. appear in their respective accounts.

SPECIMEN RULING OF LEDGER ACCOUNT

Dr. **Name of the Account** *Cr.*

Date	*Particulars*	*J.F*	*Amount* ₹	*Date*	*Particulars*	*J.F*	*Amount* ₹

Features of the Ledger Account

(i) The ledger account is divided into two sides - the left hand side is known as debit side while the right hand side is known as credit side. The abbreviations ‘Dr.’ and ‘Cr.’ are placed at the top left and right hand corners respectively as a custom.

(ii) The name of account is written in the top middle of the account.

(iii) J.F. denotes folio or page number on which its journal entry has been passed.

Difference Between Journal and Ledger

(i) The transactions are recorded first in the journal and then they are posted to the ledger. Thus journal is the book of first or original entry while the ledger is the book of second entry.

(ii) The journal is the book of chronological record while the ledger is the book of the analytical record.

(iii) The process of recording transaction in journal is termed as "Journalising" while the process of recording transactions in the ledger is known as 'Posting'.

Posting

The term 'Posting' means transferring the debit and credit items from the journal to their respective accounts in the ledger.

Rules of Posting

– The names of accounts used in the journal carried to the ledger should be exactly the same.

– Separate accounts should be opened in the ledger for posting transactions relating to different accounts recorded in the journal.

– The concerned account which has been debited in the journal should also be debited in the ledger and the account which has been credited in the journal, should also be credited in the ledger i.e., but a reference should be given of the other account.

– It is customary to use the words 'To' and 'By' while posting in the ledger. The words 'To' is used with the accounts shown on the debit side of the ledger account while the word 'By' is used with accounts which appear on the credit side of the ledger account.

– In the folio column, the page number of the journal from where the entry is transferred to ledger account is written.

– The date of the transaction is written in the date column.

Balancing Ledger Accounts

Balancing of an account means the process of equalizing the two sides of an account by putting the difference on the side where amount is short. Where the debit side of an account exceeds the credit side, the difference is put on the credit side, and the account is said to have a debit balance. This balance is brought down on the debit side while reopening the account. Similarly, where the credit side of an account exceeds the debit side, the difference is put on the debit side, and the account is said to have a credit balance. This is brought down on credit side while reopening the account.

The following steps are followed for balancing the accounts:

(i) Total the amounts of debit and credit entries in the account.

(ii) If the debit and credit sides are equal then there is no balance. The account stands automatically balanced or closed.

(iii) If the debit side total is more, put the difference on the credit side amount column, by writing the words in particulars column "By Balance c/d". If the credit side total is more, put the difference on the debit side amount column by writing the words in the particulars column "To Balance c/d".

(iv) After putting the difference in the appropriate side of the account, add both sides of the account and draw a thin line above and below the total.

(v) Bring down the debit balance on the debit side by writing the words in particulars column "To Balance b/d". Similarly bring down the credit balance on the credit side by writing the words in the particulars column "By Balance b/d".

<u>Illustration 2</u>:

Journalise the following transactions, post them in the ledger and balance the accounts in the books of Mr. Rajesh.

2015		*₹*
Jan. 1	*Started business with cash*	*2,00,000*
Jan. 3	*Purchased goods for cash*	*60,000*

Jan. 5	*Sold goods to Shyam*	*60,000*
Jan. 6	*Sold goods for cash*	*20,000*
Jan. 9	*Received cash from Shyam*	*40,000*
Jan. 13	*Goods purchased from Ram*	*40,000*
Jan. 20	*Cash paid to Ram*	*20,000*
Jan. 25	*Paid office rent*	*4,000*
Jan. 31	*Paid salaries to staff*	*20,000*
Jan. 31	*Returned goods by Shyam*	*10,000*

Solution:

In the Books of Mr. Rajesh

Journal Entries

Date	*Particulars*		*L.F.*	*Debit (₹)*	*Credit (₹)*
2015					
Jan. 1	Cash A/c	Dr.		2,00,000	
	To Capital A/c				2,00,000
	(Being capital introduced by the proprietor in cash)				
Jan., 3	Purchases A/c	Dr.		60,000	
	To Cash A/c				60,000
	(Being goods purchased for cash)				
" 5	Shyam	Dr.		60,000	
	To Sales A/c				60,000
	(Being goods sold on credit to Shyam)				
" 6	Cash A/c	Dr.		20,000	
	To Sales A/c				20,000
	(Being goods sold for cash)				
" 9	Cash A/c	Dr.		40,000	
	To Shyam				40,000
	(Being the cash received from Shyam)				
" 13	Purchases A/c	Dr.		40,000	
	To Ram				40,000
	(Being goods purchased on credit from Ram)				
" 20	Ram	Dr.		20,000	
	To Cash A/c				20,000
	(Being cash paid to Ram)				
" 25	Rent A/c	Dr.		4,000	
	To Cash A/c				4,000
	(Being office rent paid in cash)				
" 31	Salaries A/c	Dr.		20,000	
	To Cash A/c				20,000
	(Being salaries paid to staff)				
" 31	Sales Returns A/c	Dr.		10,000	
	To Shyam				10,000
	(Being goods returned by Shyam)				
		Total		4,74,000	4,74,000

Ledger Accounts

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

Date	*Particulars*	*J.F.*	*₹*	*Date*	*Particulars*	*J.F.*	*₹*
2015				2015			
Jan. 1	To Capital A/c		2,00,000	Jan. 3	By Purchases A/c		60,000
" 6	To Sales A/c		20,000	" 20	By Ram		20,000
" 9	To Shyam		40,000	" 25	By Rent A/c		4,000
				" 31	By Salaries A/c		20,000
				" 31	By Balance c/d		1,56,000
			2,60,000				2,60,000
Feb. 1	To Balance b/d		1,56,000				

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

Date	*Particulars*	*J.F.*	*₹*	*Date*	*Particulars*	*J.F.*	*₹*
2015				2015			
Jan. 31	To Balance c/d		2,00,000	Jan. 1	By Cash A/c		2,00,000
			2,00,000				2,00,000
				Feb. 1	By Balance b/d		2,00,000

Dr. **Purchases Account** *Cr.*

Date	*Particulars*	*J.F.*	*₹*	*Date*	*Particulars*	*J.F.*	*₹*
2015				2015			
Jan. 3	To Cash A/c		60,000	Jan. 31	By Balance c/d		1,00,000
" 13	To Ram		40,000				
			1,00,000				1,00,000
Feb. 1	To Balance c/d		1,00,000				

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

Date	*Particulars*	*J.F.*	*₹*	*Date*	*Particulars*	*J.F.*	*₹*
2015				2015			
Jan. 31	To Balance c/d		80,000	Jan. 5	By Shyam		60,000
				" 6	By Cash A/c		20,000
			80,000				80,000
				Feb. 1	By Balance b/d		80,000

Dr. **Shyam** *Cr.*

Date	*Particulars*	*J.F.*	*₹*	*Date*	*Particulars*	*J.F.*	*₹*
2015				2015			
Jan. 5	To Sales Account		60,000	Jan. 9	By Cash A/c		40,000
				" 31	By Sales Returns A/c		10,000
				" 31	By Balance c/d		10,000
			60,000				60,000
Feb. 1	To Balance b/d		10,000				

Dr. **Ram** *Cr.*

Date	*Particulars*	*J.F.*	₹	*Date*	*Particulars*	*J.F.*	₹
2015				2015			
Jan. 20	To Cash A/c		20,000	Jan. 13	By Purchases A/c		40,000
”31	To Balance c/d		20,000				
			40,000				40,000
				Feb. 1	By Balance b/d		20,000

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

Date	*Particulars*	*J.F.*	₹	*Date*	*Particulars*	*J.F.*	₹
2015				2015			
Jan. 25	To Cash Account		4,000	Jan. 31	By Balance c/d		4,000
			4,000				4,000
Feb. 1	To Balance b/d		4,000				

Dr. **Salaries Account** *Cr.*

Date	*Particulars*	*J.F.*	₹	*Date*	*Particulars*	*J.F.*	₹
2015				2015			
Jan. 31	To Cash Account		20,000	Jan. 31	By Balance c/d		20,000
			20,000				20,000
Feb. 1	To Balance b/d		20,000				

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

Date	*Particulars*	*J.F.*	₹	*Date*	*Particulars*	*J.F.*	₹
2015				2015			
Jan. 31	To Shyam		10,000	Jan. 31	By Balance c/d		10,000
			10,000				10,000
Feb.	To Balance b/d		10,000				

SUBSIDIARY BOOKS OF ACCOUNT

As stated earlier journal is a book of primary entry. It means all business transactions are first recorded in the journal. Journal proper is called the subsidiary book. However, it is not advisable to record all transactions in one journal for large business organizations. Therefore, the journal is sub-divided into many subsidiary books. The sub-division of journal into various subsidiary journals in which transactions of similar nature are recorded are called subsidiary books. The following are the subsidiary books:

1. Journal
2. Purchases Book
3. Sales Book
4. Purchases Returns Book
5. Sales Returns Book
6. Bills Receivable Book
7. Bills Payable Book
8. Cash Book.

PURCHASES BOOK

Purchases book is meant for recording the purchase of goods on credit only. Cash purchases are not recorded in this book.

Purchases Book

Date	*Particulars*	*Invoice No.*	*Ledger Folio*	*Details* ₹	*Amount* ₹

Entries in the purchases book are made from the invoices received from the suppliers. Posting is done in the supplier's/ creditors account daily from the purchases book with their respective amounts. At the end of week/month, the total of the purchases book is debited to the purchases account in the ledger.

In 'Particulars Column' the names of the suppliers together with details of goods purchased are recorded. In 'Details Column' detail amounts of different items are recorded whereas in 'Amount Column' the net amount of various invoices is recorded.

SALES BOOK

In the Sales Book, only credit sale of goods are recorded. Sales Book is prepared on the basis of copies of invoice sent to customers. To post sales book, the accounts of the customers are individually debited with respective amounts at the end of every month. Sales Account is credited with the monthly total of the Sales Book. In 'Particulars Column, the name of the customers along with details of the goods sold to them are recorded.

Cash Sales will be entered in the Cash Book; credit sale of various assets or investments will be recorded in General Journal.

Sales Book

Date	*Particulars*	*Invoice No.*	*Ledger Folio*	*Details* ₹	*Amount* ₹

PURCHASES RETURNS BOOK

The purchase returns books records the details of goods returned by the business organization to the supplier(s). The goods purchased for cash and returned are not recorded in this book. When the goods are returned to the supplier, a debit note is sent to him indicating that his account has been debited with the amount mentioned in the debit note. The specimen of the purchases returns book is as follows:

Purchase Returns Book

Date	*Particulars*	*Debit Note No.*	*Ledger Folio*	*Amount ₹*		*Amount ₹*	

The total of amount Column of the purchases return book is credited to the purchases returns account and the account of the supplier(s) to whom debit notes have been sent are debited individually in their respective accounts.

SALES RETURNS BOOK

The details of goods returned by the customers to the business organization are recorded in this book. Goods sold for cash and returned are not recorded in sales returns book. When goods are returned by a customer a credit note is sent to him intimating that his account has been credited with the value of goods returned. A specimen of the sales returns book is as follows:

Purchase Returns Book

Date	*Particulars*	*Credit Note No.*	*Ledger Folio*	*Amount ₹*		*Amount ₹*	

The individual accounts of the customers are credited with of the respective amounts while the periodical total of the sales returns book is posted to the debit of sales returns account.

<u>Illustration 3:</u>

Record the following transactions in the appropriate books of original entry and show how they will be posted. Assume invoice numbers, folio number, etc.

2016

Mar. 6 Purchased on credit from Kadam

200 Shirts @ ₹ 1,500 each

100 Neckties @ ₹ 500 each.

Mar.10	Sold on Credit to Mehta
	20 Bush Shirts @ 1,750 each
	40 Hand towels @ ₹ 100 each.
" 13	Goods returned to Kadam
	4 Shirts @ 1,500 each
" 17	Sold to Andley on Credit
	40 Trousers @ ₹ 1,000 each
	10 Neck-ties @ ₹ 600 each
" 18	Goods received back from Manohar, a customer
	8 Neck-ties @ ₹ 550 each
	4 Shirts @ ₹ 2,500 each
" 22	Sold to Apte on credit
	10 Bush Shirts @ ₹ 2,500 each
	200 metres of long cloth @ ₹ 150 per metre
" 28	Apte returns 2 Bush Shirts invoiced at ₹ 2,500
" 30	Purchased goods on credit from Gyani Cloth Store
	300 Bush Shirts @ ₹ 2,000 each
	400 metres of long cloth @ ₹ 125 per metre
	100 metres of shirting @ ₹ 750 per metre
	Gyani Cloth Store allows Trade Discount @ 5%
	Andley returns one Neck-tie invoiced at ₹ 600

Solution:

Purchases Book

Date	*Particulars*	*Inv. No.*	*L.F.*	*Details* ₹	*Amount* ₹
2016					
Mar. 6	Kadam				
	200 shirts ₹ 1,500 each	62	8	3,00,000	
	100 Neck-ties ₹ 500 each			50,000	3,50,000
Mar. 30	Gyani Cloth Store				
	300 Bush Shirts ₹2,000 each	6981	17	6,00,000	
	400 metre long cloth				
	@ ₹ 125 per metre			50,000	
	100 metres Shirting				
	@ ₹ 750 per metre			75,000	
				7,25,000	
	Less : Trade Discount 5%			36,250	6,88,750
	Total				10,38,750

Sales Book

Date	*Particulars*	*Inv. No.*	*L.F.*	*Details ₹*	*Amount ₹*
2016					
Mar. 10	Mehta				
	20 Bush Shirts				
	@ ₹ 1,750 each	408	9	35,000	
	40 Hand towels				
	@ ₹ 100 each			4,000	39,000
”17	Andley				
	40 Trousers				
	@ ₹ 1,000 each	409	12	40,000	
	10 Neck-ties				
	@ ₹ 600 each			6,000	46,000
” 22	Apte				
	10 Bush Shirts				
	@ ₹ 2,500 each	410	15	25,000	
	200 metre long cloth				
	@ ₹ 150 per metre			30,000	55,000
	Total				1,40,000

Purchases Returns Book

Date	*Particulars*	*Debit Note No.*	*L.F.*	*Amount ₹*	*Amount ₹*
2016					
Mar. 13	Kadam				
	4 Shirts	22	8		
	@ ₹ 1,500 each				6,000
	Total				6,000

Sales Returns Book

Date	*Particulars*	*Credit Note No.*	*L.F.*	*Amount ₹*	*Amount ₹*
2016					
Mar. 18	Manohar				
	8 Nick-ties @ ₹ 550 each	34	7	4,400	
	4 Shirts @ ₹ 2,500 each			10,000	14,400
” 28	Apte				
	2 Bush Shirts @ ₹ 2,500	35	15		5,000
” 30	Andley				
	1 Nick-tie @ ₹ 600	36	12		600
	Total				20,600

Ledger Accounts

Dr. **Kadam** *Cr.*

Date	*Particulars*	*J.F.*	₹	*Date*	*Particulars*	*J.F.*	₹
2016				2016			
Mar. 13	To Purchase Returns A/c	(PRB 3)	6,000	Mar. 6	By Purchases A/c	(PB 8)	3,50,000

Dr. **Mehta** *Cr.*

Date	*Particulars*	*J.F.*	₹	*Date*	*Particulars*	*J.F.*	₹
2016				2016			
Mar. 10	To Sales Account	(SB23)	39,000				

Dr. **Andley** *Cr.*

Date	*Particulars*	*J.F.*	₹	*Date*	*Particulars*	*J.F.*	₹
2016				2016			
Mar. 17	To Sales A/c	(SB 23)	46,000	Mar. 30	By Sales Returns Account	(SRB 10)	1,200

Dr. **Manohar** *Cr.*

Date	*Particulars*	*J.F.*	₹	*Date*	*Particulars*	*J.F.*	₹
				2016			
				Mar. 18	By Sales Returns A/c	(SRB 10)	14,400

Dr. **Apte** *Cr.*

Date	*Particulars*	*J.F.*	₹	*Date*	*Particulars*	*J.F.*	₹
2016				2016			
Mar. 22	To Sales Account	(SB 23)	55,000	Mar. 28	By Sales Returns Account	(SRB 10)	5,000

Dr . **Gyani Cloth Stores Account** *Cr.*

Date	*Particulars*	*J.F.*	₹	*Date*	*Particulars*	*J.F.*	₹
				2016			
				Mar. 30	By Purchases A/c	(PB8)	6,88,750

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

Date	*Particulars*	*J.F.*	₹	*Date*	*Particulars*	*J.F.*	₹
				2016			
				Mar. 31	By Sundries as per Sales Book	(SB 23)	1,40,000

Dr. **Purchase Account** *Cr.*

Date	*Particulars*	*J.F.*	₹	*Date*	*Particulars*	*J.F.*	₹
2016							
Mar. 31	To Sundries as per						
	Purchases Book	(PB 10)	10,38,750				

Dr. **Purchases Returns Account** *Cr.*

Date	*Particulars*	*J.F.*	₹	*Date*	*Particulars*	*J.F.*	₹
				2016			
				Mar. 31	By Sundries as per		
					Purchases Returns		
					Book	(PRB 3)	6,000

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

Date	*Particulars*	*J.F.*	₹	*Date*	*Particulars*	*J.F.*	₹
2016							
Mar. 31	To Sundries as per						
	Sales Returns						
	Book	(SRB 10)	20,000				

REVIEW QUESTIONS

Fill in the Blanks:

1. _______ is the book of primary entry in which all transactions are recorded.

2. _______ means transferring the debit and credit items from the journal to the ledger accounts.

3. When the goods purchased are returned to the supplier, ____ note is sent to him.

Bills Receivable Book

This book is used to record the details of bills receivable by the business organization. The entries to be made in this book include the name of the acceptor, date of receipt of the bill, term of the bill, due date, amount and other details. The total of the amount column of the bills receivable book is debited to bills receivable account while the amount of each bills receivable is posed to the credit of the account of the party from whom it is received.

BILLS RECEIVABLE BOOK

Bill No.	*Date Received*	*From Whom Received*	*Ledger Folio*	*Acceptor*	*Date of the Bill*	*Term*	*Due Date*	*Amount* ₹	*Disposal*

BILLS PAYABLE BOOK

This is used to record the particulars of all the bills payable accepted by the business organisation for the purpose of paying amounts due to its creditors. The acceptance is duly returned to the drawer. The amount of each bill is posted to the debit side of the drawer's account in the ledger and the total of the amount column of the bills payable book is posted to the credit of bills payable account in the ledger.

Bills Payable Book

Bill No.	*Date Acceptance*	*Drawn By*	*Ledger Folio*	*Payee*	*Date of the Bill*	*Term*	*Due Date*	*Amount ₹*	*Disposal*

CASH BOOK

Cash book is the book in which all transactions concerning cash receipts and cash payments are recorded. Cash Book is in the form of an account. It serves the purpose of Cash Account also. On the debit side, all cash receipts are recorded while on the credit side, all cash payments are recorded. In case of cash transactions, only a single aspect of transactions is recorded in ledger because the other aspect has to be recorded in Cash Book. Cash Book thus serves the purpose of a book of original entry as well as that of a ledger account.

A cash book has the following features:

(a) Only cash transactions are recorded in chronological order in the cash book.

(b) It performs the functions of both journal and ledger at the same time.

(c) All cash receipts are recorded on the debit side and all cash payments are recorded on the credit side.

(d) It records only one aspect of transaction i.e. cash.

Types of Cash Book

(i) *Single Column Cash Book*: It is like an ordinary cash account. In this all cash receipts are recorded on the left hand side (real account - debit what comes in) and all cash payments are recorded on the right hand side (real account - credit what goes out).

Dr. **Cash Book (Single Column)** *Cr.*

Date	*Particulars*	*L.F.*	*Amount ₹*	*Date*	*Particulars*	*L.F*	*Amount ₹*

(ii) *Two (Double) Column Cash Book*: It has two amount columns on both sides; one is for cash and another is for discount. Cash column is meant for recording cash receipts and payments while discount column is meant for recording discount received and allowed. The discount column on the debit side represents the discount allowed while discount column on the credit side represents the discount received.

Dr.			**Cash Book (Double Column)**						*Cr.*
Date	*Particulars*	*L.F.*	*Discount* ₹	*Amount* ₹	*Date*	*Particulars*	*L.F*	*Discount* ₹	*Amount* ₹

Note: Discount columns do not serve the function of a discount account. Discount columns are merely memorandum columns. Discount allowed account and discount received account are opened in the ledger and the totals of discount columns are posted to these accounts.

Illustration 4:

Record the following transactions in Cash Book of Mr. Singh:

2016			₹
April	1	Mohan Lal commenced business with cash	1,00,000
”	2	Bought goods for cash	65,700
”	3	Sold goods for cash	4,320
”	6	Received cash from Fateh Singh	1,800
”	6	Allowed him discount	50
”	9	Paid cash to Shugan Chand	19,500
		Discount allowed by Shugan Chand	500
”	12	Paid for Office Furniture	5,680
”	18	Sold goods for cash	7,810
”	23	Received cash from Subramaniam	9,870
”		Discount allowed to him	120
”	27	Paid for advertising	500
”	28	Cash paid to Asia Trading Co.	20,300
		Discount received	250
”	30	Cash sales	1,280
”	30	Cash received from Fateh Singh	2,850
		Discount allowed to him	100
		Salary paid in cash	3,150

Solution:

Mr. Singh

Dr. **Cash Book** Cr.

Date	*Particulars*	*L.F*	*Discount* ₹	*Cash* ₹	*Date*	*Particulars*	*L.F*	*Discount* ₹	*Cash* ₹
2016 April					2016 April				
1.	To Capital A/c			1,00,000	2.	By Purchases A/c			65,700
3.	To Sales A/c			4,320	9.	By Shugan Chand		500	19,500
6.	To Fateh Singh		50	1,800	12.	By Furniture A/c			5,680
18.	To Sales A/c			7,810	27.	By Advertising			500
23.	To Subramaniam		120	9,870	28.	By Asia Trading Co.		250	20,300
30.	To Sales A/c			1,280	30.	By Salary			3,150
30.	To Fateh Singh		100	2,850	30.	By Balance c/d			13,100
			270	1,27,930				750	1,27,930
May1	To Balance B/d			13,100					

REVIEW QUESTIONS

1. ____ Cash book has two account columns on both sides Double/Triple).

2. Only _____ transactions are recorded in cash book (cash/credit).

3. Bills Payable is _____ for the organization (asset/liability).

(iii) ***Three Columnar Cash Book:*** This type of cash book contains the following three amount columns on each side:

(a) Discount column for discount received and allowed;

(b) Cash column for cash received and cash paid; and

(c) Bank column for money deposited and money withdrawn from the bank.

Dr. **Cash Book (Triple Column)** *Cr.*

Date	*Particulars*	*L.F.*	*Discount* ₹	*Cash* ₹	*Bank* ₹	*Date*	*Particulars*	*L.F*	*Discount* ₹`	*Cash* ₹	*Bank* ₹

When triple column cash book is prepared, there is no need for a separate bank account in the ledger. The bank account maintained by the enterprise is a personal account and the cash account is a real account. For recording transactions in the bank column of the cash book the rule of debit and credit applicable to personal accounts should be followed i.e. debit the receiver and credit the giver. Thus, when cash is deposited with bank, the bank would be the receiver and would be debited in the bank column of the cash book. Similarly, for cash withdrawn from the bank the bank would be the giver and would be credited in the bank column of the cash book.

Contra Entry: If a transaction involves both cash and bank accounts, it is entered on both sides of the cash book, one in the cash column and other in the bank column, though on opposite sides. There are is called contra entries and word 'C' is indicated against that item in L.F. columns e.g. when cash is withdrawn from the bank, it is recorded on the debit side in cash column and on the credit side in the bank column. Similarly, when cash is deposited with the bank, the amount is recorded on the debit side in bank column and on the credit side in the cash column.

Illustration 5:

On 1st May, 2016 the columnar cash book of Mitra showed that he had ₹ 2,000 in his cash box and that there was a bank overdraft of ₹ 8,000. During the day the following transactions took place:

Cash withdrawn from bank for office use	10,000
Paid salaries in cash	3,000
Cash paid to Harish & Co.	6,500
Drawings in cash made by Mitra for household expenses	1,000
Received from G. Guha in settlement of an account of ₹ 10,000,	
₹ 1,800 in cash and a cheque of ₹ 8,000. The cheque was immediately deposited in bank	
Cash sales	6,500
Bank returns a cheque of ₹ 9,900 received from Kulu & Sons in settlement of an account of ₹ 10,000	
Paid rent by cheque	1,500
Cash deposited with bank	6,000

Write up the Cash Book for the day and balance it.

Solution:

Dr. **Cash Book (Triple Column)** *Cr.*

Date	Particulars	L.F.	Discount ₹	Cash ₹	Bank ₹	Date	Particulars	L.F.	Discount ₹	Cash ₹	Bank ₹
2016						2016					
May 1	To Bal. b/d			2,000		May 1	By Bal. b/d				8,000
	To Bank	(C)		10,000			By Cash	(C)			10,000
	To G.Guha		200	1,800	8,000		By Salaries A/c			3,000	
	To Sales A/c			6,500			By Harish & Co.			6,500	
	To Cash	(C)			6,000		By Drawings A/c			1,000	
	To Bal. c/d				15,400		By Kulu & Sons		100		9,900
							By Rent A/c				1,500
							By Bank	(C)		6,000	
							By Bal c/d			3,800	
			200	20,300	29,400				100	20,300	29,400
May 2	To Balance b/d			3,800		May 2	By Balance b/d				15,400

PETTY CASH BOOK

Payments in cash of small amounts like traveling expenses, postage, carriage etc. are petty cash expenses. These petty cash expenses are recorded in the petty cash book. The petty cash book is maintained by separate cashier known as petty cashier. The firm may adopt Imprest System of maintaining petty cash. The petty cashier is given a certain sum of money at the beginning of the fixed period (e.g. a month/fortnight) which is called float. The amount of float is so fixed that it may be adequate to meet petty expenses of the prescribed period. The balance in the petty cash book shows cash lying with the petty cashier.

Petty Cash Book

Amount Received	*Date*	*Particulars*	*Voucher No.*	*Total Amount Paid*	*Analysis of Payments*			
					Cartage ₹	*Postage* ₹	*Conveyance* ₹	*Misc. or Sundries* ₹

The advantages of the imprest system are as follows:

- It saves the time of the chief cashier.
- Petty cashier is not allowed to keep idle cash with him if the float is found to be more than adequate; its amount will be immediately reduced. This reduces the chances of misuse of cash by the petty cashier.
- The record of petty cash is checked by the cashier periodically, so that a mistake, if committed, is soon rectified.
- It enables a great saving to be effected in the posting of small items to the ledger accounts.
- The system trains young staff to handle cash responsibilities.

Petty Cash Book may be treated either as a part of the double entry system or merely as a memoranda book. If the former course is adopted, each payment to petty cashier is shown on the credit side of the main Cash Book which is considered to have been balanced by a debit entry in the petty cash book. The two entries are folioed against each other completing the double entry aspect. Payments recorded in the Petty Cash Book are directly posted to the different nominal accounts. Of course, entries for expenses are made only with the periodical totals of expenses under various heads. If the latter course is adopted, for amounts paid to petty cashier, petty cash account in the ledger is debited besides entering the amounts (paid to petty cashier) on the credit side of the main cash book. Periodically, different nominal accounts are debited and the petty cash account is credited in ledger for expenses recorded in Petty Cash Book.

Illustration 6:

Prepare an analytical Petty Cash Book from the following information:

Petty cash is maintained on the basis of imprest system. On 21st January, 2017 the petty cashier had with him ₹ 328. He received ₹ 672 to make up the expenses of the previous week. During the week the following expenses were met by the petty cashier:

2017			₹
March	21	Bus fare	6
”	21	Revenue stamps	85
	21	Tea for customers	22
”	22	Cartage	43
”	24	Payment to Coolie	10
	24	Telegram charges	76
	24	Refreshment for customer	52
”	25	Repairs to furniture	100
	25	Taxi charges	87
	25	Post cards	90
	25	Cloth for dusters	74
	25	Tea for customers	20

Solution:

Analytical Petty Cash Book

Amount Received	*Date*	*Particulars*	*Voucher No.*	*Total Amount Paid*	*Cartage & Cooli*	*Printing & Stationery*	*Customers Entertainment*	*Conveyance*	*Sundries*
	2017 Jan.								
328	22.	To Balance b/d							
672	21.	To Cash							
	21.	By Bus Fare		6				6	
	21.	By Rev. Stamps		85		85			
	21.	By Tea for Customers		22			22		
	22.	By Cartage		43	43				
	24.	By Cooli		10	10				
	24.	By Telegram charges		76		76			
	24.	By Refreshment to customers		52			52		
	25.	By Repairs to Furniture		100					100
	25.	By Taxi Charges		87				87	
	25.	By Post Cards		90		90			
	25.	By Cloth for Dusters		74		74			
	25.	By Tea for Customers		20			20		
		By Balance c/d		335					
1,000				1,000					
335	28.	To Balance b/d							
665	28.	To Cash A/c							

The journal entry required for various petty cash expenses are the following:

Journal Entry

		₹	₹
Cartage A/c	Dr.	53	
Postage and Telegrams A/c	Dr.	251	
Conveyance A/c	Dr.	93	
Customer's Entertainment A/c	Dr.	94	
Repairs A/c	Dr.	100	
General Expenses A/c	Dr.	74	
To Petty Cash Account			665

The Petty Cash Account in the ledger will appear as follows:

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

2017			2017		
Jan. 21	To Balance b/d	328	Jan. 25	By Sundries*	665
"	To Cash A/c	672	Jan. 28	By Balance c/d	335
		1,000			1,000
Jan. 28	To Balance b/d	335			
"	To Cash	665			

GENERAL JOURNAL

This is also known as Journal Proper or General Jounral. It is used for making the original record of such transactions for which no special journal has been kept in the business. Entries recorded in the a journal proper may be confined to the following transactions:

(i) ***Opening Entries***: Opening entries are passed at the beginning of the financial year to open the accounts by recording the assets, liabilities and capital appearing in the balance sheet of the previous year. It is written as follows:

Assets Account Dr.

To Liabilities Account

To Capital Account

(ii) ***Closing Entries***: Closing entries are passed at the end of the accounting year for closing of accounts relating to expenses and revenues. These accounts are closed by transferring their balances to the Trading and Profit & Loss Account.

(iii) ***Adjustment Entries***: At the end of the accounting year, adjustments entries are passed for outstanding/prepaid expenses, accrued income/income received in advance etc. Entries for all these adjustments are passed in the journal proper.

(iv) ***Transfer Entries***: Transfer entries are passed in the general journal for transferring an item entered in one account to another account.

(v) ***Rectification Entries***: Rectification entries are passed for rectifying errors which might have committed in the books of account.

(vi) ***Purchase of Fixed Assets***: When fixed assets are purchased on credit, the entries are passed in the general journal.

(vii) ***Sale of Worn-out or Obsolete Assets***: When obsolete assets are sold on credit, these are originally recorded in the general journal.

Illustration 7:

On 31st March, 2016 following balances are available in ledger for the year 2015-16.

	₹
Furniture (debit balance)	20,000
Stock of Goods Account (debit balance)	70,000
S. Sircar (debit balance)	14,000
M. Mitra (debit balance)	7,500
Cash (debit balance)	2,400
B. Basu (credit balance)	13,900
Capital Account (credit balance)	1,00,000

Write the opening entry for 1st April, 2016.

Solution :

Date	*Particulars*		*L.F.*	*Dr. Amount ₹*	*Cr. Amount ₹*
2016					
April 1	Furniture A/c	Dr.		20,000	
	Stock of Goods	Dr.		70,000	
	S.Sircar	Dr.		14,000	
	M. Mitra	Dr.		7,500	
	Cash A/c	Dr.		2,400	
	To B. Basu				13,900
	To Capital Account				1,00,000
	(For opening balances of various assets, liabilities and capital as on 1st April, 2016)				

TRIAL BALANCE

A trial balance is a schedule or list of debit and credit balances extracted from various accounts in the ledger including cash and bank balances from cash book. Since every transaction has a dual effect i.e. every debit has a corresponding credit and vice versa, the total of the debit balances and credit balances extracted from the ledger must tally. Thus, at the end of the accounting period or at the end of each month, the balances of the ledger accounts are extracted and trial balance is prepared to test as to whether the total debits are equal to total credits or not.

Features of a Trial Balance

It is a statement prepared in a tabular form. It has two amounts columns one for debit balances and other for credit balances.

The balances at the end of the period as shown by ledger accounts are shown in the statement.

It can be prepared on any date provided accounts are balanced.

It is a method of verifying the arithmetical accuracy of entries made in the ledger.

Objectives of Preparing Trial Balance

(i) It is a check on the accuracy of posting. If the trial balance agrees it proves that:

  (a) the books are arithmetically accurate, and

  (b) both the aspects of the transactions have been recorded in the books of original entry as well as in the ledger.

(ii) It brings together the balances of all the accounts at one place and this facilitates the preparation of final accounts and balance sheet.

Methods of Preparing the Trial Balance

(i) *Totals Method*: In this method, the totals of debit and credit sides of the ledger accounts are shown in the trial balance. The sum totals of debit and credit columns of the trial balance must be equal. This is less popular method.

(ii) *Balances Method*: In this method, the balances of ledger accounts are taken to respective debit and credit columns of the trial balance and then grand totals are taken out. The total of balances in the debit column must be equal to the total balances in the credit column of the trial balance.

Specimen of Trial Balance

Trial Balance as at ________

Sl. No.	*Particulars*	*L.F.*	*Amount (Dr.) (₹)*	*Amount (Cr.) (₹)*

Illustration 8:

Raju started business on 1st January 2017. You are required to pass entries, in journal & subsidiary books, post them in ledger and prepare trial balance under totals & balances method for January 2017. His transactions for the month were follows:

2017			₹
Jan.	1	Cash brought in by Raju as his capital	2,00,000
		Furniture purchased on credit from Nuluk Furniture Home	25,000
"	2	Goods purchased from Modi & Sons on credit	61,400
"	3	Goods purchased for cash	35,000
"	4	Goods purchased from Delhi Traders on credit	73,300
"	5	Cash sales	4,600
"	8	Sold goods to Bhatia & Co. on credit	19,860
"	11	Purchased stationery for cash	1,050
"	12	Paid Modi & Sons cash to settle account	
		Received 5% discount from the firm	......
"	13	Received from Bhatia & Co. in full settlement of account	19,800
"	17	Cash sales	10,700
"	18	Sold on credit to Ganesh & Co.	5,000
"	19	Received cash from Ganesh & Co.	1,000
"	21	Sold on credit to Hoshiar Singh	4,000
"	23	Purchased goods for cash	26,000
"	27	Hoshiar Singh becomes insolvent. A first and final dividend of ₹ 3,000 is received from his estate	
"	31	Ganesh & Co. pays cash	3,900
"	31	Discount allowed to Ganesh & Co.	100
"	31	Cash paid for rent	2,800
"	31	Depreciation on furniture	250
"	31	Payment to Delhi Traders in full settlement	73,000

Solution:

In the books of Raju

Journal Entries

Date	*Particulars*	*L.F.*	*Dr.* ₹	*Cr.* ₹
2017				
Jan. 1	Furniture Account Dr.		25,000	
	To Nuluk Furniture Home			25,000
	(For furniture purchased on credit from Nuluk Furniture Home)			
" 27	Bad Debts Dr.		1,000	
	To Hoshiar Singh			1,000
	(Bad debts written off on the insolvency of Hoshiar Singh)			
" 31	Depreciation A/c Dr.		250	
	To Furniture A/c			250
	(For depreciation provided on Furniture)			
	Total		26,250	26,250

Purchases Book

Month : January, 2017

Date	*Particulars*	*Invoice No.*	*L.F.*	*Details*	*Amount* ₹
2017					
Jan. 2	Modi & Sons Goods				61,400
Jan. 4	Delhi Traders Goods				73,300
	Total				1,34,700

Sales Book

Month : January, 2017

Date	*Particulars*	*Invoice No.*	*L.F.*	*Details*	*Amount* ₹
2017					
Jan. 8	Bhatia & Co.				19,860
" 18	Ganesh & Co.				5,000
" 21	Hoshiar Singh				4,000
					28,860

Dr. **Cash Book** *Cr.*

Date	*Particulars*	*L.F.*	*Discount*	₹	*Date*	*Particulars*	*L.F.*	*Discount*	₹
2017					2017				
Jan. 1	To Capital A/c			2,00,000	Jan. 3	By Purchases			35,000
" 5	" Sales			4,600	" 11	" Stationery			1,050
" 13	" Bhatia & Co.		60	19,800	" 12	" Modi & Sons		3,070	58,330
" 17	" Sales			10,700	" 23	" Purchases			26,000
" 19	" Ganesh & Co.			1,000	" 31	" Rent			2,800
" 27	" Hoshiar Singh			3,000	" 31	" Delhi Traders		300	73,000
" 31	" Ganesh & Co.		100	3,900	" 31	" Balance c/d			46,820
			160	2,43,000				3,370	2,43,000
Feb. 1	To Balance b/d			46,820					

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

Date	*Particulars*	*J.F.*	₹	*Date*	*Particulars*	*J.F.*	₹
2017				2017			
Jan. 31	To Balance c/d		2,00,000	Jan. 1	By Cash		2,00,000
			2,00,000				2,00,000
				Feb. 1	" Balance b/d		2,00,000

Dr. **Furniture Account** *Cr.*

Date	*Particulars*	*J.F.*	₹	*Date*	*Particulars*	*J.F.*	₹
2017				2017			
Jan. 1	To Nuluk Furniture			Jan. 31	By Depreciation		250
	Home		25,000		" Balance c/d		24,750
			25,000				25,000
Feb. 1	To Balance b/d		24,750				

Dr. **Nuluk Furniture Home** *Cr.*

Date	*Particulars*	*J.F.*	₹	*Date*	*Particulars*	*J.F.*	₹
2017				2017			
Jan. 31	To Balance c/d		25,000	Jan. 31	By Furniture		25,000
			25,000		"		25,000
				Feb. 1	By Balance b/d		25,000

Dr. **Modi & Sons** *Cr.*

Date	*Particulars*	*J.F.*	₹	*Date*	*Particulars*	*J.F.*	₹
2017				2017			
Jan. 12	To Cash A/c		58,330	Jan. 2	By Purchases		61,400
	" Discount A/c		3,070				
			61,400				61,400

Dr. **Purchases Account** *Cr.*

Date	*Particulars*	*J.F.*	₹	*Date*	*Particulars*	*J.F.*	₹
2017				2017			
Jan. 3	To Cash A/c		35,000	Jan. 31	By Balance c/d		1,95,700
" 23	" Cash A/c		26,000				
" 31	" Sundries as per						
	Purchases Book		1,34,700				
			1,95,700				1,95,700
Feb. 1	" Balance b/d		1,95,700				

Dr. **Delhi Traders** *Cr.*

Date	*Particulars*	*J.F.*	₹	*Date*	*Particulars*	*J.F.*	₹
2017				2017			
Jan. 31	To Cash A/c		73,000	Jan. 4	By Purchases		73,300
	" Discount A/c		300				
			73,300				73,300

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

Date	*Particulars*	*J.F.*	₹	*Date*	*Particulars*	*J.F.*	₹
2017				2017			
Jan. 31	To Balance c/d		44,160	Jan. 5	By Cash A/c		4,600
				Jan. 17	" Cash A/c		10,700
				Jan. 31	" Sundries as per Sales A/c		28,860
			44,160				44,160
				Feb. 1	By Balance b/d		44,160

Dr. **Bhatia & Co.** *Cr.*

Date	*Particulars*	*J.F.*	₹	*Date*	*Particulars*	*J.F.*	₹
2017				2017			
Jan. 8	To Sales A/c		19,860	Jan. 13	By Cash A/c		19,800
					" Discount A/c		60
			19,860				19,860

Dr. **Stationery Account** *Cr.*

Date	*Particulars*	*J.F.*	₹	*Date*	*Particulars*	*J.F.*	₹
2017				2017			
Jan. 11	To Cash A/c		1,050	Jan. 31	By Balance c/d		1,050
			1,050				1,050
Feb. 1	To Balance b/d		1,050				

Dr. **Ganesh & Co.** *Cr.*

Date	*Particulars*	*J.F.*	₹	*Date*	*Particulars*	*J.F.*	₹
2017				2017			
Jan. 18	To Sales A/c		5,000	Jan. 19	By Cash A/c		1,000
				" 31	" Cash A/c		3,900
					" Discount A/c		100
			5,000				5,000

Dr. **Hoshiar Singh** *Cr.*

Date	*Particulars*	*J.F.*	₹	*Date*	*Particulars*	*J.F.*	₹
2017				2017			
Jan. 21	To Sales A/c		4,000	Jan. 27	By Cash A/c		3,000
					" Bad Debts A/c		1,000
			4,000				4,000

Dr. **Bad Debts Account** Cr.

Date	Particulars	J.F.	₹	Date	Particulars	J.F.	₹
2017				2017			
Jan. 27	To Hoshiar Singh		1,000	Jan. 31	By Balance c/d		1,000
			1,000				1,000
Feb. 1	" Balance b/d		1,000				

Dr. **Rent Account** Cr.

Date	Particulars	J.F.	₹	Date	Particulars	J.F.	₹
2017				2017			
Jan. 31	To Cash A/c		2,800	Jan. 31	By Balance c/d		2,800
			2,800				2,800
Feb. 1	" Balance b/d		2,800				

Dr. **Depreciation Account** Cr.

Date	Particulars	J.F.	₹	Date	Particulars	J.F.	₹
2017				2017			
Jan. 31	To Furniture		250	Jan. 31	By Balance c/d		250
			250				250
Feb. 1	" Balance b/d		250				

Dr. **Discount Account** Cr.

Date	Particulars	J.F.	₹	Date	Particulars	J.F.	₹
2017				2017			
Jan. 31	To Sundries for Discount Allowed as per debit side of Cash Book		160	Jan. 31	By Sundries for Discount Received as per credit side of Cash Book		3,370
" 31	" Balance b/d		3,210				
			3,370				3,370

Raju's Trial Balance
(Totals Method)
as on 31st January, 2017

Sl. No.	Particulars	Debit Totals ₹	Credit Totals ₹
1.	Cash	2,43,000	1,96,180
2.	Capital Account		2,00,000
3.	Furniture Account	25,000	250
4.	Nuluk Furniture Home		25,000
5.	Modi & Sons	61,400	61,400

Sl. No.	*Particulars*	*Debit Totals* ₹	*Credit Totals* ₹
6.	Purchase Account	1,95,700	
7.	Delhi Traders	73,300	73,300
8.	Sales Account		44,160
9.	Bhatia & Co.	19,860	19,860
10.	Stationery Account	1,050	
11.	Ganesh & Co.	5,000	5,000
12.	Hoshiar Singh	4,000	4,000
13.	Bad Debts Account	1,000	
14.	Rent Account	2,800	
15.	Depreciation Account	250	
16.	Discount Account	160	3,370
		6,32,520	6,32,520

Raju's Trial Balance
(Balances Method)
as on 31st January, 2017

Sl. No.	*Particulars*	*Debit Balances* ₹	*Credit Balances* ₹
1.	Cash		46,820
2.	Capital Account		2,00,000
3.	Furniture Account	24,750	
4.	Nuluk Furniture Home		25,000
5.	Purchases Account	1,95,700	
6.	Sales Account		44,160
7.	Stationery Account	1,050	
8.	Bad Debts Account	1,000	
9.	Rent Account	2,800	
10.	Depreciation Account	250	
11.	Discount Account		3,210
		2,72,370	2,72,370

LESSON ROUND UP

- Accounting cycle includes identifying, recording, classifying and summarizing of the transactions.
- Every transaction is recorded in the Journal before being posted into the ledger. It is that book of account in which transactions are recorded in a chronological order.
- Recording in the journal is done following the rules of debit and credit.
- Posting is the process of recording transactions in the ledger based on the entries in the journal.
- The main function of a ledger is to classify or sort out all the items appearing in the journal or other subsidiary books under their appropriate accounts so that at the end of the accounting period summary of each account is easily available.
- Balancing of ledger accounts involves equalization of both sides of the account by putting the difference on the side where the amount is short.

– Various subsidiary books are: purchases book; sales book; purchases returns book; sales returns book; bills receivable book; bills payable book and cash book.

– Petty Cash Book may be maintained under Imprest System of petty cash.

– General Journal or journal proper is maintained for recording those transactions for which there are no other appointment subsidiary book.

– Trial Balance is prepared after posting the entries in ledger to verify the arithmetical accuracy of entries made in the ledger.

GLOSSARY

Journal	Book of prime entry in which every transaction is recorded before being posted into the ledger.
Compound Journal Entry	Transactions which are inter-connected or of the same nature and have taken place simultaneously are recorded by means of compound or combined journal entries Posting is the process of recording transactions in the ledger based on the entries in the subsidiary books.
Cash Book	It is a record of transactions concerning cash receipts and cash payments.
Trial Balance	A schedule or list of balances both debit and credit extracted from various accounts in the ledger.

SELF-TEST QUESTIONS

Theory Questions:

1. Distinguish between journal and ledger.
2. What do you mean by contra-entries in a columnar cash book?
3. What is meant by columnar cash book?
4. What is meant by analytical petty cash book?
5. Describe the imprest system of patty cash.

Practical Questions:

1. Journalise the following transactions:

	2016			₹
(i)	Jan.	1	Bought office furniture from Kanji & Co.	6,000
(ii)	”	5	Bought goods from F. Roy	5,000
(iii)	”	10	Bought goods from P. Gupta	10,000
(iv)	Feb.	1	Sold goods to K. Peter	4,000
(v)	”	5	Sold goods to P. Turpin & Co.	7,000
(vi)	”	12	Bought goods from C. Henry	4,500
(vii)	”	17	Bought goods from J. Jones	2,000
(viii)	”	20	Sold goods to S. Sorab & Co.	18,000
(ix)	”	23	Sold goods to B. Byramji	1,750
(x)	”	25	Received cash from P. Turpin & Co.	3,000
(xi)	”	27	Received cash from K. Peter	2,500
(xii)	”	28	Paid cash to F. Roy	1,000

(xiii)	”	28	Paid cash to P. Gupta	5,000
(xiv)	Mar.	4	Paid salaries	9,000
(xv)	”	5	Paid office rent	750
(xvi)	”.	7	Sold goods for cash	2,750
(xvii)	”	8	Bought goods for cash	1,250
(xviii)	”	11	Paid for stationery	250
(xix)	“	15	Received cash from S. Sorab & Co.	14,750
(xx)	”	15	Received cash from B. Byramji	1,750
(xxi)	”	17	Paid cash to C. Henry	3,500
(xxii)	”	17	Paid cash to J. Jones	2,000
(xxiii)	”	20	Purchased goods for cash	1,000
(xxiv)	”	25	Paid Kanji & Co.	6,000

2. Rolly Polly was carrying on business as a cloth dealer. His transactions during April, 2016 were as follows:

2012			₹
Apr.,	1	Sold cloth on credit to Gifloo	5,000
”	2	Purchased cloth from Amboo on credit	20,000
”	3	Paid rent for April by cheque	3,000
”	4	Cash purchases of cloth (paid by cheque)	8,000
		Cash sales	4,500
”	6	Paid for stationery and postage	500
”	8	Drawn cash for private use	2,500
”	10	Drawn cash from Bank for office	15,000
”	13	Purchased goods on credit from Minoo	25,000
”	16	Sold goods on credit to Gopal	18,000
”	17	Paid telephone charges	4,800
”	18	Cash sales	3,000
		Paid for advertising	3,500
”	22	Cash purchases	9,000
”	24	Purchased filing cabinet and paid by cheque	5,000
”	27	Purchased Government securities	30,000
		Paid wages for the month	8,000

Journalise the transactions and prepare ledger accounts.

3. Enter the following transactions in a triple column cash book.

March, 2016			₹
”	1	Balance at bank	20,000
		Purchased goods by cheque	10,000

		Drew cheque for office cash	500
		Purchased stationery for cash	100
”	8	Received from C-cheque	1,250
		Allowed discount	30
”	9	Received from A-cheque	1,400
		Allowed discount	40
”	10	Carriage paid in cash	30
”	12	Received cheque from D	1,750
		Allowed discount	30
”	13	Paid to coolie hired-cash	80
		Drew cheque favoring G for rent	1,800
”	15	Paid for purchases-cheque	20,000
		Received from C-cheque	900
		Allowed discount	20
”	20	Paid for postage-cash	50
		Paid K by cheque	1,950
		Discount allowed by him	50
”	22	Received cheque for sales	1,500
”	25	Paid for cleaning office	50
”	27	Paid wages-cash	500
	30	Drew cheque for electricity	2,000
		Drew cheque for office use	3,000

(Ans.: Cash in hand ₹ 2,690; Bank overdraft ₹ 12,450; Discount - Dr. ₹ 120 and Cr. ₹ 50).

MULTIPLE CHOICE QUESTIONS

Q.1 Business transactions are recorded:-

(a) in chronological order

(b) weekly

(c) at the end of the month

Q.2 Trial Balance is prepared generally for a particular period which is ?

(a) week

(b) month

(c) Quarter

(d) Year

Q.3 Goods returned of Rs. 500/- by Anil will be entered in –

(a) Purchases Book

(b) Purchases Returns A/c

(c) Sales Book

(d) Sales Returns Book

Q.4 Purpose of Sales Book is –

(a) To record all sales made by the firm

(b) To record payment due to creditors

(c) To record all credit sales made by the firm

(d) to record credit sales of goods made by the firm

Q.5 Salaries paid to staff will be debited to which A/c?

(a) Salary A/c

(b) Cash A/c

(c) Staff A/c

(d) Expense A/c

Q.6 A ledger is called a book of :-

(a) Primary entry

(b) Secondary entry

(c) Final entry

Q.7 A Ledger Account is prepared from :

(a) events

(b) transactions

(c) Journal

Q.8 Cash book is used to record.

(a) All Cash receipts only.

(b) All Cash payments only

(c) All Cash & credits sales

(d) All receipts & payments of Cash

9. Return of goods by a customer should be debited to___________

a) Customers account b) Sales return account c) Goods account d) Purchase account

10. Rent paid to landlord should be credited to

a) Landlords account b) Rent account c) Cash account d) Expense account

11. The practice of appending notes regarding contingent liabilities in accounting statements is in pursuance to:

a) Convention of consistency b) Money measurement concept c) Convention of conservatism d) Convention of disclosure

Lesson 3
Accounting Process – II
(Rectification of Errors)

LESSON OUTLINE

- Errors
- Classification of Errors
  - Clerical Errors
  - Errors of Principles
- Errors disclosed by Trial Balance
- Errors not disclosed by Trial Balance
- Review Questions
- Steps to locate Errors
- Rectification of Errors
  - Before the preparation of Trial Balance
  - After the preparation of Trial Balance but before the preparation of Final Accounts.
  - In the next accounting period
- Lesson Round-Up
- Glossary
- Self Test Questions

LEARNING OBJECTIVES

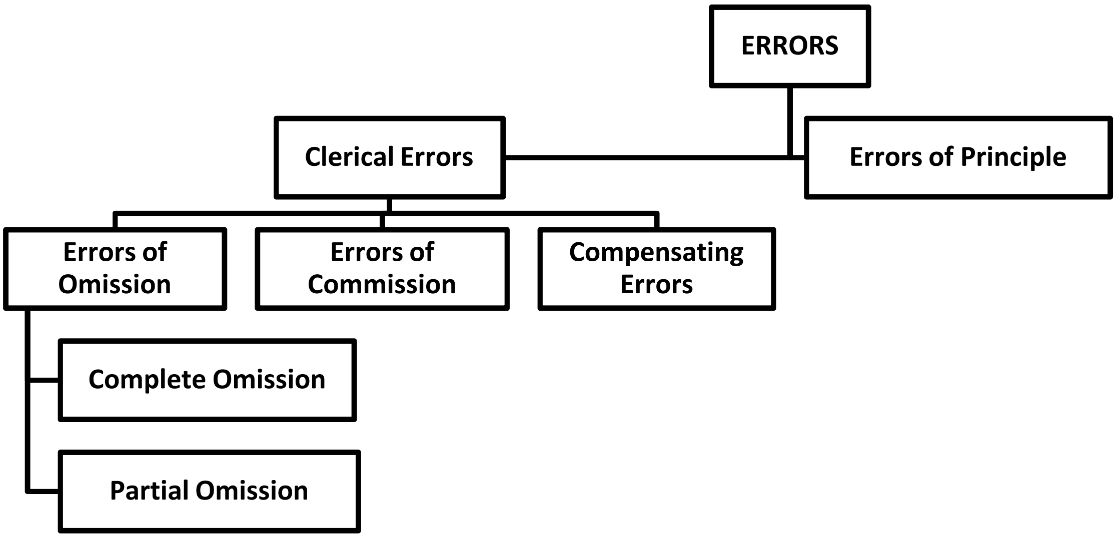
The main objective of any accountant is to ascertain the true profit and financial position of the business for the accounting period. For this, the accountant puts in best efforts to record the transactions correctly. However, the recording cannot be made error free. Certain error are bound to be committed while recording the transactions which affect the final accounts of the enterprise. Therefore, it becomes very important for the accountant to identify the errors and rectify them so that the correct and true financial position is ascertained. Errors should be rectified as and when they are found. Since, the accountant cannot simply change the figures and entries posted earlier, a certain procedure has to be followed to rectify the wrong entries.

In this lesson, we will study about accounting errors, identifying and classifying the accounting errors and the procedure for rectifying those errors before the preparation of trial balance, before the preparation of final account and in the next accounting period.

ERRORS

Accounting errors are the errors committed by persons responsible for recording and maintaining accounts of a business firm in the course of accounting process. These errors may be in the form of omitting the transactions to record, recording in wrong books, or wrong account or wrong totalling and so on. While discussing about the trial balance, we have seen that preparation of trial balance is a method of verifying the arithmetical accuracy of entries made in the ledger. But it may be noted that an agreement of the trial balance does not prove that- (i) all transactions have been correctly analyzed and recorded in the proper accounts; and (ii) all transactions have been recorded in the books of original entry. Hence, we can say that a trial balance should not be regarded as a conclusive proof of the correctness of the books of account, that is if the trial balance does not agree, there are errors or mistakes but even if the trial balance agrees, there may be errors in the accounts.

CLASSIFICATION OF ERRORS



A. Clerical Errors

Errors other than errors of principle are called clerical errors. The following are the types of clerical errors.

1. ***Errors of Omission***: These errors arise as a result of some act of omission on the part of the person responsible for the maintenance of books of account. It refers to the omission of a transaction at the time of recording in subsidiary books or posting to ledger. Omission may be complete or partial.

   (a) ***Complete Omission***: When any particular transaction has not at all been entered in the journal or in the book of original entry, it cannot be posted into the ledger at all and complete error of omission will occur. The trial balance is not affected at all by such errors e.g. failure to record completely credit sales in sales book. However, the trial balance will agree, if debit side as well as credit side of a journal entry is not posted to ledger.

   (b) ***Partial Omission***: This means that the transaction is entered in the subsidiary book, but is not posted to the ledger, such errors affect the agreement of trial balance e.g. omitting to post the discount columns of the cash book.

2. ***Errors of Commission***: These errors arise due to some positive act of commission on the part of the person responsible for the maintenance of the books of account. These mistakes are committed because of ignorance, lack of proper accounting knowledge and carelessness of the accounting staff. They are committed while recording transactions. These errors may or may not affect the agreement of trial balance.

For example:

- Mistake in balancing an account.
- Mistake in posting in so far as the amount is wrongly written. A common mistake, for example, is to transpose figures - to write ₹ 115 instead of ₹ 151. This will cause a mistake of ₹ 36 and a corresponding difference in the trial balance. The total of all the figures of the difference thus caused is 9 or multiples of 9. (Students should note that in case of transposition of figures, (i) the difference in trial balance will always be divisible by 9, (ii) the total of all the figures of the difference will also be divisible 9. Suppose, you have written 67895 instead of 95678 or in any other way, provided the figures are the same, the difference 27783 (i.e. 95678 - 67895) is divisible by 9. Hence, if the difference in trial balance is divisible by 9, it may be assumed that there may be transposition of figures.
- Making an entry on the wrong side. For example, if instead of debiting an account with ₹ 500 it is credited with the amount, the debit balance, in the trial balance will be shorter by ₹ 1,000. A mistake on the wrong side causes the difference to be double of the amount involved.
- A mistake in the casting of subsidiary books. A mistake in the total of the Purchases Book will affect the Purchases Account, a mistake in the total of the Sales Book will mean a corresponding mistake in the Sales Account. Similarly, total of the Returns Book, if wrongly done, would mean that the Returns Inwards Account or Returns Outwards Account will be posted with wrong amount. These mistakes will be reflected in the trial balance.

It must be noted that a mistake in the totals of the subsidiary books will not affect the correctness of the various personal accounts of customers and creditors.

3. ***Compensating Errors***: They are group of errors, the total effect of which is not reflected in the trial balance. These errors are neutralizing in nature, hence one error is compensated by other error or errors of opposite nature. For example, an extra debit in purchase account may be compensated by an extra credit in sales account. Thus, compensating errors do not affect the agreement of trial balance.

B. Errors of Principle

These errors arise because of the failure to differentiate between capital expenditure and revenue expenditure and capital receipts and revenue receipts. The distinction between capital and revenue is of relevance because any incorrect adjustment or allocation in this respect would falsify the final results shown by the profit and loss account and the balance sheet. These errors do not affect the agreement of trial balance. For example, debiting purchase of furniture to office expenses account, crediting sale of furniture to sales account, etc.

ERRORS DISCLOSED BY TRIAL BALANCE

Trial balance in general, discloses any error which affects one side of the account. These errors are disclosed by the trial balance as both sides of trial balance do not agree.

Examples:

- Error in casting subsidiary books.
- Error in carrying forward the total of one page the next page.
- Error in posting from book of subsidiary record to ledger.
- Error in balancing an account.
- Omission of casting etc.
- Posting an amount on the wrong side of a ledger account.
- Double posting to an account.
- Error in carrying a balance of an account to the trial balance.

The trail balance may not agree also become

– Trial balance has a mistake in itself, or

– Schedule of debtors or schedule of creditors is wrong

ERRORS NOT DISCLOSED BY TRIAL BALANCE

The agreement of a trial balance is only a check of arithmetical accuracy of the ledger but it is not a conclusive proof as to the absolute accuracy of the books. The following errors will not affect the agreement of trial balance and hence are not disclosed by the trial balance:

(i) *Errors of Complete Omission*: If a transaction was not recorded at all, the agreement of the trial balance will not be affected. For example, if goods worth ₹ 2,000 have been received back from a customer and the entry has not at all been made in the Returns Inwards Book then, the Customer's Account will not be credited and the Returns Inwards Account also will not be debited. Thus, there will be no debit and credit, and the trial balance will agree even though there is a mistake.

(ii) *Errors of Commission*: If a transaction was debited or credited to a wrong account with correct amount and on the correct side in the books of original entry or in the ledger, trial balance will remain unaffected.

(iii) *Compensatory Errors:* These are errors which are neutralized by the commission of another error or errors of the same magnitude but of opposite nature, which makes the trial balance to agree. For instance, the overcasting of a sales book by (say) ₹ 3,000 and thereby the excess credit to the sales account, will be arithmetically off-set either by over debiting or under crediting a single account or several accounts with a total sum of ₹ 3,000.

(iv) *Errors of Principle*: Errors of principle like furniture purchased debited to purchase account, building sold credited to sales account, commission paid for purchase of land debited to commission account etc. will not affect trial balance as they are related to allocation of amount received or spent between revenue and capital. There will be no effect on trial balance because double entry will be passed and one account will be debited and other credited. So the debit and credit side of trial balance will definitely agree.

(v) *Recording Wrong Amount in Subsidiary Book*: If a wrong amount is written in subsidiary books, then entries on both the debit and credit sides will be on the basis of the wrong amount and then the trial balance will naturally agree.

(vi) *Errors of Duplication*: This is the error of entering a transaction more than once in the subsidiary books.

REVIEW QUESTIONS

1. Classify the following errors:

(i) Credit sale of ₹ 1,500 to P was correctly recorded in sales book but not posted to P's Account.

(ii) Purchases book was undercast by ₹ 100.

(iii) Cash paid to Brij Behari, ₹ 500 was debited to Bankey Behari as ₹ 5,000.

(iv) Purchase of furniture ₹ 3,000 was recorded in Purchases Book.

(v) Whitewashing charges ₹ 500 were debited to Buildings Account.

[*Ans.* Errors of Omission = (i), Errors of Commission = (ii), (iii), Errors of Principle = (iv), (v)]

2. Which of the above mentioned errors will not affect the trial balance?

[*Ans*. (iv) and (v)]

3. What will be effect of the above mentioned errors on the profits for the year?

[*Ans.* Increase in profit by ₹ 2,400]

STEPS TO LOCATE ERRORS

Whenever there is a difference in the trial balance even by a small amount, the mistakes involved must be located. A small amount may be the net result of a number of mistakes and it is not safe to ignore a difference in trial balance howsoever small it may be. The following steps are suggested to find out errors:

(i) Total the debit and credit columns of the trial balance again. If one amount has been shown for a group of accounts (for example, in place of all customers individually, only one amount against "Sundry Debtors" may be shown), recheck the total of the list of such accounts.

(ii) See that the balances of all accounts including the cash, bank balances have been written in the trial balance.

(iii) See that there is no mistake in the balancing of the various accounts.

(iv) Find out the exact difference in the trial balance. Look for such accounts which show the same amount. It is possible that the balance of the particular account has been omitted from the trial balance. Accounts showing a balance equal to half the difference should also be checked; the amount may have been written on the wrong side of the trial balance

(v) Recheck the totals of the subsidiary books.

(vi) If the difference is a large one, compare the figures with the trial balance of the corresponding date of the previous year. Any account showing a rather large difference over the figures of the corresponding trial balance of the previous year should be rechecked.

(vii) Posting of all the amounts corresponding to the difference or half the difference should be checked.

(viii) If the difference is still not traced, posting of the accounts will have to be checked. For this, it is better, first of all, to check the posting of the totals of subsidiary books such as sales book, purchases book, returns books etc. The subsidiary books should then be gone through to see if any items have not been posted. It should also be checked whether the various accounts have been opened with correct balances. Nominal accounts should be checked first, then real accounts and then personal accounts should be taken up.

RECTIFICATION OF ERRORS

It is better to rectify errors always through journal entries. However, if an error is located immediately after it has been entered, the accountant may neatly cross out the wrong amount and initial the rectification. There should not be any overwriting. If however, some time has elapsed between the commission of the error and its detection, the error should be rectified by making suitable journal entries only.

Need for Rectification of Errors:

– To present the correct accounting information.

– To show the accurate profit or loss made during the year by preparing the profit & loss account.

– To disclose the true financial position by preparing the balance sheet.

Rectification before the Preparation of Trial Balance

When errors are detected before the preparation of the trial balance, it should be ascertained whether they are one sided errors or two sided errors. According to the nature of errors, different steps are taken for their rectification.

(a) *Errors Affecting One Account (One Sided Errors)*: Errors affecting one account may occur due to the following reasons:

(i) Wrong casting.

(ii) Wrong balancing.

(iii) Wrong posting.

(iv) Wrong carry forward.

(v) Forgetting to show an amount in the trial balance.

For rectification of these type of errors, no journal entry is required to be passed, only the relevant account, in the ledger is to be debited (for short debit or excess credit) or is to be credited (for short credit or excess debit) according to the situation.

While rectifying one sided errors it should be remembered that the double entry aspect of the rectifying entry will not be complete. For example, if P's account has been debited with ₹ 365 for credit sales of ₹ 356 correctly recorded in sales book, then the rectifying entry will be ₹ 9 made on the credit side of P's account only. No account will be debited with this amount of ₹ 9.

Illustration 1:

Rectify the following:

(i) An entry for the goods sold to Madhav for ₹ 1,020 was posted to his account as ₹ 1,200.

(ii) ₹ 1,000 being the monthly total of discount allowed to customers was credited to discount account in the ledger.

(iii) ₹ 2,750 received from Sohan was credited to Mohan as ₹ 3,750.

(iv) Total of Purchases Book was ₹ 10,000 short.

(v) Sales of old furniture for ₹ 1,750 to Old Wares Stores was recorded in sales book. Book value of the furniture was ₹ 2,500.

Solution:

(i) Credit Madhav with ₹ 180 saying "By Excess debit for sales on .....₹ 180".

(ii) Debit the Discount Account with ₹ 2,000 saying "To Rectification of wrong credit of ₹ 1,000 for discount allowed.... ₹ 2,000.

(iii) Credit Sohan with ₹ 2,750 and debit Mohan with ₹ 3,750.

(iv) Debit Purchases Account with ₹ 10,000 saying "To Short total of Purchases Book..... ₹ 10,000".

(v) Debit Sales Account with ₹ 1,750 and Loss on Sale of Furniture Account with ₹ 750 and credit Furniture Account with ₹ 2,500.

(b) *Errors Affecting Two or More Accounts. (Two Sided Errors)*: Errors which affect two or more accounts are as follows:

(i) Errors of complete omission.

(ii) Errors in recording in the subsidiary books.

(iii) Errors in posting to wrong account with or without wrong amount.

(iv) Errors of principle.

For rectification of these types of errors, following steps may be taken:

(i) Write down in the rough sheet, the correct entry necessary for recording the transaction.

(ii) Write down in the rough sheet the entry that has actually been passed.

(iii) Pass in the journal the requisite entry to arrive at the correct entry of step (i) and cancel the entry of step (ii).

Example: A purchase of ₹ 5,000 from Rajesh entered in the purchases day book as ₹ 500. The rectification of this error shall involve:

			₹	₹	
(a)	Purchases A/c	Dr.	5,000		(correct entry)
	To Rajesh			5,000	
(b)	Purchases A/c	Dr.	500		(entry passed)
	To Rajesh			500	
(c)	The rectifying entry in the journal will be:				
	Purchases A/c	Dr.	4,500		(rectifying entry)
	To Rajesh			4,500	

Illustration 2:

Pass journal entries necessary to rectify the following errors:

1. *An amount of ₹ 2,000 withdrawn by the proprietor for his personal use has been debited to Trade Expenses Account.*
2. *A purchase of goods from Nathan amounting to ₹ 3,000 has been wrongly entered in the Sales Book.*
3. *A credit sale of ₹ 1,000 to Santhanam has been wrongly passed through the Purchases Book.*
4. *₹ 1,500 received from Malhotra have been credited to Mehrotra.*
5. *₹ 3,750 paid on account of salary to the cashier Dhawan stands debited to his personal account.*
6. *A contractor's bill for extension of premises amounting to ₹ 2,75,000 has been debited to Building Repairs Account.*
7. *On 25th March, goods of the value of ₹ 5,000 were returned by Akash Deep and were taken into stock but the returns were entered in the books under date 3rd April, i.e.; after the expiration of the financial year on 31st March.*
8. *A bill of ₹ 2,000 for old office furniture sold to Sethi was entered in the Sales Day Book.*
9. *An amount of ₹ 800 received on account of interest was credited to Commission Account.*

Solution:

Journal Entries

Date	*Particulars*		*L.F.*	*Dr. (₹)*	*Cr. (₹)*
1.	Drawings Account	Dr.		2,000	
	To Trade Expenses Account				2,000
	(For the amount withdrawn for personal use wrongly charged to the trade expenses account)				
2.	(a) Sales Account	Dr.		3,000	
	To Nathan				3,000
	(Being the cancellation of the entry passed through the Sales Book)				
	(b) Purchases Account	Dr.		3,000	
	To Nathan				3,000
	(To record the credit purchases from Nathan)				
	Alternatively: It is better to pass a combined entry:				
	Sales Account	Dr.		3,000	
	Purchases Account	Dr.		3,000	
	To Nathan				6,000
	(For cancellation of entry passed through the Sales Book and record the credit purchases from Nathan)				
3.	Santhanam	Dr.		2,000	
	To Purchases Account				1,000
	To Sales Account				1,000
	(Rectification of the mistake caused by entering sale for ₹ 1,000 to Santhanam in the Purchases Book)				
4.	Mehrotra	Dr.		1,500	
	To Malhotra				1,500
	(Being the rectification of wrong credit given to Mehrotra instead of Malhotra)				
5.	Salaries Account	Dr.		3,750	
	To Dhawan				3,750
	(Being the adjustment of salary wrongly debited to the personal account of the cashier)				
6.	Building Account	Dr.		2,75,000	
	To Building Repairs Account				2,75,000
	(Being the adjustment of amount wrongly debited to the building account for building repairs)				
7.	Returns Inwards Account	Dr.		5,000	
	To Akash Deep				5,000
	(Being the entry necessary to record the return inwards within the financial year)				
	Entry in the books of next accounting year's				
	Akash Deep	Dr.		5,000	
	To Return Inwards Account				5,000
	(Cancellation of unwanted entry)				
8.	Sales Account	Dr.		2,000	
	To Office Furniture Account				2,000
	(Being the sale of old office furniture wrongly passed through the sales book)				
9.	Commission Account	Dr.		800	
	To Interest Account				800
	(Being the adjustment of amount wrongly credited to the commission account for interest received)				

Note :- In entry 7, the entry passed to record the above returns made on 3rd April, will have to be cancelled by passing a reverse entry as and when error is located.

Rectification after the Preparation of Trial Balance but before the Preparation of Final Accounts

(a) ***Errors Affecting One Account (One Sided Errors)***: Every one sided error detected after the preparation of trial balance will be rectified opening suspense account.

Suspense Account:

When a trial balance does not agree, efforts are made to locate errors and rectify them. However, if reason for disagreement of trail balance cannot be found, a new account called suspense account is opened in order to give trial balance an appearance of agreement. Then final accounts are prepared. Debit balance in suspense account is shown on assets side while credit balance is recorded on liabilities side.

A suspense account is opened in two instances i.e.

(i) *To balance a disagreed trial balance* – In the trial balance, if the debits are short the difference has to be debited to Suspense Account and if the credits are short, Suspense Account has to be credited to make trial balance agree apparently. Thus trial balance is tallied and final accounts are prepared. Later, when errors are detected, the rectifying entries are passed. The suspense account will show balance until all entries are corrected. When all errors affecting the trial balance have been rectified by means of journal entries, the Suspense Account will show no balance.

(ii) *To post uncertain items*: Sometimes, an item cannot be posted to the correct account because of lack of information. In this case, the error is rectified by means of journal entry opening suspense account. Thus, suspense account is opened and is given the debit or credit as the case may be. When debit is short of credit, the difference is debited to Suspense Account making the debits equal to the credits. Similarly, if in a rectifying journal entry, credit is otherwise short of debit, the difference is credited to Suspense Account. Later when error is detected, the rectifying entry is passed.

You received a remittance of ₹ 2,000, but you may not know who has sent the amount. Therefore, for the time being you may pass the following entry:

Cash Account	Dr.	2,000	
To Suspense Account			2,000
(Being remittance received from unknown person)			

Later when you get the information that Mr. Ram Singh had sent the amount, then pass the following entry:

Suspense Account	Dr.	2,000	
To Ram Singh			2,000
(Being credit given for the sender for remittance which had been credited previously to suspense account)			

(b) ***Errors Affecting Two or More Accounts (Two Sided Errors)***: For rectification of two sided errors, the following steps may be taken:

(i) Write down on the rough sheet, the correct entry necessary for recording the transaction.

(ii) Write down on the rough sheet, the entry that has actually been passed.

(iii) Pass in the journal, the requisite entry to arrive at the correct entry of step (i) and to cancel entry of step (ii).

Example: Sale of old furniture for ₹ 3,000 has been credited to sales account. The rectification of this error shall call for:

(a) Cash Account	Dr.	3,000	(correct entry)

	To Furniture Account			3,000	
(b)	Cash Account	Dr.	3,000		(entry passed)
	To Sales Account			3,000	
(c)	The rectifying journal entry will be:				
	Sales Account	Dr.	3,000		(rectifying entry)
	To Furniture Account			3,000	

Illustration 3:

Pass journal entries to rectify the following errors assuming the existence of Suspense Account:

(i) Goods bought from Mukesh amounting to ₹ 5,500 was posted to the credit of his account as ₹ 5,000.

(ii) Sales book was overcast by ₹ 10,000.

(iii) While carrying forward the total of one page of the Purchases Book to the next, the amount of ₹ 2,12,350 was written as ₹ 2,13,250.

(iv) Cartage ₹ 780 paid on machinery newly acquired was debited to carriage inward account.

(v) Purchases returns to Shivalker Bros. ₹ 3,100 were not recorded in purchases returns book but the account of Shivalker Bros. was duly debited with the amount.

(vi) Drawings of goods costing 300 were not recorded in the books of account.

(vii) Whitewashing expenses, ₹ 670 were posted from cash book to the nominal account as ₹ 760.

Also prepare Suspense Account starting it with debit balance of ₹ 320. Have you any comments to offer on Suspense Account?

Solution:

Journal

Date	*Particulars*		*LF*	*Dr. Amount (₹)*	*Cr. Amount (₹)*
(i)	Suspense Account	Dr.		500	
	To Mukesh				500
	(For rectification of short credit to Mukesh)				
(ii)	Sales Account	Dr.		10,000	
	To Suspense Account				10,000
	(For rectification of wrong total of Sales Book)				
(iii)	Suspense Account	Dr.		900	
	To Purchases Account				900
	(For rectification of wrong carry forward of total from one page to another in the Purchases Book)				
(iv)	Machinery Account	Dr.		780	
	To Carriage Inwards Account				780
	(For rectification of wrong debit to carriage inwards for cartage paid on newly acquired machinery)				

(v)	Suspense Account	Dr.	3,100	
	To Purchases Returns Account			3,100
	(For rectification of omission of credit to Purchases Returns Account for goods returned to Shivalkar Bros.)			
(vi)	Drawings Account	Dr.	300	
	To Purchases Account			300
	(For rectification of omission of drawings of goods costing ₹ 300 by the proprietor)			
(vii)	Suspense Account	Dr.	90	
	To Whitewashing Account			90
	(For rectification of excess debit to whitewashing account)			

LEDGER

Dr. **Suspense Account** *Cr.*

		Particulars	₹			*Particulars*	₹
	To	Differnce in trial balance	320	(ii)	By	Sales Account	10,000
(i)	To	Mukesh	500				
(iii)	To	Purchases Account	900				
(v)	To	Purchases Returns	3,100				
(vii)	To	Whitewashing Account	90				
	To	Balance c/d	5,090				
			10,000				10,000
					By	Balance b/d	5,000

Comment: As suspense account still shows a balance, it means all errors have not yet been rectified.

Illustration 4:

Rectify the following errors by passing necessary journal entries:

(i) Goods purchased for proprietor's use for ₹ 2,500 was debited to purchases account;

(ii) ₹ 2,750 received from Hari Chand was debited to his account;

(iii) Returns inward book was short totalled by ₹ 650.

(iv) Interest received on deposit ₹ 500 had been debited in the cash book, but had not been credited to interest account.

(v) ₹ 2,000 being purchases returned were posted to the debit of purchases account.

(vi) Interest on overdraft ₹ 1,200 was not posted to the ledger from the cash book.

(vii) An invoice for the purchase of machinery costing ₹ 1,00,000 was erroneously passed again and entered into the books.

Solution:

Rectifying Journal Entries

Date	*Particulars*		*L.F.*	*Dr. Amount (₹)*	*Cr. Amount (₹)*
(i)	Drawings A/c	Dr.		2,500	
	To Purchases A/c				2,500
	(Goods purchased for personal use wrongly debited to purchases account, error now rectified)				
(ii)	Suspense A/c	Dr.		5,500	
	To Hari Chand				5,500
	(Cash received from Hari Chand of ₹ 2,750 wrongly debited to his account, now rectified)				
(iii)	Returns Inward A/c	Dr.		650	
	To Suspense A/c				650
	(Returns inward book under-cast by ₹ 650, now rectified)				
(iv)	Suspense A/c	Dr.		500	
	To Interest Received A/c				500
	(Interest received not having been credited, error now rectified)				
(v)	Suspense A/c	Dr.		4,000	
	To Purchases A/c				2,000
	To Purchases Returns A/c				2,000
	(Purchases returns wrongly debited to purchases account, now rectified)				
(vi)	Interest A/c	Dr.		1,200	
	To Suspense A/c				1,200
	(Being interest on overdraft not posted to the ledger from cash book, error now rectified)				
(vii)	Supplier's A/c	Dr.		10,000	
	To Machinery A/c				10,000
	(Being invoice for purchase of machinery recorded in books twice, error now reversed)				

Rectification in the Next Accounting Period

The method of rectification of errors in the next accounting period depends upon the fact whether the account affected was part of the trading and profit & loss account. If the account affected is not part of the trading and profit & loss account, the rectification is done in the usual manner. However, if error involves an account having its impact on the profit, a Profit & Loss Adjustment Account is opened. While rectifying errors, all nominal accounts are replaced by Profit & Loss Adjustment Account. Profit and Loss Adjustment

Account is transferred to capital account of the sole proprietor or partners capital accounts in the case of partnership; In the case of a joint stock company the account is transferred to Profit and Loss Appropriation Account.

Examples:

(a) Wages of ₹ 2,500 paid for the installation of machinery charged to wages account. In the same accounting period, the rectifying entry would be:

		₹	₹
Machinery Account	Dr.	2,500	
To Wages Account			2,500

But if the final accounts have been prepared, the wages account has been closed by transfer to trading account, so the rectifying entry will be:

Machinery Account	Dr.	2,500	
To Profit and Loss Adjustment Account			2,500

(b) Salaries paid ₹ 3,500 posted to wages account in the ledger. In the same accounting period, the rectifying entry would be:

Salaries Account	Dr.	3,500	
To Wages Account			3,500

But if the final accounts have been prepared, no entry is required to be passed because both the accounts are nominal accounts and the profit has not been affected by the error.

Ascertainment of Correct Profit for the previous period

If in an accounting period, errors affecting nominal accounts take place and they are not detected and rectified before the close of the books of accounts for the period concerned, the profit as revealed by the Profit and Loss Account for the period will be incorrect. The correct profit for the period can be ascertained in the next accounting period after all such errors have been detected and rectified. If the Profit and Loss Adjustment Account reveals a profit, it should be added to the profit, as revealed by the Profit and Loss Account of the previous period to know the correct profit for the previous period. On the other hand, if Profit and Loss Adjustment Account shows a loss, it would be deducted from the profit of the previous accounting period, to ascertain the correct profit for the previous year.

Illustration 5:

The trial balance of M. Mukherjee did not tally on 31.3.2016. The following errors were detected afterwards. Pass the necessary journal entries to rectify the errors and find out the difference in trial balance assuming that all errors have been rectified.

(i) A sum of ₹ 600 received from Mathur on 31.3.2016 was entered in the cash book on 2.4.2016.

(ii) Returns inwards book was undercast by ₹ 300.

(iii) The purchase of typewriter for ₹ 25,000 was entered in the purchases day book.

(iv) Wages of workmen engaged in the construction of building amounting ₹ 35,000 were debited to wages account.

(v) A purchase of ₹ 2,671 had been posted to the debit of supplier's account as ₹ 2,617.

(vi) Goods amounting to ₹ 1,000 had been returned by Raju and were taken into stock, but no entry was passed in the books for the transaction.

(vii) ₹ 24,000 paid for purchase of T.V. for proprietors own use had been charged to miscellaneous expense account.

(viii) A sale of ₹ 600 to Sethi was credited to his account with ₹ 60.

(ix) A sale of ₹ 2,000 has been passed through the purchases journal.

(x) ₹ 75 paid for repairs to furniture had been entered in the total column of petty cash book, but not entered in the appropriate analysis column, the total of which has been posted.

Solution:

Rectifying Journal Entries

Date	*Particulars*		*L.F.*	*Dr.* (₹)	*Cr.* (₹)
(i)	No further entry required as receipt has already been recorded and no nominal account is ……				
(ii)	Returns Inwards A/c	Dr.		300	
	To Suspense A/c				300
	(Returns inward book was undercast by ₹ 300, error now rectified)				
(iii)	Typewriter A/c	Dr.		25,000	
	To Purchases A/c				25,000
	(Typewriter purchased was wrongly passed through purchases day book, error now rectified)				
(iv)	Building A/c	Dr.		35,000	
	To Wages A/c				35,000
	(Wages paid for construction of building was wrongly debited to wages account, error now rectified)				
(v)	Suspense A/c	Dr.		5,288	
	To Supplier's A/c (₹ 2,671 + ₹ 2,617)				5,288
	(Purchase of ₹ 2,671 from supplier wrongly debited to his account by ₹ 2,617, error now rectified)				
(vi)	Returns Inwards A/c	Dr.		1,000	
	To Raju				1,000
	(Goods returned by Raju not entered in the books of account, now entered)				
(vii)	Drawings A/c	Dr.		14,000	
	To Miscellaneous Expenses A/c				14,000
	(Purchase of T.V. for owner earlier charged to miscellaneous expenses account, error now rectified)				

Date	*Particulars*		*L.F.*	*Dr.* (₹)	*Cr.* (₹)
(viii)	Sethi (600 + 60)	Dr.		660	
	To Suspense A/c				660
	(Being goods of ₹ 600 sold to Sethi wrongly credited to his account for ₹ 60, error now rectified)				
(ix)	Suspense A/c	Dr.		4,000	
	To Purchases A/c				2,000
	To Sales A/c				2,000
	(Being a sale of ₹ 2,000 wrongly passed through purchases journal, error now rectified)				
(x)	Repairs to Furniture A/c	Dr.		75	
	To Suspense A/c				75
	(Being repairs for furniture earlier not posted from petty cash book, error now rectified)				

Dr. **Suspense A/c** *Cr.*

Date	*Particulars*	*Amount* ₹	*Date*	*Particulars*	*Amount* ₹
	To Supplier's A/c	5,288		By Difference in trial balance	8,253
	To Purchases A/c	2,000		(Keeping ……….)	
	To Sales A/c	2,000		By Returns Inwards A/c	300
				By Sethi	660
				By Repairs to Furniture A/c	75
		9,288			9,288

Illustration 6:

While closing his books of account, Om Prakash finds that the Trial Balance on that date, i.e. 31st March, 2016 is out by ₹ 907 excess debit. He places the difference in a newly opened Suspense Account and prepares his final accounts which reveal a profit of ₹ 14,780 for the year ended 31st March, 2016. In April 2012, the following errors were detected in the accounts for the year 2015-16;

- *(i) Purchases book was undercast by ₹ 1,000.*
- *(ii) Cash received from Jamna Das ₹ 687 was posted to the debit of Janki Das as ₹ 678.*
- *(iii) Discount received ₹ 7,630 and discount allowed ₹ 6,873, the totals of the appropriate columns in cash book were not posted to the ledger.*
- *(iv) Schedule of debtors was totalled ₹ 1,16,280 instead of ₹ 1,16,380. Om Prakash maintains a provision for bad debts @ 5%.*
- *(v) Bank charges and interest, ₹ 115 remained unposted to the debit side of the nominal account.*
- *(vi) Depreciation on furniture ₹ 2,970 was wrongly recorded as ₹ 2,790.*

Pass journal entries to rectify the above-mentioned errors, prepare Suspense Account and Profit and Loss Adjustment Account and ascertain the correct amount of profit for the year ended 31st March, 2012.

Solution:

Journal

Date	*Particulars*		*LF*	*Dr. Amount (₹)*	*Cr. Amount (₹)*
(i)	Profit and Loss Adjustment Account	Dr.		1,000	
	To Suspense Account				1,000
	(Being rectification of error caused by undercasting of Purchases Book for the year 2015-16 by ₹ 1,000)				
(ii)	Suspense Account	Dr.		1,365	
	To Jamna Dass				687
	To Janki Dass				678
	(Being rectification of wrong debit of ₹ 678 to Janki Das and omission of credit of ₹ 687 to Jamna Das, in 2015-16 books)				
(iii)	Suspense Account	Dr.		757	
	To Profit and Loss Adjustment Account				757
	(Being rectification of omission of posting of discount received ₹7,630 and discount allowed ₹ 6,873 in 2015-16)				
(iv)	Schedule of Debtors Account	Dr.		100	
	Profit and Loss Adjustment Account	Dr.		5	
	To Suspense Account				100
	To Provision for Bad Debts Account				5
	(Being rectification of schedule of debtors and also rectification of Provision for bad debts account due to wrong basis on which the amount of bad debts was calculated in 2015-16)				
(v)	Profit and Loss Adjustment Account	Dr.		115	
	To Suspense Account				115
	(Rectification of omission of posting to bank charges and interest account)				
(vi)	Profit and Loss Adjustment Account	Dr.		180	
	To Furniture Account				180
	(Being rectification of wrong entry for depreciation on furniture)				

Ledger Accounts

Dr. **Suspense Account** Cr.

Date	Particulars	Amount ₹	Date	Particulars	Amount ₹
2016 March 31	To Balance c/fd	907	2016 March 31	By Difference in Trial Balance	907
2016 April 1	To Jamna Das	687	2016 April 1	By Balance b/fd	907
				By P & L Adj. A/c	1,000
	To Janaki Das	678		By Schedule of Debtors	100
	To P & L Adjustment	757		By P & L Adj. A/c	115
		2,122			2,122

Dr. **Profit and Loss Adjustment Account** Cr.

		Particulars	₹			Particulars	₹
(i)	To	Suspense Account	1,000	(iii)	By	Suspense Account	757
(iv)	”	Provision for Bad Debts	5		By	Loss transferred to Capital A/c	543
(v)	”	Suspense Account	115				
(vi)	”	Furniture Account	180				
			1,300				1,300

Actual profit for the year ended 31st March, 2015-16 = ₹ 14,780 – ₹ 543 = ₹14,237.

Illustration 7:

The books of account of Bipin Lal for the year ended 31st March, 2016, were closed with a difference in the trial balance carried forward. Subsequently the following errors were detected:

(i) ₹ 1,500 being the total of discount column on the credit side of the cash book was not posted to discount account.

(ii) Closing stock was overstated by ₹ 9,000 being casting error in the schedule of inventory.

(iii) Returns outwards book was undercast by ₹ 150.

(iv) A credit sale of ₹ 870 was wrongly posted as 780 to the customer's account.

(v) ₹ 6,000 being the cost of purchase of office furniture was entered in the purchases book.

Pass rectification entries, prepare suspense account, and find the effect of correction on profit for the year ended 31st March, 2016.

Solution:

Rectification Entries

Date	*Particulars*	*L.F.*	*Dr. Amount*	*Cr. Amount*
(i)	Suspense A/c Dr.		1,500	
	To Profit and Loss Adjustment A/c			1,500
	(Discount received not posted from cash book to ledger, error now rectified)			
(ii)	Profit and Loss Adjustment A/c Dr.		9,000	
	To Stock in Trade			9,000
	(Closing stock was overstated by ₹ 9,000, error now rectified)			
(iii)	Suspense A/c Dr.		150	
	To Profit and Loss Adjustment A/c			150
	(Returns outwards book undercast, error now rectified)			
(iv)	Customer's Dr.		90	
	To Suspense A/c			90
	(Credit sale of ₹ 870 wrongly posted as 780, to the customer's account, error now rectified)			
(v)	Office Furniture A/c Dr.		6,000	
	To Profit and Loss Adjustment A/c			6,000
	(Purchase of office furniture wrongly entered in purchases account, error now rectified)			

Dr. **Suspense Account** *Cr.*

	Particulars	*Amount (₹)*		*Particulars*	*Amount (₹)*
To	Profit and Loss Adjustment A/c	1,500	By	Balance b/fd (Balancing figure)	1,560
To	Profit and Loss Adjustment A/c	150	By	Customer's A/c	90
		1,650			1,650

Dr. **Profit and Loss Adjustment Account** *Cr.*

	Particulars	*Amount (₹)*		*Particulars*	*Amount (₹)*
To	Stock in Trade	9,000	By	Suspense A/c	1,500
			By	Suspense A/c	150
			By	Office furniture A/c	6,000
			By	Loss transferred to Capital A/c	1,350
		9,000			9,000

Illustration 8:

On 31st March 2016, an accountant of a sole proprietorship concern could not agree his trial balance. He put the difference in a newly opened suspense account and closed the books of account for the year. In the subsequent accounting year, the following errors in the books for the year 2015-16 were located:

(i) ₹ 8,000 paid for purchase of office furniture was posted to the purchases account.

(ii) The sales book was overcast by ₹ 100.

(iii) Wages paid for installation of machinery, ₹ 2,750 had been debited to wages account as ₹ 5,250

(iv) A cheque for ₹ 7,330 was received from Rao after allowing him a discount of ₹ 70. It was endorsed in favour of Sen in full settlement of ₹ 7,500. The cheque was dishonoured, but no entry for dishonour was passed in the books.

Pass journal entries to rectify the above-mentioned errors. Also prepare the suspense account and profit and loss account assuming that all the errors have been located.

Solution:

Rectifying Journal Entries

Date	*Particulars*		*L.F.*	*Dr.(₹)*	*Cr.(₹)*
(i)	Office Furniture A/c	Dr.		8,000	
	To Profit & Loss Adjustment A/c				8,000
	(Cost of office furniture purchased wrongly debited to purchases account, error now rectified)				
(ii)	Profit & Loss Adjustment A/c	Dr.		100	
	To Suspense A/c				100
	(Rectification of error caused by over-casting of sales book by ₹100)				
(iii)	Machinery A/c	Dr.		2,750	
	Suspense A/c	Dr.		2,500	
	To Profit & Loss Adjustment A/c				5,250
	(Wages ₹ 2,750 paid for the erection of machinery debited to wages account as ₹ 5,250, error now rectified)				
(iv)	Rao (₹7,330 + 70)	Dr.		7,400	
	Profit & Loss Adjustment A/c	Dr.		100	
	To Sen				7,500
	(Cheque received from Rao for ₹ 7,330 after allowing him ₹ 70 discount and endorsed in favour of Sen against ₹ 7,500 dishonoured; no entry made earlier for dishonour, error now rectified)				

Dr. **Suspense A/c** *Cr.*

	Particulars	₹		*Particulars*	₹
To	Profit & Loss Adjustment A/c	2,500	By	Balance b/fd (difference in Trial Balance—balancing figure)	2,400
			By	Profit & Loss Adjustment A/c	100
		2,500			2,500

Profit & Loss Adjustment A/c

	Particulars	₹		*Particulars*	₹
To	Suspense A/c	100	By	Office Furniture A/c	8,000
To	Sen	100	By	Machinery A/c	2,750
To	Capital A/c		By	Suspense A/c	2,500
	(Transfer of profit)	13,050			
		13,250			13,250

LESSON ROUND UP

– Accounting errors can be classified into errors of principle and clerical errors.

– Clerical errors are further classified into errors of omission, errors of commission and compensating errors.

– Some errors affect the agreement of trial balance and are disclosed by the trial balance e.g. errors in casting, carry forward, totaling, balancing of accounts etc.

– Some errors do not affect the agreement of the trial balance and hence are not disclosed such as errors of complete omission, errors of commission, compensating errors and errors of principle.

– Most of the errors are rectified by passing journal entries.

– The difference in trial balance is transferred to Suspense Account if the errors are not identified.

– Profit & Loss Adjustment Account is opened to rectify the which involve nominal accounts in the next according period.

GLOSSARY

Accounting Errors Mistakes committed by persons recording and keeping accounts.

Errors of Principle These errors arise because of the failure to differentiate between capital expenditure and revenue expenditure and capital receipts and revenue receipts.

Errors of Commission These errors arise due to some positive act of commission on the part of the person responsible for the maintenance of the books of account.

Errors of Omission These errors arise as a result of some act of omission on the part of the person responsible for the maintenance of books of account.

Compensating Errors The total effect of these errors is not reflected in the trial balance.

SELF-TEST QUESTIONS

Practical Questions:

1. On 31st March, 2016 the accountant of a firm, while preparing the final accounts for the year, finds that the trial balance is out by ₹ 1,000 excess credit. He places the amount in Suspense Account. In April 2016, the under mentioned errors are discovered:

   (i) The opening balance of furniture and fittings account for 2015-16 was written as ₹ 2,6,700 instead of ₹ 27,600. The firm depreciates furniture and fittings @ 10% p.a. on written down value basis.

   (ii) Sales Book for February 2016 was found overcast by ₹100.

   (iii) A sum of ₹ 575 was received from I.N. Chakarvaty but the amount was wrongly credited to I.N. Chaturvedy.

(iv) Cartage amounting to ₹ 125 paid in respect of new machinery purchased on 29th March was debited to carriage inwards account.

(v) Goods invoiced at ₹ 130 were returned by Neelam Stores but by mistake an entry was passed in Returns Outwards Book.

Pass journal entries necessary to rectify the errors without affecting the profit for 2015-16. Also show Suspense Account.

2. How would you rectify the following errors?

(i) A sale of goods of the value of ₹ 2,500 to R. Roberts has been wrongly debited to Robertson & Co.

(ii) A purchase of ₹ 1,500 from S. Narayan instead of being credited to him from the Invoice Book, has been wrongly debited to him.

(iii) Cash ₹ 750 received from P. Basu and entered on the receipt side of the cash book has not been posted.

(iv) A payment of ₹ 250 made to J. Jones for cash purchase of goods from him stands debited to his account.

(v) A payment of ₹ 9,000 in respect of salary has been posted twice to salaries account.

(vi) An amount of ₹ 4,500 drawn by the proprietor for his personal use stands debited to general expenses account.

(vii) The total of the discount column on the debit side of the cash book for the month has been added short by ₹ 200.

(viii) ₹ 400 relating to purchase of office stationery has been wrongly debited to the personal account of the proprietor.

(ix) A credit purchase of ₹ 750 from Ramdas & Co. stands wrongly credited to Ramji & Co.

3. After getting an agreed trial balance, the account of M/s Senco Stores drafted the trading and profit loss a/c and the balance sheet. The following errors were then detected by the auditors:

(a) ₹ 2,500 received from the insurance company in full payment of claim for loss of stock in transist was deposited by the proprietor into his private bank account and was not recorded in the business books.

(b) Goods purchased for ₹ 2,000 were included in stock, but the invoice was not entered in the books for the period under review.

(c) There were compensating errors in the books i.e. (i) a payment of ₹ 300 as commission to a sales agent had not been posted from the cash book; (ii) dividends received were undercast by ₹ 100; (iii) purchases amounting to ₹ 190 were not posted to the account of the supplier from purchases journal and (iv) debit side of a customer's account was overcast by ₹ 10.

(d) Goods sold for ₹ 500 were returned by a customer, but no record of this was made in the books although the returned goods were included in the stock at their cost price, ₹ 380.

Show the journal entries and effect of these errors and summarise the alterations necessary in the originally drafted statement of accounts.

4. A merchant, while balancing his books of account, finds that the trial balance shows ₹ 3,765 excess credit. Being required to prepare the final accounts, he places the difference to a newly opened suspense account, which he carries forward. In the next accounting year, he locates the following errors:

(i) A sale for ₹ 4,000 has been passed through the purchases book. The customer's account has, however, been correctly debited.

(ii) A sum of ₹ 896 paid to Dwarka Prasad has been credited to Durga Prasad as ₹ 869.

(iii) Salary ₹ 5,500 paid to a peon has been debited to the peon's personal account.

(iv) Schedule of debtors has been totalled ₹ 3,66,560 instead of ₹ 3,76,560. A provision for bad debts @ 5% of the debtors has been created.

Draft journal entries necessary for rectifying the above-mentioned errors.

Prepare the suspense account and show the ultimate effect of the errors on the last year's profit by preparing profit and loss adjustment account.

MULTIPLE CHOICE QUESTIONS

1) Favourable balance of cash book implies that

   A) Credit balance of cash book

   B) Debit balance of cash book

   C) Bank overdraft

   D) Adjusted balance of cash book

2) A cash deposit made by business appears on the bank statement as _______ balance

   A) Debit

   B) Credit

   C) Expenses

   D) Liability

3) Bank reconciliation statement is the comparison of a bank statement (sent by bank) with the _________ (prepared by business)

   A) Cash receipt journal

   B) Cash payment journal

   C) Cash book

   D) Financial statements

4) A check returned by bank marked "NSF" means that

   A) Bank can't verify your identity

   B) There are not sufficient funds in your account

   C) Check has been forged

   D) Check can't be cashed being illegal

5) In the Bank reconciliation statement "Deposit in transit" is usually

   A) Subtracted from bank balance

   B) Added to bank balance

   C) Added to Cash book balance

   D) Subtracted from cash book balance

6) Bank reconciliation statement is prepared by

   A) Accountant of the business

   B) Manager of the business

   C) Controller of the bank

   D) Accountant of the bank

7) Which of the following error results in unadjusted cash book balance?

A) Outstanding checks

B) Unpresented checks

C) Deposit in transit

D) Omission of Bank charges

8) Bank charges amounting to $5000 was not entered in the cash book. Identify the correct adjustment in cash book

A) Bank charges will be debited in cash book

B) Bank charges will be added to cash book balance

C) Bank charges will be credited in cash book

D) Bank charges need no adjustment in cash book

9) Unpresented checks also referred as

A) Uncollected checks

B) Uncredited checks

C) Outstanding checks

D) Bounced checks

10) ________ are checks that are issued by the business but not yet presented to bank

A) Uncollected checks

B) Uncredited checks

C) Outstanding checks

D) Bounced checks

Lesson 4
Accounting Process – III
(Capital and Revenue Items)

LESSON OUTLINE

- Capital Expenditure
- Revenue Expenditure
- Difference between Capital and Revenue Expenditure
- Deferred Revenue Expenditure
- Comparison between Capital and Deferred Revenue Expenditure
- Capital and Revenue Receipts
- Difference between Capital and Revenue Receipts
- Capital and Revenue Profits
- Capital and Revenue Losses
- Review Questions
- Contingent Assets
- Contingent Liabilities
- Lesson Round Up
- Glossary
- Self Test Questions

LEARNING OBJECTIVES

The main purpose of accounting is to ascertain and present the true results of the business in terms of profit or loss during a particular accounting period. The profit or loss of a business can be ascertained by matching business revenues against the cost of the same period. Therefore, a clear understanding between capital and revenue (expenditures and receipts) is necessary for the correct ascertainment of profit or loss as revenue items are included only in income statement and capital items form part of balance sheet figures. The distinction between the capital and revenue transactions is done by analysing the basic nature of transactions. The classification depends upon the recurringness of the transaction and the relation of the transaction to an accounting period.

In this lesson, we will study in detail about basic concept of capital and revenue receipts and expenditure. Herein, we would also touch, in brief, the concept of contingent assets and liabilities of business.

There is no business like show business, but there are several businesses like accounting.

David Letterman

CAPITAL EXPENDITURE

Capital expenditure is that expenditure which results in acquisition of an asset or which results in an increase in the earning capacity of a business. The benefit of such expenditure lasts for a long period of time.

Examples: Purchases of land, buildings, machinery, furniture, patents, etc. All these assets stay in business and are used again and again. Other examples are money paid for goodwill (like the right to use the established name of an outgoing firm) since it will attract the old firm's customers and thus will result in higher sales and profits; money spent to reduce working expenses like conversion of hand-driven machinery to power-driven machinery and expenditure enabling a firm to produce a large quantity of goods. Expenditure which does not result in an increase in capacity or in reduction of day-to-day expenses is not capital expenditure, unless there is a tangible asset to show for it.

All sums spent up to the point an asset is ready for use should also be treated as capital expenditure. Examples are: fees paid to lawyer for drawing a purchase deed of land, overhauling expenses of second hand machinery, cartage paid for bringing machinery to the factory from supplier's premises and money spent to install a machinery; and even interest on loans taken to acquire fixed assets only for the period before the asset becomes operational.

REVENUE EXPENDITURE

Expenses whose benefit expires within the year of expenditure and which are incurred to maintain the earning capacity of existing assets are termed as revenue expenditure. Amounts paid for wages, salary, carriage of goods, repairs, rent and interest, etc., are examples of revenue expenditure. Depreciation on fixed assets is also a revenue expenditure. To the extent the materials are used up, they will be revenue expenditure. Similarly, cost of goods sold is revenue expenditure. Costs incurred to acquire an asset are capital but costs incurred to keep them in working condition or to defend their ownership are revenue. Fee paid to a lawyer for checking whether all the papers are in order before land is purchased is capital expenditure. But if later a suit is filed against the purchaser, the legal costs will be of revenue type.

DIFFERENCE BETWEEN CAPITAL AND REVENUE EXPENDITURE

The following are the points of distinction between capital expenditure and revenue expenditure:

(i) Capital expenditure is incurred in acquiring or improving permanent assets which are not meant for resale. But revenue expenditure is a routine expenditure incurred in the normal course of business and includes cost of sales as also the upkeep of fixed assets etc.

(ii) Capital expenditure seeks to improve the earning capacity of the business whereas revenue expenditure is incurred to maintain the earning capacity of the business.

(iii) Capital expenditure is normally a non-recurring outlay but revenue expenditure is usually a recurring features.

(iv) Capital expenditure produces benefits over several years. Hence, only a small part is charged as depreciation to income statement and the rest appears in the balance sheet. But revenue expenditure is consumed within an accounting year and the entire amount is charged to the (current year's) income statement. Hence, it does not appear in the balance sheet. Deferred revenue expenditure is however an exception to this rule.

DEFERRED REVENUE EXPENDITURE

There are certain expenses which may be in the nature of revenue but their benefit may not be consumed in the year in which such expenditure has been incurred; rather the benefit may extend over a number of years, for example, heavy advertising expenditure incurred in introducing a new line or developing a new market. Charges of these expenses are deferred because such expenses benefit more than one accounting period. The matching principle demands this. The basis of charge is usually proportionate to the benefit consumed/reaped.

The practice which varies considerably is to write off the amount over the period of years in which the benefit is expected to accrue say 3 to 5 years. If the expenditure can be ear-marked as being in respect of a specified object, the expenditure should be written off during the life of that object. Example: Heavy advertising expenses on a new product, accidental losses like loss arising from a fire or an earthquake; the loss may be spread over a few years. The deferred revenue expenditure not yet written off is shown on the assets side of the balance sheet. In the case of joint stock companies, it is deducted from reserves.

Thus, deferred revenue expenditure is revenue in character but —

(i) the benefit of which is not exhausted in the year of expenditure, or

(ii) is applicable either wholly or in part to the future years, or

(iii) is accidental with heavy amount and it is not prudent to charge it against the profit of one year.

The deferred revenue expenditure may be classified into the following three categories:

(i) Expenditure partly paid in advance, where a portion of the benefit has been derived within the accounting period and the balance will be reaped in a number of future years. Therefore, the benefit to be reaped in future is shown in the balance sheet as an asset e.g. special advertising expenditure for a new product.

(ii) Expenditure in respect of service rendered which for any sound reason is considered as an asset or more properly not considered to be allocable to the one accounting period e.g. cost of experiments, discount on issue of debentures etc.

(iii) Amounts representing loss of an exceptional nature e.g. property confiscated in a foreign country, loss on uninsured assets, etc.

COMPARISON BETWEEN CAPITAL AND DEFERRED REVENUE EXPENDITURE

The main feature of capital expenditure is that it results in a benefit which will accrue to the business enterprise for a long time, say 10 or 15 years. Deferred revenue expenditure also results in a benefit which will accrue in future period but generally for 3 to 5 years.

The capital expenditure or the resulting asset is usually capable of being reconverted into cash though may be at a loss. This is not possible in the case of deferred revenue expenditure. At times, heavy loss such as loss due to earthquake is treated as deferred revenue expenditure in the sense that they are written off over a period of 3 to 5 years. Such a loss cannot be treated as a capital expenditure.

CAPITAL AND REVENUE RECEIPTS

Capital receipts comprise of payments or contributions into the business by the proprietor, partners or companies towards the capital of the firm and also any sum received from debenture-holders, any loans and the proceeds of sale of any fixed assets of a business enterprise.

Revenue receipts are the outcome of a firm’s activity in the accounting period, part of its rewards for offering goods or services to the public e.g. sales, commission, fees received for services, interest on investment, etc. Revenue receipts must be set off against the revenue expenses in order to calculate the profit or loss of the business in an accounting period. Capital receipts and expenditure have no bearing on the profit or loss for the accounting period. The distinction between capital receipts and revenue receipts can be drawn as follows:

DIFFERENCE BETWEEN CAPITAL RECEIPTS AND REVENUE RECEIPTS

Capital Receipts	***Revenue Receipts***
(i) Amount realised by the sale of fixed assets or by issue of shares or debentures is a capital receipt.	(i) Amount realised by sale of goods or rendering services is always a revenue receipt.
(ii) A receipt in substitution of a source of income is a capital receipt.	(ii) A receipt in substitution of an income is a revenue receipt.

(iii) Amount received for surrender of certain rights under an agreement is a capital receipt, because a capital asset is being given up in the form of these rights.	(iii) Amount received as compensation under an agreement for the loss of future profits is a revenue receipt.
(iv) Instead of lump sum payment if the payment is received in installments, it is a capital receipt.	(iv) If an income is received in a lump sum it is a revenue receipt.
(v) Amount realised from the sale of a capital asset or investment is capital receipt.	(v) Amount realised from the sale of an asset kept for sale is revenue receipt.

CAPITAL AND REVENUE PROFITS

While preparing the final accounts, distinction has to be made between capital profits and revenue profits. Revenue profits are earned in the ordinary course of business. They appear in the profit and loss account and are available for distribution as profit, or for creating reserves and funds, or for being used in the business. However, capital profits are those which are earned as a result of selling some fixed assets, or in connection with raising capital for the firm. For instance, a building purchased for ₹ 4,50,000 was subsequently sold for ₹ 4,75,000, this ₹ 25,000 will be profit of capital nature. Similarly, when a company issues its shares of the face value ₹ 10 for ₹ 11 each, it is said that shares have been issued at a premium, the amount of premium being a capital profit. Capital profits are either capitalized i.e. transferred to capital account or transferred to capital reserve account which may be utilized for meeting capital losses.

CAPITAL AND REVENUE LOSSES

Revenue losses are the losses which arise during the normal course of business whereas capital losses are those which occur when selling fixed assets or raising share capital. If a building purchased for ₹ 5,00,000 is sold for ₹ 4,50,000, there will be capital loss of ₹ 50,000. Similarly, when shares of the face value of ₹ 101 are issued at ₹ 9 i.e. at a discount of ₹ 1, the amount of discount will be a capital loss.

Treatment of capital losses is not different from that of capital profits. Just as capital profits are not shown in the profit and loss account, similarly capital losses are not shown in the profit and loss account. They are shown in the balance sheet on the assets side. As and when capital profits arise, capital losses are gradually written off against them. If however, capital losses are huge, the common practice is to spread them over a number of years and charge a part thereof to profit and loss account of each such year. But if they are negligible, they are debited to profit and loss account of the year in which they occur.

REVIEW QUESTIONS

1. Expenses whose benefit expires within the year are _________.
2. _________ profits are earned in the ordinary course of business.
3. Payment into the business by proprietor is_________ receipt.
4. White-washing charges of office building is an example of _______ expenditure.

Illustration 1:

State which of the following expenditures are capital, revenue, deferred revenue expenditures and capital loss:

(i) Cost of overhauling and painting a second-hand truck newly purchased.

(ii) Cost of making more exits in a cinema hall under order of the Government.

(iii) ₹ 25,000 were spent on air conditioning the office of the General Manager.

(iv) An old machine which stood in the books at ₹ 15,000 was sold for ₹ 13,000.

(v) ₹ 2,000 were paid as municipal tax in connection with a building which was purchased last year for ₹ 2,00,000.

(vi) ₹ 30,000 were spent on heavy advertising in connection with the introduction of a new product.

(vii) ₹ 500 was paid out in connection with carriage on goods purchased.

(viii) A temporary room constructed for ₹ 25,000 for storing raw material for the construction of a big building.

(ix) ₹ 5,00,000 was spent on putting up a gallery in a theatre hall.

(x) Freight and cartage amounting to ₹ 4,000 were paid on purchase of a new plant and a sum of ₹ 2,000 was spent as erection charges of that plant.

Solution:

(i) When a second hand machine is purchased, the entire expenditure incurred in the beginning to make it fit for working is treated as capital expenditure. The value of the machine is increased by the amount spent. Therefore, the cost of overhauling and painting the truck will be treated as capital expenditure.

(ii) Making more exits in a cinema hall does not increase the capacity of the hall and therefore, it should be treated as revenue expenditure.

(iii) The sum of ₹ 25,000 spent on air conditioning the office of General Manager is capital expenditure because it represents a fixed asset. Moreover, the effect of air conditioning will be available for several years to come, and it can possibly be disposed of, if desired, at a future date, when it will fetch some amount.

(iv) The old machine costing ₹ 15,000 was sold for ₹ 13,000 only, and the loss of ₹ 2,000 is clearly a capital loss.

(v) ₹ 2,000 paid by way of municipal tax on a building purchased is an item of revenue nature. It is an expenditure of routine nature, which was necessary for using the building.

(vi) Since the benefit of ₹ 30,000 spent on advertising will occur for several years, it is of capital nature. It may be treated as a deferred revenue expenditure and be written off against the profit and loss account of a number of years.

(vii) The expenditure of ₹ 500 incurred on carriage on goods purchased is of revenue nature because the goods are meant for resale.

(viii) ₹ 25,000 spent on construction of temporary room should be treated as capital expenditure because it was necessary for the construction of the main building. The cost of the room will be added to the cost of the building.

(ix) When a new gallery is put up, it will increase the number of seats (capacity) of the hall. Therefore, this cost of ₹ 5,00,000 should be treated as a capital expenditure.

(x) The expenditure incurred by way of freight and cartage amounting to ₹ 4,000 and the erection charges of ₹ 2,000 are both of capital nature. The former has been incurred in connection with the receipt of a capital asset while the latter has been incurred for erecting it so that it may be used for business purposes.

Illustration 2:

State whether the following expenses are capital, revenue or deferred revenue expenditure:

(i) A Ltd. spent ₹ 2,00,000 for overhauling the machinery which improved the capacity utilization and saved running expenditure by ₹ 15,000 p.a.

(ii) M/s Capital Properties, property dealers, purchased ten flats @ ₹ 7,00,000 each.

(iii) A firm incurred ₹ 10,000 to retain the title of a land purchased for business in litigation with third party.

(iv) Compensation paid to undesirable employees.

(v) M/s Durga & Co. spent ₹ 2,50,000 for organizing an Inter-school Cricket Tournament in Delhi. This was held for advertising their new school bag and certain books and stationery which they wanted to market.

(vi) ₹ 12,000 paid to Mahanagar Telephone Nigam Ltd. for installing a telephone in the office.

(vii) Damages paid on account of breach of contract to supply certain goods.

(viii) ₹ 25,000 has accrued during the year on term loan obtained and utilized for the construction of factory building and purchase of machinery, however, the production did not commence till the last date of the year.

(ix) Imported goods worth ₹ 1,75,000 confiscated by customs authorities for non-disclosure of material facts.

(x) ₹ 20,000 spent for the trial run of newly installed machinery.

Solution:

(i) Expenses for overhauling the machinery increased capacity utilization which contributes to increase the revenue generating capacity. Also, saving in revenue expenditure for more than one accounting period will accrue from this overhauling which will increase future profits. Hence, this expense is capital in nature.

(ii) Purchase of flats in the ordinary course of business by property dealers is revenue expenditure as flats are stock in trade for it.

(iii) Legal expenses incurred to retain the title of land are expenses for maintaining the asset. The expenses will not generate any revenue in future directly. Hence, it is revenue in nature.

(iv) Compensation paid to retrench undesirable employees is expected to increase revenue earning capacity of the business because such undesirable employees would either waste resources or time with adverse effect on profit. The expenditure is capital in nature.

(v) The purpose of expenses incurred for organizing the Inter-School Cricket Tournament is to advertise for some new products. This advertisement has some enduring effect so far as the marketability of the new products is concerned. The expense may be treated as deferred revenue expenditure.

(vi) The money deposited with Mahanagar Telephone Nigam Ltd. for acquiring a telephone connection is treated as an asset; hence it is a capital expenditure.

(vii) Damages paid on account of the breach of contract to supply certain goods are treated as revenue expenditure incurred in the ordinary course of the business.

(viii) Interest accrued on term loan obtained and utilized for the construction of factory building and purchase of machinery should be treated as capital expenditure since commercial production did not start till the last date of the accounting year.

(ix) The confiscation of imported goods by the customs authorities is a loss arisen on account of negligence and is of abnormal nature. It is appropriate to write it off to profit and loss account over a period of 2 to 5 years treating it as a deferred revenue expenditure.

(x) Expenses incurred for trial-run of newly installed machinery is capital expenditure in nature.

CONTINGENT ASSETS AND CONTINGENT LIABILITIES

(i) CONTINGENT ASSETS:

The assets in which the possibility of an economic benefit depends solely upon future events that can't be controlled by the company are contingent assets. Due to the uncertainty of the future events, these assets are not placed on the balance sheet. However, they are presented in the company's financial statement notes. These assets are often simply rights to a future potential claim based on past events.

"A contingent asset is a possible asset that arises from past events the existence of which will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the enterprise."

Contingent assets usually arise from unplanned or other unexpected events that give rise to the possibility of an inflow of economic benefits to the enterprise.

Contingent assets are not recognized in financial statements since this may result in the recognition of income that may never be realised. It is usually disclosed in the report of the approving authority where an inflow of economic benefits is probable. However, when the realisation of income is virtually certain, then the related asset is not a contingent asset and its recognition is appropriate.

Example: A potential settlement from a lawsuit or legal processes. The company does not have enough certainty to place the settlement value on the balance sheet, so it can only mention about the potential in the notes. This improves the accuracy of financial statements.

(ii) CONTINGENT LIABILITIES

The possibility of an obligation to pay certain sums dependent on future events is known as contingent liability. Contingent liabilities are liabilities that may or may not be incurred by an entity depending on the outcome of a future event.

They are defined obligations by a company that must be met, but the probability of such payment is minimal. The nature and extent of the contingent liabilities is described in the footnote to the balance sheet.

These liabilities are recorded in a company's accounts and shown in the balance sheet only when both probable and reasonably estimable.

Some good examples of contingent liabilities would be an outstanding lawsuit, bank guarantee etc. Suppose, if a company issued by a former employee for ₹500,000 for discrimination, the company will have a liability if it is found guilty. However, if the company is not found guilty, the company will not have an actual liability. Such a liability is known as a contingent liability.

"A contingent liability is a possible obligation that arises from past events and the existence of which will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the enterprise. It is a present obligation that arises from past events but is not recognised because it is not probable that an outflow of resources embodying economic benefits will be required to settle the obligation or a reliable estimate of the amount of the obligation cannot be determined".

LESSON ROUND UP

– All items of capital expenditure are taken in the balance sheet while all items of revenue nature are taken in the income statement.

– Deferred revenue expenditure is revenue in character but the benefit of it is not exhausted in the same year, or is applicable either wholly or in part of the future years, or is accidental with heavy amount and it is not prudent to charge against the profit of one year.

– Revenue receipts must be set off against the revenue expenses in order to calculate the profit or loss of the business in an accounting period.

– Capital receipts and expenditure have no bearing on the profit or loss for the accounting period.

– Revenue profits appear in the income statement and are available for distribution as profit, or for creating reserves and funds, or for being used in the business.

– Capital profits are either capitalized i.e. transferred to capital account or transferred to capital reserve account which may be utilized for meeting capital losses.

– Contingent assets are not recognized in financial statements since this may result in the recognition of income that may never be realised.

– Contingent liabilities are recorded in a company's accounts and shown in the balance sheet only when both probable and reasonably estimable.

GLOSSARY

Capital Expenditure	Expenditure incurred in acquiring or improving an asset which is not meant for sale.
Revenue Expenditure	Expenditure of a routine nature and incurred to maintain an asset.
Deferred Revenue Expenditure	Heavy expenditure of revenue nature
Capital Receipts	Payments or contributions into the business by the sole proprietor, partners or other shareholders towards the capital of the firm.
Revenue Receipts	Outcome of a firm's activity as rewards for offering goods or services to the public.
Revenue Profits	Earned in the ordinary course of business.
Capital Profits	Earned as a result of selling some fixed assets or raising capital for the firm.
Revenue Losses	They arise during the normal course of business
Capital Losses	They occur on selling the fixed assets or in raising of share capital.
Contingent Assets	They are rights to a future potential claim based on past events.
Contingent Liabilities	These are defined obligations by a company that must be met, but the probability of such payment is minimal.

SELF-TEST QUESTIONS

1. State the considerations which would guide you in deciding whether any particular expense should be regarded as capital expenditure or revenue expenditure.
2. Explain deferred revenue expenditure with examples.
3. What are contingent assets and contingent liabilities? Give examples.
4. Distinguish between capital receipts and revenue receipts.
5. Differentiate between capital expenditure and deferred revenue expenditure.
6. State in each of the following cases whether the expenditure is (a) capital expenditure, (b) revenue expenditure, or (c) deferred revenue expenditure.
   – Repairs to furniture.
   – Legal expenses incurred to defend a suit for breach of contract to supply goods.
   – Custom duty paid on imported machinery.
   – Heavy expenditure incurred on advertising a new product.
   – Carriage paid on goods purchased.
   – Amount spent to overhaul a motor truck purchased second-hand.
   – Wages paid to workers for setting up new machinery.
   – Preliminary expenses incurred in setting up a joint stock company.
   – Wages paid to workers for converting raw material into finished goods.
   – Office rent paid in advance for three years.

MULTIPLE CHOICE QUESTIONS

1) What is depreciation?

   A) Cost of a fixed asset

   B) Cost of a fixed asset's repair

   C) The residual value of a fixed asset

   D) Portion of a fixed asset's cost consumed during the current accounting period

2) Under which depreciation method the amount of depreciation expenses remains same throughout the useful life of a fixed asset

   A) Straight line method

   B) Reducing balance method

   C) Number of units produced method

   D) Machine hours method

3) A company purchased a vehicle for Rs.6000. I will be used for 5 years and its residual value is expected to be Rs.1000. What is the annual amount of deprecation using straight line method of depreciation?

   A) 1000

   B) 2000

   C) 3000

   D) 3300

4) What is the accumulated deprecation?

   A) Sum of all depreciation expenses of a fixed asset

   B) Depreciation expenses

   C) Cost of depletion of assets

   D) Future value of fixed asset

5) Which of the following is the normal balance of an accumulated depreciation account?

   A) Debit balance

   B) Credit balance

   C) Nil balance

6) How trial balance shows the accumulated depreciation?

   A) as a debit item

   B) as a credit item

   C) It doesn't show

7) Which of the following is a double entry for depreciation expenses?

   A) Accumulated depreciation debit and depreciation expenses Credit

   B) Depreciation expenses Debit and accumulated depreciation Credit

   C) Cash Debit and depreciation expenses Credit

   D) Depreciation expenses Debit and cash Credit

8) An alternative term used for accumulated depreciation expenses?

   A) Provision for depreciation

   B) Cumulative depreciation

   C) Targeted depreciation

   D) Depletion

9) Which of the following is/are a kind of depreciation expenses?

   A) Amortization

   B) Depletion

   C) Both of them

10) A fixed asset was bought for Rs. 5000. Its accumulated depreciation is Rs. 3000 and rate of depreciation is 20%. Calculate its depreciation expenses for the current accounting period using reducing balance method?

   A) 600

   B) 2000

   C) 300

   D) 400

Lesson 5
Bank Reconciliation Statement

LESSON OUTLINE

- Introduction
  - Bank
  - Types of Personal Accounts in Bank
  - Deposits
  - Withdrawals
  - Bank Pass Book
  - Bank Reconciliation Statement
- Review Questions
- Causes of difference between bank balance as per cash book and pass book
- Significance of Bank Reconciliation Statement
- Procedure of Preparing Bank Reconciliation Statement
- Preparation of Bank Reconciliation Statement when overdraft balances are given
- Preparation of Bank Reconciliation Statement when extracts of cash book and pass book are given
- Lesson Round-Up
- Glossary
- Self Test Questions

LEARNING OBJECTIVES

In the modern times, business operates in a financial system of the country wherein it uses the facilities and services provided by the banks. Most of the business houses conduct majority of transactions through bank account. Business enterprises record transactions with the bank in the bank columns of the cash book. Bank also maintains accounts of customers in its ledger which are supplied to customers by the bank in the form of a statement or a book called pass book. So, it becomes necessary to compare and check the transactions done with the bank and those recorded in the books of account of organisation. Bank reconciliation statement is a tool for such comparison and arriving at the causes and amount of difference between the two, if any.

In this lesson, we will study in detail about reconciling the bank account with the bank balance as per cash book of any organization.

INTRODUCTION

Bank

A bank is an institution which deals in money. Its main business is to accept deposits and to lend money. It also collects money and makes payments on behalf of its clients. Bank account is a personal account and the account-holders record their transaction with the bank in a similar manner as they do with any other person.

Types of Personal Accounts in Bank

Mainly the money can be deposited with a bank-in-following types of accounts.

(i) Current Account: In a Current Account, money can be deposited as often as desired and also, it can be withdrawn without notice as often as necessary. In this account, with the permission of the bank, the amount withdrawn can be in excess of the amount deposited; the excess amount withdrawn is called overdraft. Generally, no interest is allowed by banks on deposits in current accounts. On the other hand, a charge is made by the bank, known as bank charges periodically. The client can instruct the bank to collect money, say interest or dividends on investments made by the client and to make payments say premiums of insurance policy on his behalf. The bank credits the client’s account with such collections made and debits the client’s account with such payments. It charges money for such services; the amount of the charge is debited by the bank to the client’s account. Businessmen invariably prefer the current account to other types of accounts as this type of account alone meets all their requirements.

(ii) Savings Account: In a Savings Bank Account, deposits can be made as often as required but there are restrictions on the number as well as amount of withdrawals that can be made and hence a savings bank account fails to meet the requirements of most of the businessmen. But this account has the advantage that bank allows interest on the deposits made in it. This account is really meant for individuals who wish to save or institutions which do not need withdrawals very often.

(iii) Fixed Deposit Account: In a Fixed Deposit, money is deposited only once and cannot be withdrawn before the expiry of that period for which it is made. The bank pays interest on such deposits. Fixed deposit is evidenced by a receipt called Fixed Deposit Receipt issued by the bank in the name of the depositor. The receipt has to be surrendered to the bank on the expiry of the term on the stipulated date for withdrawal of money deposited and interest allowed thereon by the bank.

(iv) Recurring Deposit Account: In Recurring Deposit Account, a fixed amount of money is deposited every month for a fixed tenure mostly ranging from one to five years. The small monthly saving in the Recurring Deposit Scheme enable the depositor to accumulate a handsome amount on maturity. The bank pays interest on such deposits compounded quarterly at a fixed rate.

Deposits

In savings accounts and current accounts, a deposit is made by filling up a form called pay-in-slip. There is a counterfoil which is stamped by the bank’s cashier and signed by him and returned to the client. This counter-foil is evidence that money has been duly received by the bank. Separate pay-in-slips have to be filled in for depositing cash and cheques. Also, there are different pay in slips for local and out-station cheques.

Withdrawals

Withdrawals are made by means of cheques. A cheque is an unconditional order on the bank made by the client instructing the bank to pay a certain sum of money to the person named in the cheque or his order or the bearer. In the case of a savings bank account withdrawals may be allowed by filling in withdrawal form supplied by the bank rather than cheques.

The money deposited with bank is debited to bank account while money withdrawn from the bank is credited to bank account. The record of money deposited and withdrawn from the bank is maintained by the business in its cash book with bank columns which can be balanced on any date and the balance so arrived at is known as bank balance as per cash book.

Bank Pass Book

The bank on its part maintains in its ledger the account of its customers. Pass book is a copy of the client's account in the bank's ledger. Bank issues pass book to its client. It is the duty of the client to send it to bank at intervals so that transactions can be recorded up-to-date. Pass book shows the transactions already entered into by the bank and the client (like cheques and cash deposited, amounts withdrawn, cheques paid by the bank, collections and payments made by the bank on behalf of the client) and the balance or overdraft shown by the client's account at the bank. The money deposited by the customer is credited to his account and the money withdrawn from the bank is debited to his account. The balance as per bank ledger indicated in the bank pass book is called the bank balance as per pass book.

Bank Reconciliation Statement

The bank pass book and bank columns of the cash book record the same transactions. In the pass book, the transactions are recorded from the point of view of the bank whereas in cash book they are recorded from the point of view of the client. The bank balance as per pass book, can therefore, be expected to be equal to the bank balance as revealed by the cash book. However, in actual practice the two balances rarely agree because of the time-lag of a few days between the entries made by the firm in cash book and by the bank in the pass book. Thus, a comparison is necessary to find out the items on account of which difference has arisen and a need to reconcile the two balances. Thus, a bank reconciliation statement is a statement which is prepared as on a particular date to reconcile the bank balance as per cash book with balance as per pass book by showing all causes of difference between the two.

REVIEW QUESTIONS

Fill in the blanks:

(a) A bank is an institution which deals in ___________.

(b) In a ________________ with the bank, money can be deposited as often as desired and also, it can be withdrawn without notice as often as necessary.

(c) In a savings bank account, restrictions are made on the __________ as well as _________of withdrawals.

(d) A deposit is made by filling up a form called _____________.

(e) In Recurring Deposit Account, deposits are made mostly every _____.

CAUSES OF DIFFERENCE BETWEEN BANK BALANCE SHOWN BY CASH BOOK AND THAT SHOWN BY PASS BOOK

The following are the reasons for the difference between the balances shown by the cash book and the pass book.

(i) Cheques issued but not presented for payment:

When a cheque is drawn or issued in favour of a third party, it is immediately recorded in the cash book by debiting the party and crediting the bank and this has the effect of reducing the bank balance in the cash book. But the bank will not debit client's account until that cheque is presented for payment, and honoured. So long as it is not presented, the balance shown in the pass book is more than the balance shown by the cash book.

(ii) Cheques deposited for collection but not yet collected:

The client debits bank column of cash book as soon as he deposits cheques with the bank for collection, but the bank credits client's account only when it has collected cash on the cheque so deposited. It results in bank balance as per cash book being higher than the balance as per pass book.

(iii) Bank charges not entered in the cash book:

The bank charges some amount from each customer by way of incidental charges, collection charges, etc.

and debits his account for this reason from time to time. As soon as these charges are made, the bank debits the customer's account in its own books and this reduces the bank balance. But the customer will know such charges only when he receives a statement of account from the bank, until then, bank balance as per pass book will be less than bank balance as per cash book.

(iv) Interest credited or debited by bank, not entered in the cash book:

When bank allows interest to a customer for deposits, it will credit customer's account and his bank balance as per pass book will increase. But the customer will not pass the entry in cash book simultaneously till he knows the fact, thus the balances will differ. Likewise, interest on overdraft is debited to the customers' account and till the same is not entered in the cash book, it will result in a difference in the balances.

(v) Direct collections on behalf of customers:

A banker may receive amounts due to the customer by way of dividends, rent, interests etc. directly from the persons concerned on account of standing instructions of the customer to such persons. Similarly, debtors may also deposit the amounts directly to the bank. The bank credits the account of the customer for such collections as soon as it gets such payments. But same will be entered in the cash book only when customer receives the statement from the bank. Thus the balances differ.

(vi) Direct payment by bank:

Usually, the bank is given standing instructions for certain payments to be made, such as payment of insurance premium, interest on loan, electricity bill etc. Bank, while making payments, debits pass book but the customer has no information of the same till he is informed. It results in a difference in balances.

(vii) Dishonour of cheques/bills:

When cheque or bill of exchange discounted with the bank is dishonoured, the same is debited in the pass book but not given effect in the cash book until the intimation is received. It will cause a difference in the two balances.

(viii) Cheques received and entered in the cash book but omitted to be deposited into the bank.

When cheque is received, the same is entered in the cash book but it may not be deposited into the bank immediately. This will cause a difference in the two balances.

(ix) Errors:

There may be errors in the accounts maintained by the customer or/ and by the bank. A wrong debit or credit given by the customer or the bank leads to a difference in the balances.

SIGNIFICANCE OF BANK RECONCILIATION STATEMENT

(i) It highlights the causes of difference between the bank balance as per cash book and the balance as per pass book. Necessary adjustments can, therefore, be carried out at an early date.

(ii) It reduces the chance of fraud by the staff dealing with cash and cash bring.

(iii) It acts as a moral check on the staff of the organization to keep the cash records always up to date.

(iv) Bank balance as per cash book cannot be accepted as final unless it is supported by statement of passbook. When these two balances do not tally, reconciliation becomes essential to determine the correct bank balance that can be used while finalizing the accounts.

(v) It helps in finding out actual position of the bank balance.

PROCEDURE OF PREPARING BANK RECONCILIATION STATEMENT

A bank reconciliation statement is prepared as on a particular date for a particular period to reconcile the bank balance as per cash book with balance as per pass book by showing causes of difference between the two. The statement starts with bank balance as per cash book and then additions to and subtractions from this balance are made to arrive at the balance as per pass book. Alternate procedure is to start with bank balance as per pass book and to end up with bank balance as per cash book.

Steps for preparing a bank reconciliation statement:

(i) The cash book should be completed and the balance as per bank column on a particular date should be found out covering the period for which the statement has to be prepared.

(ii) The bank should be requested to complete and send to the firm the bank pass book.

(iii) Check the entries of the debit and credit sides of the bank columns of the cash book with corresponding entries on the credit and debit sides of the pass book relating to the same period.

(iv) The items not tallying should be classified into common groups according to their characteristics.

(v) The balance as shown by any one book (i.e. the cash book or the bank pass book) should be taken as the base. This is, as a matter of fact, the starting point for determining the balance as shown by the other book after making suitable adjustments taking into account the causes of difference.

(vi) The effect of the particular cause of difference on the balance shown by the other book should be noted.

(vii) In case, the cause has resulted in an increase in the balance shown by the other book, the amount of such increase should be added to the balance as per the former book which has been taken as the base.

(viii) In case, the cause has resulted in a decrease in balance shown by the other book, the amount of such decrease should be deducted from the balance as per the former book which has been taken as the base.

SPECIMEN OF BANK RECONCILIATION STATEMENT

(From Balance as per Cash Book)

Bank Reconciliation Statement as on....

Particulars	₹	₹
Balance as per Cash Book		XXX
Add :		
Cheques issued but not yet presented for payment	XXX	
Interest allowed by the bank	XXX	
Direct payment by customers into bank	XXX	
Interest on investment received by the bank	XXX	
Dividend on shares collected by the bank	XXX	
Rebate on bills retired under rebate through the bank but full amount entered in the cash book	XXX	
Any wrong credit in the pass book	XXX	XXX
		XXX
Less :		
Cheques deposited with the bank but not yet collected	XXX	
Bank charges	XXX	
Insurance premium paid by the bank	XXX	
Interest on overdraft charged by the bank	XXX	
Dishonoured cheques / bills	XXX	
Drawings made but not entered in the cash book	XXX	
Cheques received entered in the cash book but not yet deposited	XXX	
Any wrong debit in the pass book	XXX	(XXX)
Balance as per Pass Book		XXX

Note: If the reconciliation statement has been started with balance, as per the pass book, to arrive at balance as per cash book the entries made above should be reversed i.e. all added items should be deducted and deducted items should be added.

SUMMARY **PREPARATION OF BANK RECONCILIATION STATEMENT**		
Transactions	**Starting with the Bank Balance as per Pass Book**	**Starting with the Bank Balance as per Cash Book**
Cheques issued but not presented	*Deduct* : The amount of unpresented cheques.	*Add* : The amount of unpresented cheques.
Cheques deposited but not yet collected	*Add* : The amount of cheques deposited	*Deduct* : The amount of cheques deposited
Cheques received and entered in the bank column of the cash book but not deposited	*Add* : The amount of cheques.	*Deduct* : The amount of cheques.
Dishonour of cheques deposited with banks earlier	*Add* : The amount of dishonoured cheques	*Deduct* : The amount of dishonoured cheques
Collection of interest and dividends and interest allowed by the banker not yet recorded in the cash book.	*Deduct* : The amount of these items	*Add* : The amount of these items.
Bank charges	*Add* : The amount of bank charges	*Deduct* : The amount of bank charges.
Balance	Bank Balance as per Cash Book	Bank Balance as per Pass Book

PREPARATION OF BANK RECONCILIATION STATEMENT WHEN OVERDRAFT BALANCES ARE GIVEN

In case the books show an adverse balance i.e. an overdraft, the procedure is just the reverse of that which has been discussed in the case of a favorable balance. Overdraft means overdrawing of a bank account. The customer is allowed to draw from his account over and above his balance subject to a limit agreed upon. The bank pass book will show a debit balance in the account of the customer and similarly there will be a credit balance in the bank column of the cash book.

SPECIMEN OF BANK RECONCILIATION STATEMENT

(From overdraft balances)

Bank Reconciliation Statement as on....

Particulars	₹	₹
Overdraft as per Cash Book		XXX
Add :		
Cheques deposited into bank but not yet collected	XXX	
Bank charges	XXX	
Insurance premium paid by the bank	XXX	
Interest on overdraft charged by the bank	XXX	
Dishonoured cheques / bills	XXX	
Drawings made but not entered in cash book	XXX	
Cheques received and entered in the cash book but not deposited	XXX	
Any wrong debit in the pass book	XXX	XXX
Less :		
Cheques issued but not yet presented for payment	XXX	
Interest allowed by the bank	XXX	
Direct payment by customers into bank	XXX	
Interest on investment received by the bank	XXX	
Dividend on shares collected by the bank	XXX	
Rebate on bills retired under rebate through the bank but full amount entered in the cash book	XXX	
Any wrong credit in the pass book	XXX	(XXX)
Overdraft as per Pass Book		XXX

Note: If the reconciliation statement has been started with overdraft as per the pass book to arrive at overdraft as per the cash book the entries made above should be reversed i.e. all added items should be deducted and all deducted items should be added.

SUMMARY
PREPARATION OF BANK RECONCILIATION STATEMENT

Transactions	***Starting with the Overdraft as per Cash Book***	***Starting with the Overdraft as per Pass Book***
Cheques issued but not presented	*Deduct*: The amount of unpresented cheques.	*Add*: The amount of unpresented cheques.
Cheques deposited but not yet collected	*Add*: The amount of cheques deposited	*Deduct*: The amount of cheques deposited
Cheques received entered in the bank column of the cash book but not deposited	*Add*: The amount of cheques.	*Deduct*: The amount of cheques.

Dishonour of cheques deposited earlier	*Add*: The amount of dishonoured cheques	*Deduct*: The amount of dishonoured cheques
Collection of interest and dividends and interest by banks	*Deduct*: The amount of these items	*Add*: The amount of these items.
Bank charges	*Add*: The amount of bank charges	*Deduct*: The amount of bank charges.
Balance/ Overdraft	Bank Overdraft as per Cash Book	Bank Overdraft as per Pass Book

Alternative Method is to keep two columns 'Plus' and 'Minus'. All additions are to be shown in 'plus' column while all deductions in the 'minus' column. Balance is to be shown in 'plus' column while overdraft is shown in 'minus' column.

PREPARATION OF BANK RECONCILIATION STATEMENT WHEN EXTRACTS OF CASH BOOK AND PASS BOOK ARE GIVEN

In some instances, students are given extracts from the cash book and the pass book and are required to find out causes of differences and prepare a bank reconciliation statement. In solving such a problem, the following points should be noted:

(i) Heading of the pass book, and

(ii) Period for which cash book and pass book are given.

Heading of the pass book can be given in two ways:

(i) Party in account with bank: It means pass book is a copy of party's account in the books of bank. Generally, pass book is written in this form. The student should compare debit side of the cash book with credit side/column of the pass book and also compare credit side of the cash book with debit side of the pass book.

(ii) Bank in account with party: It means pass book is the copy of bank's account (so far as it relates to the party) in the books of bank. In this form the student should compare debit side of the cash book with the debit side/ column of the pass book and credit side with credit side/column.

Practically in such situations, upto date bank statement is obtained and the cash book is amended by incorporating only those transactions in respect of which entries have been made in the pass book. The errors in the cash book are also rectified by suitable entries and thus the upto date bank balance as per cash book is obtained. This balance appears in the balance sheet.

For examination purpose, a reconciliation statement may be prepared after amending the cash book especially if it is mentioned or when the firm prepares reconciliation statement on the date of closing the books of account.

ILLUSTRATIONS

Illustration 1:

On 31st March, 2016 the pass book of Mitra showed a credit balance of ₹ 2,16,000. A comparison of pass book and cash book revealed the following:

		₹
(i)	*Cheques deposited but not cleared by 31st March*	*1,08,150*
(ii)	*Cheques issued by Mitra but not presented for payment before 1st April, 2016*	*26,000*
(iii)	*Insurance premium paid by bank on behalf of Mitra but not yet recorded in cash book*	*52,075*
(iv)	*Commission charged by bank not yet recorded in cash book*	*750*
(v)	*Interest on bonds collected by bank on behalf of Mitra not yet recorded in cash book*	*25,000*

Bank balance as per cash book as on 31st March, 2016 is ₹ 3,25,975. Prepare a Bank Reconciliation Statement as on 31st March, 2013.

Solution:

Bank Reconciliation Statement of Mitra

as on 31st March, 2016

Particulars	₹	₹
Balance as per Pass Book		2,16,000
Add :		
Cheques deposited with bank but not yet collected	1,08,150	
Commission charged	52,075	
Insurance premium paid by the bank	750	1,60,975
		3,76,975
Less:		
Cheques issued but not yet presented for payment	26,000	
Interest on bonds received by the bank	25,000	51,000
Balance as per Cash Book		3,25,975

Alternatively:

Bank Reconciliation Statement of Mitra
as on 31st March, 2016

Particulars	₹	₹
Balance as per Cash Book		3,25,975
Add :		
Cheques issued but not yet presented for payment	26,000	
Interest on bonds received by the bank	25,000	51,000
		3,76,975
Less:		
Cheques deposited into bank but not yet collected	1,08,150	
Commission charged	52,075	
Insurance premium paid by the bank	750	1,60,975
Balance as per Pass Book		2,16,000

<u>Illustration 2</u>:

The cash book of Shri Gupta showed an overdraft of ₹ 30,000 on 31.3.2016. The scrutiny of the entries in the cash book and the pass book revealed that:

(a) *On 22nd March, cheques totaling ₹ 6,000 were sent to bankers for collection, out of these, a cheque for ₹ 1,000 was wrongly recorded on the credit side of the cash book and cheques amounting to ₹ 300 could not be collected by bank within the accounting year.*

(b) *A cheque for ₹ 4,000 was issued to a supplier on 28th March, 2016. The cheque was presented to bank on 4th April, 2013.*

(c) *There were debits in the pass book for interest ₹ 2,000 on overdraft and bank charges ₹ 600 not recorded in the cash book.*

(d) *The credit side of the bank column of the cash book was undercast by ₹ 100.*

(e) *A cheque for ₹ 1,000 was issued to a creditor on 27th March, but the same was not recorded in the cash book. The cheque was, however, duly en-cashed before 31st March.*

(f) *As per standing instructions, the banker collected dividend of ₹ 500 on behalf of Gupta and credited the same to his account within 31st March, 2016. The fact was, however, intimated to Gupta on 3rd April, 2016.*

You are required to prepare a bank reconciliation statement as on 31st March, 2016.

Solution:

Shri Gupta

Bank Reconciliation Statement as on 31.3.2016

Particulars	₹	₹
Bank Overdraft as per Cash Book		30,000
Add :		
Cheques deposited into bank but not yet collected	300	
Bank charges not yet recorded in cash book	600	
Interest on overdraft charged by the bank	2,000	
Credit side of the bank column of the cash book undercast	100	
Cheques issued to creditor not recorded in the cash book but duly encashed by 31st March	1,000	4,000
		34,000
Less:		
Cheque wrongly recorded on the credit side of the cash book (₹ 1,000 x 2)	2,000	
Cheques issued but not yet presented for payment	4,000	
Dividend collected by the bank but not recorded in the cash book	500	6,500
Overdraft as per Pass Book		27,500

Illustration 3:

From the following information, prepare Bank Reconciliation Statement as on 31st March, 2016:

Cash Book of Mr. S. Ray

Dr. **(Bank Columns only)** *Cr.*

Date	***Particulars***	***Amount*** ₹	***Date***	***Particulars***	***Amount*** ₹
2016			*2016*		
Mar. 1	*To Balance b/fd*	*7,000*	*Mar. 5*	*By Drawings*	*5,000*
" 5	*" Manohar Lal*	*4,000*	*" 8*	*" Interest*	*150*
" 10	*" Deepak Kumar*	*10,000*	*" 10*	*" Cheque Book*	*100*
" 17	*" Sher Singh*	*13,000*	*" 15*	*" Salaries*	*3,500*
" 25	*" Mohan Lal*	*4,000*	*" 17*	*" Ajit Singh*	*4,000*
" 31	*" Harish Kumar*	*1,900*	*" 21*	*" Abdul & Co.*	*5,000*
			" 25	*" Karim & Sons*	*7,000*
			" 30	*" Harish & Co.*	*1,000*
			" 31	*" Balance c/fd*	*14,150*
		39,900			*39,900*

Bank Pass Book

(Bank in Account with Mr. S. Ray)

Dr. *Cr.*

Date			*Particulars*	*Amount* ₹	*Date*			*Particulars*	*Amount* ₹
2016					*2016*				
Mar.	*1*	*To*	*Balance b/fd*	*7,000*	*Mar.*	*5*	*By*	*Drawings*	*5,000*
"	*8*	*"*	*Manohar Lal*	*4,000*	*"*	*8*	*"*	*Interest*	*150*
"	*15*	*"*	*Deepak Kumar*	*10,000*	*"*	*10*	*"*	*Cheque Book*	*100*
"	*24*	*"*	*Sher Singh*	*13,000*	*"*	*15*	*"*	*Salaries*	*3,500*
"	*28*	*"*	*Interest on*		*"*	*22*	*"*	*Ajit Singh*	*4,000*
			Investment	*1,200*	*"*	*29*	*"*	*Abdul & Co.*	*5,000*
"	*30*	*"*	*Rent*	*300*	*"*	*31*	*"*	*Bank charges*	*32*
"	*31*	*"*	*Bhura Mal*	*800*	*"*	*31*	*"*	*Electricity charges*	*78*
					"	*31*	*"*	*Balance c/fd*	*18,440*
				36,300					*36,300*

Solution:

Bank Reconciliation Statement

as at 31st March, 2016

Particulars	₹	₹
Balance as per Cash Book		14,150
Add :		
Cheques issued but not presented for payment	8,000	
Interest on investment collected by bank	1,200	
Rent collected by bank	300	
Direct deposit by the customer	800	10,300
		24,450
Less: Cheques deposited but not yet collected	5,900	
Bank charges	32	
Electricity charges	78	6,010
Balance as per pass book		18,440

***Illustration 4*:**

On 30th April, 2016 the cash book of Sircar showed a bank overdraft of ₹ 1,970. A comparison of entries in the pass book with those in the cash book revealed the following:

- *Cheques deposited with the bank but not yet credited in the pass book ₹ 8,505.*
- *Cheques issued by Sircar but not yet presented by payees to bank for payment ₹ 12,500.*
- *Interest on fixed deposit credited by bank understanding instructions but not yet recorded in cash book ₹ 650.*

Prepare bank reconciliation statement as on 30th April, 2016 to ascertain the balance as per pass book.

Solution:

Mr. Sircar

Bank Reconciliation Statement as at 30th April, 2016

Particulars	₹	₹
Overdraft as per cash book		1,970
Add :		
Cheques deposited with the bank but not yet credited in pass book		8,505
		10,475
Less :		
Cheques issued but not yet presented to bank for payment	12,500	
Interest on fixed deposit credited by bank understanding instructions	650	13,150
Balance as per pass book		2,675

Illustration 5:

On 30th April, 2016 pass book of Ghosh showed a debit balance of ₹ 32,675. You are required to prepare bank reconciliation statement taking into consideration the following information:

	₹
Cheques issued but not yet presented for payment	*18,513*
Total cheques deposited with bank for collection	*1,38,000*
But so far credited in the pass book	*1,12,000*
Interest collected by the bank but not recorded in cash book by Ghosh	*1,200*
Bank charges not yet entered in cash book	*150*

Solution:

Mr. Ghosh

Bank Reconciliation Statement as at April 30, 2016

Particulars	₹	₹
Overdraft as per pass book		32,675
Add :		
Cheques issued but not yet presented for payment	18,513	
Interest collected by bank but not yet recorded in cash book by Ghosh	1,200	19,713
		52,388
Less :		
Cheques deposited with bank not yet credited in pass book (₹1,38,000 – ₹1,12,000)	26,000	
Bank charges not yet entered in cash book	150	26,150
Overdraft as per cash book		26,238

The bank reconciliation statement can also be prepared by having two amount columns, one for the amounts that increase the positive balance (or reduce the overdraft) and one for those amounts that reduce positive balance (or increase the overdraft). The first may be headed "+" and the second "-", the opening balance is first entered in the appropriate column and finally the two columns are balanced. The illustration given above is solved below in the manner just stated:

Mr. Ghosh

Bank Reconciliation Statement as at April 30, 2016

Particulars	(+) ₹	(-) ₹
Overdraft as per pass book		32,675
Cheques issued but not yet presented for payment		18,513
Interest collected by bank but not yet recorded in cash book		1,200
Cheques deposited with bank not yet credited in pass book	26,000	
Bank charges not yet entered in cash book	150	
Overdraft as per cash book	26,238	
	52,338	52,338

Illustration 6:

From the following information supplied by Shri Mehta, prepare his bank reconciliation statement as on 31st March, 2016 after amending the cash book on that date:

		₹
1.	*Bank overdraft as per bank statement*	*1,65,000*
2.	*Cheques issued but not yet presented for payment*	*87,500*
3.	*Cheques deposited with the bank but not yet collected*	*1,05,000*
4.	*Cheque recorded in the bank column of the cash book but not sent to the bank for collection*	*20,000*
5.	*Payments received from customers direct by the bank*	*35,000*
6.	*Bank charges debited in the statement*	*200*
7.	*A bill for ₹ 30,000 (discounted with the bank in February at ₹ 29,780) dishonored on 31st March and noting charges paid by the bank*	*100*
8.	*Premium on life policy of Mehta paid by the bank on standing advice*	*1,800*
9.	*Overdraft (credit) on 25.3.2013, ₹ 80,000 carried over as debit balance on the next day.*	

***Solution*:**

Cash Book

Dr. **(Bank Column only)** *Cr.*

	Particular	₹		*Particular*	₹
31.3.2016			31.3.2016		₹
To	Balance b/fd (balancing figure)	29,600	By	Bank charges	200
”	Customer (amount directly collected by Bank)	35,000	”	Customer (discounted bill dishonoured and noting charges paid by bank)	30,100
”	Balance c/d	1,27,500	”	Drawings (life insurance premium paid by bank)	1,800
			”	Error (overdraft balance carried over as debit balance)	1,60,000
		1,92,100			1,92,100
			1.4.2016		
			By	Balance b/d	1,27,500

Notes:

(a) Discounted value of the bill is immaterial here, because on dishonor, the bank has debited the pass book with ₹ 30,100.

(b) Overdraft credit balance means overdraft as per Cash Book.

Bank Reconciliation Statement of Shri Mehta

as on 31st March, 2016

Particulars	₹	₹
Overdraft as per bank statement		1,65,000
Add:		
Cheques issued but not presented for payment		87,500
		2,52,500
Less:		
Cheques deposited with the bank but not collected	1,05,000	
Cheques recorded in cash book but not sent to bank for collection	20,000	1,25,000
Overdraft as per cash book		1,27,500

Illustration 7:

On 31st March, 2016, the cash book of Ajay Ghosh showed a bank overdraft of ₹ 3,458. On examination of the cash book and bank statement, the following discrepancies were noted:

(i) Cheques issued for ₹1,200 were entered in the cash book but were not presented at the bank till first week of April, 2016.

(ii) Cheques amounting to ₹ 1,000 were entered in the cash book on 30th March, 2016 but were banked on 2nd April, 2016.

(iii) Cheques amounting to ₹ 500 were deposited in the bank but were not collected till March 31st, 2016.

(iv) A cheque for ₹ 300 received from Mr. Dass Gupta and deposited in the bank was dishonored but advice of non-payment was not received from the bank upto 31st March.

(v) ₹ 3,000 being the proceeds of a bill collected on 20th March did not appear in the cash book.

(vi) ₹ 300 being the proceeds of a bill collected on 20th March were omitted to be credited in the pass book.

(vii) The pass book showed an amount of ₹ 340, being rent which his tenant Madan Gopal had directly deposited on the bank on 30th March, 2016. The item did not appear in cash book.

(viii) A bill payable of ₹ 600 was duly paid off on 30th March according to the instructions of Ajay Ghosh but this was not entered in cash book before 1st April, 2016.

(ix) Bank charges of ₹ 30 and interest an overdraft ₹ 170 appeared in the pass book but not in the cash book.

Prepare a bank reconciliation statement and find out the balance as per pass book.

Solution:

Ajay Ghosh

Bank Reconciliation Statement as on 31st March, 2016

	Particulars	₹	₹
Overdraft as per cash book			3,458
Add :	Items increasing overdraft in pass book:		
	Cheques entered in cash book but not banked	1,000	
	Cheques deposited but not collected	500	
	Cheques deposited but dishonoured	300	
	Bill collected but omitted to be entered in pass book	300	
	Pay off of bills payable not entered in cash book	600	
	Bank charges	30	
	Interest on overdraft	170	2,900
			6,358
Less :	Items reducing overdraft in pass book:		
	Cheques issued, not presented for payment	1,200	
	Bill collected, not entered in cash book	3,000	
	Direct deposit of rent into bank	340	4,540
	Overdraft as per pass book		1,818

Illustration 8;

On 31st March 2013, the cash book of a trader showed a bank overdraft of ₹ 15,280. On a comparison of the cash book with the bank pass book, the trader ascertained the following differences.

	(₹)
Cheques deposited with bank, but not credited by the bank	*20,000*
Interest on securities collected by the bank, but not yet recorded in the cash book	*2,560*
Dividend collected by the bank, but not yet recorded in the cash book	*2,000*
Cheques issued, but not yet presented to the bank for payment	*74,800*
Bank charges not yet recorded in the cash book	*680*

Solution:

Bank Reconciliation Statement as on 31st March 2013

Particulars	*Plus items (₹)*	*Minus items (₹)*
Overdraft as per cash book		15,280
Cheques deposited with the bank but not yet credited by bank		20,000
Interest on securities collected by the bank, but not yet recorded in the cash bank	2,560	
Dividend collected by the bank, but not yet recorded in the cash book	2,000	
Cheques issued, but not yet presented to the bank for payment	74,800	
Bank charges not yet recorded in the cash book		680
	79,360	35,960

Balance as per pass book = ₹ 79,360 – ₹ 35,960 = ₹ 43,400.

Dr. **Cash Book (Bank Columns only)** *Cr.*

Particulars	₹	*Particulars*	₹
To Interest on securities	2,560	By Balance b/fd	15,280
To Dividends received	2,000	By Bank charges	680
To Balance c/d	11,400		
	15,960		15,960
		By Balance b/d	11,400

Illustration 9:

The following is a summary of the Cash Book of Shri Mohan Das, for the month of June 2016.

	₹		₹
Receipts	*14,690*	*Balance b/d*	*7,610*
Balance c/d	*5,540*	*Payments*	*12,620*
	20,230		*20,230*

All receipts are banked and payments are made by cheque.

On investigation it is found that:

- *Bank charges of ₹ 1,360 entered in the bank statement had not been entered in the cash book.*
- *Cheques drawn amounting to ₹ 2,670 had not been presented to the bank for payment.*
- *Cheques received totaling ₹ 17,620 had been entered in the cash book and paid into the bank, but had not been credited by the bank until July, 2016.*
- *A cheques for ₹ 1,220 had been entered as a receipt in the cash book instead of as a payment.*
- *A cheque for ₹ 1,250 had been debited by the bank in error.*
- *A cheque received for ₹ 800 had been dishonored. No adjustments had been made in the cash book.*
- *All dividends receivable are credited directly to the bank account. During June, amount totaling ₹ 2,620 were credited by the bank and no entries were made in the cash book.*
- *A cheque drawn for ₹ 600 in favour of a creditor had been incorrectly entered in the cash book as ₹ 6,000.*
- *The balance brought forward should have been ₹ 7,110*
- *The bank statement as on 30th June, 2016, showed an overdraft ₹ 17,820.*

You are required to:

- *Show the adjustments required in the cash book; and*
- *Prepare a bank reconciliation statement as on 30th June, 2016.*

Solution:

Shri Mohan Das
Cash Book

Dr. **(Bank column only)** *Cr.*

Particulars	₹	*Particulars*	₹
30.6.2016		*30.6.2016*	
To Dividend	2,620	By Balance b/d	5,540
To Creditor - cheque drawn for ₹ 600 wrongly entered as ₹ 6,000	5,400	By Bank charges	1,360
To Error - wrong carry forward of balance on 1st June, 2011	500	By Error - cheque issued wrongly entered as received ₹ 1,220	2,440
To Balance c/d	1,620	By Customer - cheque returned	800
	10,140		10,140

Bank Reconciliation Statement
as on 30th June, 2016

Particulars	₹	₹
Bank balance as per cash book (overdraft)		1,620
Add: Cheques deposited but not credited by the bank until after 30th June, 2011	17,620	
Cheque debited by the bank in error	1,250	18,870
		20,490
Less: Cheque issued but not presented for payment		2,670
Bank overdraft as per bank statement		17,820

LESSON ROUND UP

- Bank's main business is to accept deposits and to lend money.
- Money can be deposited with a bank in Recurring Deposit types of accounts: Current Account, Savings Account form main and Fixed Deposit Account
- Pass book is a copy of the client's account in the bank's ledger.
- The balance as per bank ledger indicated in the bank pass book is called the bank balance as per pass book.
- Bank Reconciliation Statement is a statement prepared as on a particular date to reconcile the bank balance as per cash book with balance as per pass book by showing all causes of difference between the two balance.
- Overdraft means that the money withdrawn from bank account is in excess of the money deposited in the bank.
- The following are the usual causes of difference between the balances as shown by the cash book and pass book
    - Cheques issued but not presented for payment
    - Cheques deposited with the bank but not yet collected and credited by bank
    - Bank charges not entered in the cash book
    - Interest credited or debited by the bank not entered in the cash book
    - Amount collected by the bank on behalf of the customer
    - Amount paid by the bank on standing instructions of the customer
    - Dishonor of cheque(s)/bill(s)
    - Cheques received and entered in the cash book but omitted to be paid into the bank
    - Errors either in cash book or in pass book

GLOSSARY

Current Account	Account in which money can be deposited as often as desired and can be withdrawn without notice as often as necessary.
Savings Bank Account	Account in which deposits can be made as often as required but there are restrictions on the number as well as amount of withdrawals that can be made.
Fixed Deposit	Account in which money is deposited only and cannot be withdrawn before the expiry of that period for which fixed deposit is made.
Recurring Deposits Account	Account in which money is deposited monthly & withdrawn only after the expiry of fixed tenure.

SELF-TEST QUESTIONS

Theory Questions

1. What is a bank reconciliation statement?
2. What is the significance of preparing a bank reconciliation statement?
3. What are the types of personal accounts in bank?
4. Describe the reasons why bank balance as per cash book may not agree with the bank balance as per pass book.
5. Briefly mention the steps of preparing bank reconciliation statement.

Practical Questions

1. On 31st March, 2012 the cash book of Gupta showed a debit bank balance of ₹ 4,800. Prepare a bank reconciliation statement as at that date taking into account the following additional information:
   – Cheques deposited but not yet credited by bank ₹ 3,610.
   – Cheques issued but not yet presented by payees for payment in the bank ₹ 2,050.
   – Bank charges appearing in pass book but not yet recorded in cash book ₹ 40.
   – Collections made by the bank and appearing in pass book but not yet recorded in cash book ₹ 1,000.

   [*Balance as per Pass Book ₹ 4,200*].

2. On 31st March, 2012 the cash book of a trader shows a bank overdraft of ₹ 1,800. A comparison of the cash book with the pass book reveals the following facts:
   – Cheques issued but not presented for payment upto 31st March, 2012 ₹ 8,500.
   – Cheques deposited with the bank on 31st March, 2012 but credited by bank on 1st April, 2012 ₹ 9,200.
   – Bank charges debited by bank, ₹ 230 and dividends collected by bank on behalf of the trader ₹ 5,000 have not been recorded in the cash book.
   – A cheque of ₹ 1,400 received from X and deposited with the bank on 26th March, 2012 was recorded as that of ₹ 400 in the cash book.

   You are required to prepare a bank reconciliation statement after passing the necessary entries in the cash book to bring its balance up-to-date. The firm closes the books on 31st March. How much will be shown in the balance sheet as bank balance/overdraft?

   (*Balance as per Pass Book ₹ 3,270; Amended cash book balance ₹ 3,970.*)

3. Following are the transactions recorded in the bank column of the Cash Book of Madhur for the month ending 31 December, 2011 :

Dr. **Cash Book (Bank Columns)** *Cr.*

Date 2012	Particulars		₹	Date 2012	Particulars		₹
Dec.				Dec.			
19	To	Cash	54,000	1	By	Balance b/fd	60,000
24	”	Buddha	36,000	8	”	Ram	3,000
26	”	Chaitanya	15,000	10	”	Lakshman	600
31	”	Balance c/fd	11,460	19	”	Bharat	360
				24	”	Shatrughan	52,500
			1,16,460				1,16,460

On the receipt of Bank Statement on 31st December, 2012, Madhur collected the following information:

- Credit in pass book not recorded in the cash book ₹ 300
- Interest on Government bonds collected by the bank but not entered in the cash book ₹ 1,620.
- Cheques for ₹ 1,51,000 deposited but the bank collected only ₹ 1,36,000.
- Dividend collected by the bank directly but not intimated the same to Madhuri ₹ 1,500.
- Interest on overdraft charged by the bank but not entered in the cash book ₹ 1,500.
- Cheques for ₹ 1,56,460 issued by the trader but presented to the bank for payment only ₹ 1,3,960.

Amend the Cash Book and prepare a Bank Reconciliation Statement from the above information.

4. From the following information supplied by Vikas, prepare bank reconciliation statement as on March 31, 2013.
   - Bank balance as per passbook ₹7,700.
   - Cheques issued for ₹1,75,200 were entered in cash book as ₹1,72,500. Cheques for ₹65,000 were not presented for payment till March 31, 2013.
   - A cheque of ₹8,500 paid into the bank had been debited by the bank in error.
   - Cheques received and recorded but not sent to bank for collection ₹12,400.
   - Payment received from a customer direct by the bank ₹27,300 but no entry was made in the cash book.
   - ₹44,900 was entered in the cash book as paid into bank on 30.3.2013 but was credited by the bank on 2.4.2013.
   - The bank column on payment side of the cash book had been undercast by ₹1, 000.
5. From the following particulars, ascertain the balance as would appear in the bank pass book of Mohan on 31st March, 2012. The cash book showed a credit balance of ₹82,000 on that date
   - Cheques issued, but not presented for payment by 31st March, 2012 ₹23,000
   - Cheques paid into bank, but not cleared by 31st March, 2012 ₹30,000
   - Interest charged on overdraft appeared in the pass book only ₹ 500
   - Bank charges debited by bank, but not recorded in the cash book ₹ 200
   - Interest on debentures collected by bank, but not recorded in the cash book ₹6,000
   - Bank paid insurance premium as per standing instructions, not yet recorded in the cash book ₹2,200
   - A customer paid into the firm's bank account directly ₹ 10,000
6. The following is a summary of the Cash Book of Shri Mohan Das, for the month of June 2012.

Dr. *Cr.*

Particulars	₹	Particulars	₹
Receipts	14,690	Balance b/fd	7,610
Balance c/fd	5,540	Payments	12,620
	20,230		20,230

All receipts are banked and payments are made by cheques. On investigation, it is found that:

- Bank charges of ₹ 1,360 entered on the bank statement had not been entered in the cash book.
- Cheques drawn amounting to ₹ 2,670 had not been presented to the bank for payment.

– Cheques received totaling ₹ 17,620 had been entered in the cash book and paid into the bank, but had not been credited by the bank until July, 2011.

– A cheques for ₹ 1,220 had been entered as a receipt in the cash book instead of as a payment.

– A cheque for ₹ 1,250 had been debited by the bank in error.

– A cheque received for ₹ 800 had been dishonoured. No adjustments had been made in the cash book.

– All dividends receivable are credited directly to the bank account. During June, amount totaling ₹ 2,620 were credited by the bank and no entries were made in the cash book.

– A cheque drawn for ₹ 600 in favour of a creditor had been incorrectly entered in the cash book as ₹ 6,000.

– The opening balance brought forward in the cash book should have been ₹ 7,110

– The bank statement as on 30th June, 2012, showed an overdraft ₹ 17,820.

You are required to: Show the adjustments required in the cash book; and Prepare a bank reconciliation statement as on 30th June, 2012.

MULTIPLE CHOICE QUESTIONS

1. Interest on drawings is:

   a) Expenditure for the business b) Cost for the business c) Gain for the business d) None of the above

2. Goods given as samples should be credited to:

   a) Advertisement account b) Sales account c) Purchase account d) None of the above

3. Outstanding salaries are shown as: a) Added to Salaries while preparing P & La/c b) Shown in liability side of Balance sheet under current Liability c) (a) &(b) above d) None of the above

4. Income tax paid by a sole proprietor on his business income should be:

   a) Debited to trading account b) Debited to profit and loss account c) Deducted from capital account in the balance sheet d) None of the above

5. All direct & indirect expenses related to business are charged:

   a) Profit and loss account b) Trading account c) Trading account Profit and Loss account d) Directly to Balance sheet

6. According to schedule VI Companies Act which item is not shown on Asset side of Balance sheet :

   a) Investment b) Current Loan & Advances c) Provision d) Lease Holds

7. Trade Payables are recorded in…………….

   a) Asset side of B/S b) Liability side of B/S c) P & L a/c d) None of the above

8. Investment of X company profit in shares of other company PQR Pvt. ltd are recorded in……………….

   a) Asset side of Balance Sheet b) Liability side of Balance Sheet c) Profit & Loss a/c d) Not recorded in Balance Sheet

9. Preliminary expenses are recorded in……………….. a) Equity and liabilities-Liability side of B/S b) Current liabilities- Liability side of B/S c) Fixed assets- Asset side of B/S d) Asset side of B/S

10. Carriage outward is charged to a) Debit side Profit & Loss a/c b) Debit side Trading a/c c) Credit side of Profit & Loss a/c d) Credit side of trading a/c

Lesson 6
Depreciation Accounting

LESSON OUTLINE

- Introduction
  - Meaning of Depreciation
  - Definition of Depreciation
  - Characteristics of Depreciation
  - Causes of Depreciation
  - Objectives of Providing Depreciation
  - Factors in Measurement of Depreciation
- Accounting Concept of Depreciation
- Review Questions
- Methods of Providing Depreciation
  - Uniform Charge Methods
  - Declining Charge Methods
  - Other Methods
- Review Questions
- Change in Method of Depreciation
- Calculation of Profit or Loss on Assets Sold
- Depreciation and Replacement of Assets
- Lesson Round Up
- Glossary
- Self Test Questions

LEARNING OBJECTIVES

Capital expenditures results in the acquisition of fixed assets for utilisation in the process of providing goods and services to the customers. Fixed assets are utilised for a number of accounting periods. Value of fixed asset decreases with the passage of time. Moreover, the portion of asset utilised for generating revenue, should be recovered during the accounting year to match the expenses of a period with the revenue of the same period. This allocation of portion of fixed assets is the concept of depreciation, which will be dealt with in detail in this lesson.

The objective of this lesson is to make students understand the meaning, causes and nature of depreciation and accounting treatment of depreciation. It will provide an understanding of the principles and methods of calculating and accounting of depreciation.

INTRODUCTION

Meaning of Depreciation

A business enterprise acquires different types of fixed assets depending upon its requirements and financial conditions. Fixed assets have a long life and are held for use in the business for production of goods and services. Whenever an asset is used in business its value gets reduced and sooner or later the asset becomes useless. Depreciation is a permanent, continuous and gradual shrinkage in the book value of a fixed asset. It is the fall in the quality or value of a fixed asset through physical wear and tear due to use or passage of time or from any other cause. Depreciation takes place irrespective of regular repairs and maintenance. As the asset is used for business purpose, the annual loss in the value of the asset is like any other expenditure. Hence, the cost of fixed assets has to be written off over its useful economic life as a loss.

Thus, depreciation is a process of allocating the cost of a fixed asset over its estimated useful life in a rational and systematic manner.

Definition of Depreciation

The Institute of Charted Accountants of India has defined depreciation as "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. Depreciation is allocated so as to charge a fair proportion of depreciable amount in each accounting period during the expected useful life of the asset. Depreciation includes amortisation of assets whose useful life is predetermined."

Depreciation Accounting has been defined by the American Institute of Certified Public Accountants as " a system of accounting which aims to distribute the cost or other basic value of tangible capital assets less salvage (if any) over the estimated useful life of the unit (which may be a group of assets) in a systematic and rational manner. It is a process of allocation and not of valuation."

Characteristics of Depreciation

The following are the important characteristics of depreciation:

(i) Depreciation refers to a permanent, continuous and gradual decrease in the utility value of a fixed asset and it continues till the end of the useful life of the asset.

(ii) Depreciation is a charge against profit (i.e. revenue earned) for a particular accounting period.

(iii) Depreciation is always computed in a systematic and rational manner since it is not a sudden loss.

(iv) Depreciation is a process of allocation of expired cost and not of valuation of fixed assets.

(v) Whatever method for calculating depreciation is followed, the exact amount of depreciation can never be calculated, and it can only be estimated.

(vi) Depreciation is caused due to physical factors and functional factors.

(vii) The fundamental objectives of depreciation are - (a) to maintain the nominal capital invested in fixed assets, and (b) to allocate the expired portion of the cost of fixed assets over a number of accounting periods.

(viii) Depreciation is must, i.e. it always takes place whether the asset is carefully handled or neglected.

(ix) If the market value of a fixed asset is fluctuating, the same does not affect the amount of depreciation so made on the respective assets.

(x) Depreciation is calculated in respect of fixed assets only, i.e. plant, machinery, furniture etc.

(xi) Total depreciation cannot exceed its depreciable value or original cost where the scrap value is nil.

Causes of Depreciation

(i) *Physical Wear and Tear Resulting from Use*: Tangible fixed assets like, machinery, buildings, furniture etc. get worn out or torn out on account of friction, strain, weathering, intensity of use, chemical reaction, handling etc. This is the most important cause of charging depreciation in respect of such assets which are in constant use.

(ii) *Physical Deterioration Resulting from Atmospheric Exposure*: Number of assets deteriorates for being continually exposed nature.

(iii) *Passage of Time*: A machine also becomes potentially useless by the passage of time. It is so even if the machine is kept continuously idle.

(iv) *Depletion*: Wasting assets such as mines and quarries lose their value because they get exhausted on account of continuous extractions.

(v) *Obsolescence*: Sometimes an asset becomes useless because of technical changes within the industry, technical progress in other industries, changes in tastes and habits of consumers, changes in supply and locations of natural resources etc.

Objectives of Providing Depreciation

The objectives of providing depreciation are as follows:

(i) *To ascertain the correct profit*: When a particular asset is used for earning the income of the business, the depreciation in the value of assets should be deducted from the income in order to calculate the correct and real profit of the business.

(ii) *To present true financial position*: In order to show the true financial position of the business in the balance sheet, it is necessary that assets must be shown at their true values after deducting reasonable depreciation. If depreciation is not provided, the assets will be overstated in the financial statements and it will be against sound business principles.

(iii) *To make provision for replacement of assets*: Since depreciation is a non-cash expense, the amount charged can be kept separately and utilised for the replacement of the fixed asset after the expiry of the useful life of the asset.

(iv) *To ascertain the proper cost of the product*: In order to ascertain the cost of production, it is necessary to charge depreciation as an item of cost of production.

(v) To maintain the capital invested in the cost of the asset intact in the business so that it can be reinvested in profit earning process.

(vi) To derive maximum tax benefit.

(vii) *To meet the legal requirements*: In the case of joint stock companies, it is necessary to charge depreciation on fixed assets before declaring dividends.

Factors in Measurement of Depreciation

The factors which affect measurement of depreciation are given below:

(i) The original cost of asset: The cost includes all cost incurred in acquiring the asset, i.e. purchase price including transportation and installation costs, if any.

(ii) The additions, if any, made to the assets during the year taking into consideration the date on which these additions were made.

(iii) The estimated useful life of the asset.

(iv) The scrap or the residual value of the asset.

(v) Obsolescence, i.e., the chance of the asset going out of fashion.

(vi) The working hours of the asset concerned.

(vii) The repairs and renewals.

(viii) The skill of the operators who handle the asset.

(ix) The legal provisions or other restrictions relating to depreciation.

ACCOUNTING CONCEPT OF DEPRECIATION

Depreciable assets are assets which

- are expected to be used for more than one accounting period;
- have a limited useful life and
- are held by the organization for use in the production or supply of goods and services.

When a fixed asset is purchased, it is recorded in the books of accounts at its original cost. But, the fixed asset is used to earn revenues for a number of accounting periods in future with the same acquisition cost until the concerned fixed asset is sold or discarded. It is therefore, necessary that a part of the acquisition cost of the fixed asset is treated or allocated as an expense in each of the accounting periods in which the asset is used. This allocation of cost in the form of an expense is known as depreciation in accounting.

Suppose, a business purchases a machinery for ₹ 10,00,000 and after using it for five years, it is sold for ₹ 2,00,000. The cost of the machinery used in the business is ₹ 8,00,000 (₹10,00,000 – ₹2,00,000). This cost must be allocated as an expense of the business at the rate of ₹1,60,000 (8,00,000 ÷ 5) for each of five accounting periods in which the machinery has been used to earn revenues. This ₹ 1,60,000 charge as expense is called accounting concept of depreciation.

It is the cost for the services obtained from the use of the asset in the same manner as the cost of wages, rent, etc. Depreciation is the expense charged to profit and loss account before arriving at the net profit for the year. In other words, the cost of fixed asset in the form of depreciation has to be matched against the revenues of the years over which the asset is used.

Thus, in accounting, depreciation means apportionment or allocation of the cost of the fixed asset over its useful life. Its aim is to spread over and allocate or distribute the cost of the fixed asset to the years of its use and charge the depreciable cost to profit and loss account before arriving at the profits of each of the accounting periods in which the fixed asset utilized.

Purpose of Depreciation Accounting: The primary purpose of depreciation accounting is cost allocation. Provision for depreciation in the profit and loss account does not involve the outflow of cash and hence funds to the extent of depreciation charged over the years will remain in the business and these funds can be easily used for replacement of asset.

SUMMARY

- Depreciation accounting is the process of allocating the cost of the tangible fixed asset less its salvage value over its serviceable life.
- Depreciation is an expense that is to be charged against the revenue whether the business makes profit or incurs loss;
- Depreciation provides funds for replacing the asset when its useful life ends. Depreciation is not a process of valuation but it is an allocation. Even if the market value of an asset increases, depreciation has to be recorded because of allocation process.

JOURNAL ENTRIES

(1) WHEN THE DEPRECIATION IS DIRECTLY CHARGED TO ASSET ACCOUNT:

Depreciation Account	Dr.
To Asset Account	

The asset account in this case appears at its reduced value in the balance sheet i.e.

Cost or book value	XXX
Less: Depreciation for the accounting period.	XXX

Depreciation expense is transferred to the debit of profit and loss account.

Profit and Loss Account	Dr.
To Depreciation Account	

(2) WHEN PROVISION FOR DEPRECIATION ACCOUNT IS OPENED:

For charging depreciation:

Depreciation Account	Dr.
To Provision for Depreciation Account	

For transferring depreciation expense to Profit and Loss Account:

Profit and Loss Account	Dr.
To Depreciation Account	

In this method, the asset account is not affected by the amount of depreciation and the value of asset appears in the ledger and the balance sheet at its original cost. The amount of depreciation written off is accumulated in provision for depreciation account.

When the asset is sold or discarded or exchanged for a new asset, the total accumulated depreciation for that asset in the provision for depreciation account is transferred to that asset account by the following journal entry.

Provision for Depreciation A/c	Dr.
To Relevant Asset A/c	

Thus, the balance in the provision for depreciation account always shows the accumulated depreciation on the assets which are in use or not sold out.

In the balance sheet, the asset account is shown at its original cost less balance in the provision for depreciation account.

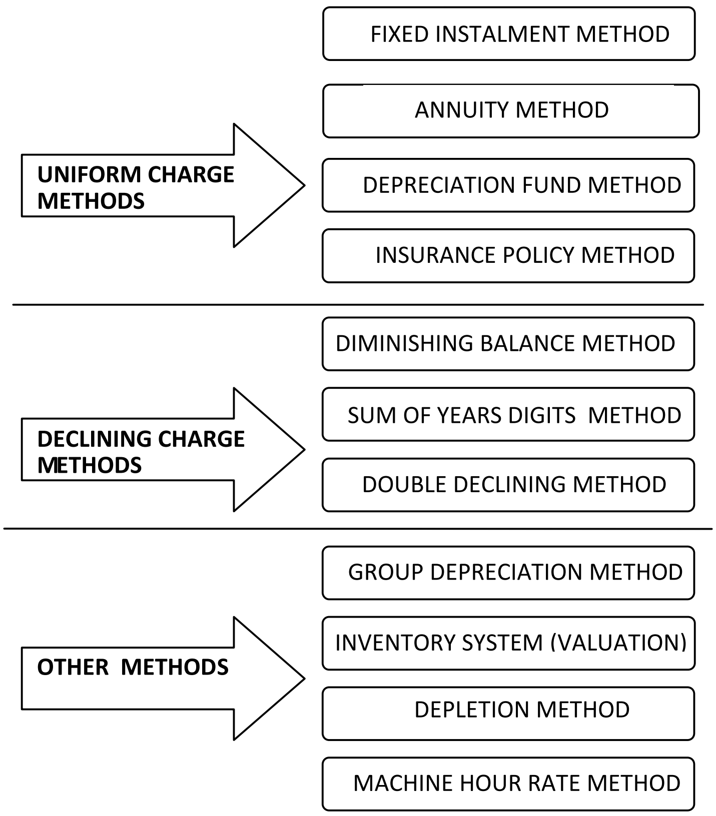
On the assets side of the balance sheet	
Relevant Asset A/c	XXX
Less: Provision for Depreciation	XXX

Alternatively, the asset account can be shown at its original cost on the assets side and provision for depreciation account can be shown on the liabilities side. But the former method is better and recommended.

REVIEW QUESTIONS

1. Depreciation is the process of allocating cost of ____________ over its estimated life.
2. ____,____,____ are some of the causes of depreciation.
3. Fixed costs are recorded in the books of accounts at _____ value less _________.

METHODS OF PROVIDING DEPRECIATION



A. UNIFORM CHARGE METHODS

Depreciation is charged uniformly every year for those assets which are uniformly productive. Four methods fall in this category:

1. Fixed Instalment Method or Straight Line Method

Under this method, a fixed proportion of the original cost of the asset (less residual value) is written off each year so that asset account may be reduced to its residual value at the end of its estimated economic useful life. It is assumed that depreciation is a function of time. Depreciation is charged on a uniform basis every year till the asset is written off.

$$\text{Depreciation} = \frac{\text{Original Cost of the Fixed Assets (Including Exp require to make asset into working condition)} - \text{Estimated Scrap Value}}{\text{Life of the Assets in Number of Year}}$$

$$\text{Percentage of Depreciation} = \frac{\text{Depreciation} \times 100}{\text{Original Cost of the Fixed Assets}}$$

Note:

- Additional asset purchased during the year must be depreciated only from the date of purchase to the close of the accounting period.
- When no date of addition is mentioned, depreciation may be charged for half of the year on the assumption that addition was made in the middle of the year.

– Assets sold during the year should be depreciated from the beginning of the year till the date of sale.

ADVANTAGES

– *It is a simple and easy method.*
– *The value of the asset can be completely written off, i.e. the value can be reduced to zero its estimated scrap value.*
– *This method can be applied where asset gets depreciated because of effluxion of time like furniture, equipments, patents, leasehold etc.*
– *There is no change either in the rate or amount of depreciation over the useful life of the asset.*
– *The value of the asset each year in the balance sheet is reasonably fair.*

DISADVANTAGES

– *The assumption that the asset shall be equally useful throughout its life seems to be illogical.*
– *It does not take into account the effective utilization of the asset.*
– *Even though the asset is used uniformly from period to period, the total charge for the use of the asset keeps on increasing every year. This is because cost of repairs in each subsequent year rises though equal amount of depreciation is written off every year.*

Illustration 1:

A firm acquired a machinery on 1st July 2010 at a cost of ₹ 45,000 and spent ₹ 5,000 for its installation. The firm writes off depreciation at 10% per annum on the original cost every year. The books are closed on 31st March every year. Show Machinery Account and Depreciation Account for three years.

Solution:

Dr. **Machinery Account** *Cr.*

Date	*Particulars*	₹	*Date*	*Particulars*	₹
2013			2014		
Jul 1	To Bank	45,000	Mar.31	By Depreciation	
Jul 1	To Bank (Installation Expenses)	5,000		(10% on ₹50,000 for 9 months)	3,750
			Mar.31	By Balance c/d	46,250
		50,000			50,000
2014			2015		
April 1	To Balance b/d	46,250	Mar. 31	By Depreciation	
				(10% on ₹50,000)	5,000
			Mar. 31	By Balance c/d	41,250
		46,250			46,250
2015			2016		
April 1	To Balance b/d	41,250	Mar. 31	By Depreciation	
				(10% on ₹50,000)	5,000
			Mar. 31	By Balance c/d	36,250
		41,250			41,250
2016					
April 1	To Balance b/d	36,250			

Dr. **Depreciation Account** Cr.

Date	*Particulars*	₹	*Date*	*Particulars*	₹
2013			2014		
Mar.31	To Machinery A/c	3,750	Mar.31	By Profit & Loss A/c	3,750
2014			2015		
Mar.31	To Machinery A/c	5,000	Mar.31	By Profit & Loss A/c	5,000
2015			2016		
Mar.31	To Machinery A/c	5,000	Mar.31	By Profit & Loss A/c	5,000

DECLINING CHARGE METHODS

The amount of depreciation charged decreases for each subsequent year of the asset's life. This method can be applied:

(a) When the asset becomes old and receipts decline or

(b) When it is necessary to charge depreciation according to the asset's expected earnings.

The following three methods fall in this category.

1. Diminishing Balance Method (Reducing Balance Method)

Under this method, depreciation is calculated at a certain percentage each year on the balance of the asset which is brought forward from the previous year. The amount of depreciation charged for each period is not fixed but it goes on decreasing gradually as the opening balance of the asset in each year will reduce. Thus, amount of depreciation becomes higher at in the earlier periods and becomes gradually lower in subsequent periods, while repairs and maintenance charges increase gradually.

$$\text{Depreciation} = 1 - \sqrt[n]{\frac{\textbf{Net Residual Value}}{\textbf{Cost of Acquisition}}}$$

Rate of Depreciation = 1 – n

Where, n = life of the asset in years.

ADVANTAGES	DISADVANTAGES
– It is a simple and easy method.	– It is difficult to determine an appropriate rate of depreciation.
– Every year, there is an equal burden for using the asset. This is because depreciation goes on decreasing every year whereas cost of repairs increases.	– The value of the asset cannot be brought down to zero.
– The obsolescence problem is given due care since major part of the depreciation is charged in earlier years and the management may find it easy to replace the asset.	– Depreciation is neither based on the use of the asset nor distributed evenly throughout the useful life of the asset.
– Income tax authorities recognize this method.	
– All items including additions are added together and depreciated at the same rate.	

DISTINCTION BETWEEN STRAIGHT LINE METHOD AND DIMINISHING BALANCE METHOD OF DEPRECIATION

Straight Line Method	***Diminishing Balance Method***
(i) Depreciation is charged at a fixed rate on the original cost of the asset.	(i) Depreciation is charged at a fixed rate on the original cost in the first year and on the written down value (cost-minus total depreciation) in the subsequent years.
(ii) The amount of depreciation remains the same in all the years of useful life of the asset.	(ii) The amount of depreciation goes on decreasing year after year.
(iii) The total burden on the profit and loss account is more in the later years because the repair charges increase while the amount of	(iii) The total burden on the profit and loss account is almost same in the early years as well as is the later years because of more

	depreciation remains the same.		depreciation plus repairs cost in the beginning and less depreciation plus more repairs cost in the later years.
(iv)	The book value of the asset becomes zero or equal to scrap value.	(iv)	The book value never becomes zero.
(v)	It is easy to calculate the rate of depreciation.	(v)	It requires the use of mathematical tables.
(vi)	It is suitable where repair charges are less and obsolescence is not frequent.	(vi)	It is suited where repair charges are more in later years and also where there is obsolescence.

Illustration 6:

A firm acquired machinery on 1st July 2010 at a cost of ₹ 45,000 and spent ₹ 5,000 for its installation. The firm writes off depreciation at 10% per annum on diminishing balance method. The books are closed on 31st March every year. Show Machinery Account and Depreciation Account for three years.

Solution:

Dr. **Machinery Account** *Cr.*

Date	*Particulars*	*₹*	*Date*	*Particulars*	*₹*
2010			2011		
Jul 1	To Bank	45,000	Mar.31	By Depreciation	
Jul 1	To Bank (Installation Expenses)	5,000		(10% on ₹50,000 for 9 months)	3,750
			Mar.31	By Balance c/d	46,250
		50,000			50,000
2011			2012		
April 1	To Balance b/d	46,250	Mar. 31	By Depreciation (10% on ₹ 46,250)	4,625
			Mar. 31	By Balance c/d	41,625
		46,250			46,250
2012			2013		
April 1	To Balance b/d	41,625	Mar. 31	By Depreciation (10% on ₹ 41,625)	4,163
			Mar. 31	By Balance c/d	37,462
		41,625			41,625
2013					
April 1	To Balance b/d	37,462			

Dr. **Depreciation Account** Cr.

Date	*Particulars*	*₹*	*Date*	*Particulars*	*₹*
2011			2011		
Mar.31	To Machinery A/c	3,750	Mar.31	By Profit & Loss A/c	3,750
2012			2012		
Mar.31	To Machinery A/c	4,625	Mar.31	By Profit & Loss A/c	4,625
2013			2013		
Mar.31	To Machinery A/c	4,163	Mar.31	By Profit & Loss A/c	4,163

CHANGE IN METHOD OF DEPRECIATION

Consistency principle of accounting requires that same accounting practices and methods should be observed and followed from year to year as otherwise the reported profit or loss will not be comparable. Hence, it is expected that the concern should consistently follow the method of depreciation which is once chosen. However, sometimes, a change in the method becomes inevitable.

According to "Accounting Standard-6 (AS-6) Depreciation Accounting", issued by the Institute of Chartered Accountants of India, when a change in the method of depreciation is made, depreciation is re-calculated in accordance with the new method from the date of asset coming into use. In brief, change in method is permitted retrospectively, that is, from the date of purchase of existing assets.

Steps for change in method of depreciation

- Calculate the value of asset by the new method on the date of change.
- Calculate the depreciation of the past period of asset by both the existing and new method.
- Find the difference between the both.
- Then the difference has to be adjusted in the current year's asset account by giving debit or credit to profit and loss account.

Illustration 7:

M Ltd. which depreciates its machinery @ 10% per annum according to diminishing balance method, had on 1st April, 2016 ₹ 4,86,000 balance in its machinery account. During the year ended 31st March, 2016, the machinery purchased on 1st April, 2013 for ₹ 60,000 was sold for ₹ 40,000 on 1st October, 2015 and a new machinery costing ₹ 70,000 was purchased and installed on the same date; installation charges being ₹ 5,000.

The company wants to change its method of depreciation from diminishing balance method to straight line method w.e.f. 1st April, 2013 and adjust the difference before 31st March, 2016, the rate of depreciation remaining the same as before.

Show the machinery account for the year ended 31st March, 2016.

Solution:

Dr. **Machinery Account** *Cr.*

Date	*Particulars*	*₹*	*Date*	*Particulars*	*₹*
2015			2015		
Apr. 1	To Balance b/d	4,86,000	Oct. 1	By Bank	40,000
Oct. 1	To Bank (cost and installation charges)	75,000		By Profit and Loss A/c (loss on sale of machinery)	6,170
			2016		
			Mar. 31	By Depreciation A/c	60,180
				By Profit and Loss A/c (Additional depreciation)	5,400
				By Balance c/d	4,49,250
		5,61,000			5,61,000

Working Notes:

		₹
(1)	Calculation of loss on sale of machinery:	
	Cost of machinery on April 1, 2013	60,000
	Less: Depreciation for 2013-14	6,000

	54,000
Less: Depreciation for 2014-15	5,400
	48,600
Less: Depreciation for half year	2,430
Book value as on 1st October, 2016	46,170
Less: Amount realised from sale	40,000
Loss on sale	6,170

(2) Additional depreciation:

Cost of machinery on 1st April, 2013 $\left(4,86,000 \times \frac{100}{90} \times \frac{100}{90}\right)$	6,00,000
Book value on 1st April, 2013 for machinery sold in 2015	60,000
Book value on 1st April, 2013 on original group	5,40,000
Depreciation for 2 years (2013-14 and 2014-15) @ 10% on ₹ 5,40,000	1,08,000
Less: Depreciation provided for 2 years under diminishing balance method (₹ 54,000 + ₹48,600)	1,02,600
Additional depreciation due to change in the system charged to profit and loss account	5,400

(3) Depreciation for 2015-16

On machinery sold	2,430
On machinery purchased and installed	3,750
On machinery brought from previous year (i.e. on ₹ 5,40,000 on straight line method)	54,000
	60,180

CALCULATION OF PROFIT OR LOSS ON ASSETS SOLD

Assets may be sold or discarded before or on the expiry of its useful life. Then it is necessary to calculate the profit or loss, if any, on such sale. For this purpose the book value of the assets at the date of sale is to be calculated by deducting the total depreciation from the date of purchase to the date of sale from the original cost. If the sale price is more than the book value there is profit on sale of the assets and if the sale price is less than the book value, the difference will be loss on sale.

> *Profit or loss on sale of assets = Sale price of asset - Book value of the asset on the date of sale*
> *Book value of the asset on the date of sale = Original cost of the asset – Total depreciation on the asset till date of sale*

The following journal entries are passed to record the above transactions when the depreciation is directly credited to the asset account:

(i) On sale of assets:

Bank Dr.

To Assets Account (with the sale price)

(ii) For profit on sale of asset:

Asset Account Dr.

To Profit and Loss Account

(In case of loss the above entry is reversed.)

When Provision for Depreciation Account is maintained then the asset account appears at its cost price and the following accounting procedure is followed:

(i) Transfer of accumulated depreciation including the depreciation created at the time of sale:

Provision for Depreciation Account Dr.

To Asset Account

(ii) On sale of the asset:

Bank Dr.

To Asset Account

(iii) If the amount of accumulated depreciation and sale price put together is less than the original cost of the asset, the difference is loss on sale and transferred to profit and loss account:

Profit and Loss Account Dr.

To Asset Account

(iv) In case the accumulated depreciation and sale price put together is more than the original cost of the asset, the difference is treated as profit on sale and is credited to profit and loss account:

Asset Account Dr.

To Profit and Loss Account

When Provision for Depreciation Account is maintained on sale of asset, alternatively, it is suggested to open an `Asset Disposal Account' in such case the following accounting entries may be passed:

(i) On transfer of original cost of asset to Asset Disposal Account:

Asset Disposal Account Dr.

To Asset Account

(ii) On sale of the asset:

Bank Dr.

To Asset Disposal Account

(iii) On transfer of Provision for Depreciation Account to Asset Disposal Account:

Provision for Depreciation Account Dr.

To Asset Disposal Account

(iv) For profit on disposal of asset:

Asset Disposal Account Dr.

To Profit and Loss Account

(In case of loss the above entry is reversed.)

Illustration 8:

On 1st April, 2013, a firm purchased a machinery for ₹ 2,00,000. On 1st October in the same accounting year, additional machinery costing ₹ 1,00,000 was purchased. On 1st October, 2014, the machinery purchased on 1st April, 2013, having become obsolete, was sold off for ₹ 90,000. On 1st October, 2015, new machinery was purchased for ₹ 2,50,000 while the machinery purchased on 1st October, 2013 was sold for ₹ 85,000 on the same day.

The firm provides depreciation on its machinery @ 10% per annum on original cost on 31st March every year.

Show machinery account, provision for depreciation account and depreciation account for the period of three accounting years ending 31st March, 2013.

Solution:

Dr. **Machinery Account** *Cr.*

Date	*Particulars*	₹	*Date*	*Particulars*	₹
2014			2013-14		
Apr. 1	To Bank	2,00,000	Mar.31	By Depreciation a/c	25,000
			Mar.31	By Balance c/d	2,75,000
Oct. 1	To Bank	1,00,000			3,00,000
		3,00,000			
2015			2014-15		
Apr. 1	To Balance b/d	2,75,000	Oct. 1	By Depreciation A/c (Machinery 1)	10,000
				By Bank Account	90,000
				By Profit & Loss A/c	80,000
				By Depreciation A/c (Machinery 1 & 2)	10,000
				By Balance b/d	85,000
					2,75,000
		2,75,000			
2014-15			2014-15		
Apr. 1	To Balance b/d	85,000	Oct. 1	By Depreciation A/c	5,000
Oct. 1	To Profit & Loss A/c	5,000		By Bank Account	85,000
	To Bank	2,50,000		By Depreciation A/c	12,500
				By Balance b/d	2,37,500
		3,40,000			3,40,000

Dr. **Depreciation Account** *Cr.*

Date	*Particulars*	₹	*Date*	*Particulars*	₹
2011	To Provision for		2011		
Mar.31	Depreciation A/c	25,000	Mar.31	By Profit & Loss A/c	25,000
2011	To Provision for		2012		
Oct. 1	Depreciation A/c	10,000	Mar.31	By Profit & Loss A/c	20,000
2012	To Provision for				
Mar.31	Depreciation A/c	10,000			
		20,000			20,000
2012	To Provision for		2013		

Oct. 1	Depreciation A/c	5,000	Mar.31	By Profit & Loss A/c	17,500
2013	To Provision for				
Mar.31	Depreciation A/c	12,500			
		17,500			17,500

DEPRECIATION AND REPLACEMENT OF ASSETS

In the context of present inflationary conditions, it will be appropriate to provide for depreciation on the replacement cost instead of on the historical cost. This is because of the fact that depreciation is provided for replacing the asset. Sufficient funds will not be available for replacing an asset at the end of its serviceable life. If depreciation is provided on the basis of historical cost, there is substantial increase in the cost of the new asset to replace the old asset. But following difficulties may crop up when replacement cost system is used:

(a) Estimating replacement cost in advance is difficult.

(b) The method of charging depreciation on the basis of replacement cost is not recognized by income tax authorities.

(c) The method of charging depreciation on replacement cost during inflationary conditions is preferred but not during period of falling prices.

(d) According to the Companies Act, depreciation should be charged on the original cost of the asset and any deficiency or surplus arising due to sale of such asset should be transferred to the profit and loss account.

(e) Any new asset purchased, with few exceptions, is always of a better quality than the asset replaced. Hence, it is difficult to calculate the cost of the asset replaced.

These difficulties can be obviated by taking the following steps:

(a) The additional amount required for replacing the asset over and above the original cost of the asset may be estimated. Every year, an appropriate amount may be transferred from profit and loss account besides usual depreciation on asset to provide for additional amount required for replacement of the asset over and above the original cost of the asset. It may be debited to Profit and Loss Appropriation Account and credited to Replacement Reserve account.

(b) The Replacement Reserve Account may be credited every year with interest at the current rate on the accumulated balance standing to the credit of the account.

LESSON ROUND UP

– Depreciation is the process of allocation of cost of the asset to the period of its useful life. It is not the process of valuation of asset.

– Depreciation is used for recording the expired utility of a physical asset.

– Causes of depreciation are: physical wear and tear; deterioration in value of asset; disuse; depletion; obsolescence; accidents, etc.

– Depreciation is provided to: ascertain the correct profit; present correct financial position; make provision for replacement of asset; ascertain proper cost of the product; maintain uniform rate of return; attain maximum tax benefit; to meet the legal requirements, etc.

– The main factors in measurement of depreciation are: total cost of the asset; estimated useful life; estimated residual value, etc.

– The various methods of depreciation are: fixed installment method or straight line method; diminishing balance method or written down value method and other methods.

– In order to adjust depreciation for past periods due to change of method, depreciation is to be calculated for the past period of asset used both by existing as well as by the changed method and the difference is adjusted in the current year's asset account by giving debit or credit to profit and loss account.

GLOSSARY

Depreciation	Depreciation is a process of allocating the cost of a fixed asset over its estimated useful life in a rational and systematic manner.
Useful Economic Life	Useful economic life of an asset is either the period over which a depreciable asset is expected to be used by the organization or the number of production or similar units expected to be obtained from the use of the asset by the organization.
Depreciable Value	It is the cost price of the asset less scrap value or salvage value of the asset.
Salvage Value	The estimated value of an asset at the end of its useful life.

SELF-TEST QUESTIONS

Theory Questions

1. Why is correct calculation of depreciation necessary?
2. What are the methods of providing depreciation?
3. Discuss the various factors which are considered for calculating depreciation.
4. What are the various causes of depreciation on fixed assets?
5. Distinguish between straight line and diminishing balance methods of depreciation.
6. What do you mean by replacement cost? What are the difficulties faced while providing for depreciation on the basis of replacement cost? What steps may be taken to obviate these difficulties?
7. Distinguish between sinking fund and annuity methods of depreciation.
8. "Depreciation is a process of allocation and not of valuation". Comment.

Practical Questions

1. Deva Ltd. charges depreciation on its plant and machinery @10% per annum on the diminishing balance method. On 31st March, 2013, the company decides to adopt straight line method of charging depreciation with retrospective effect from 1st April, 2009, the rate of depreciation being 15%. On 1st April, 2012, the plant and machinery account stood in the books at ₹ 2,91,600. On 1st July, 2012, a sum of ₹ 65,000 was realised by selling a machine cost of which on 1st April, 2009 was ₹ 90,000. On 1st January, 2013, a new machine was acquired at a cost of ₹ 1,50,000. Show the plant and machinery account in the books of the company for the year ended 31st March, 2013.
2. A firm acquired a machine for ₹ 5,00,000 on 1.4.2010. Depreciation was to be charged at 20% p.a. on straight line method. During 2012-13, a modification was made to improve machine's technical reliability at a cost of ₹ 50,000 which it was considered would extend the useful to life of machine for 2 years. At the same time one important component of the machine was replaced at a cost of ₹ 10,000 because of excess wear and tear. Routine maintenance during the said accounting period cost ₹ 7,500. Show the machine account, provision for depreciation on machine account and charge to profit and loss account for the year ending 31st March, 2013.

3. Suman Enterprises purchased machinery on 1st April 2010 for ₹71,800 and paid ₹3,200 on its installation. New machinery was acquired for ₹45,000 on October 1, 2010. On 1st April 2011, first machinery was sold at ₹50,000 and on the same date fresh machinery was purchased for ₹45,000. Depreciation is provided annually on 31st March at 10% p.a. on written down value method. On April 1, 2012 the firm changed the method of providing depreciation and decided to provide depreciation at 10% p.a on the original cost with retrospective effect. Prepare machinery account to ascertain the value of machinery as on 31st March 2013.

4. Simmon Ltd., charges deprecation on its plant and machinery @ 10% per annum on the diminishing balance method. On 31st March, 2013, the company decided to adopt straight line method of charging depreciation with retrospective effect from 1st April, 2010, the rate of depreciation being 15% p.a.

5. On 1st April, 2012, the plant and machinery account stood in the books of account at ₹5,00,000. On 1st August, 2012 a sum of ₹1,00,000 was realised by selling a machine the cost of which on 1st April, 2010 was ₹1,50,000. On 1st January, 2013 a new machine was acquired at a cost of ₹3,00,000. Show the plant and machinery account in the books of the company for the year ended 31st March, 2013.

MULTIPLE CHOICE QUESTIONS

1. X,Y, Z are partners in a firm. If B is to be admitted as a new partner:

   (A) Old partnership has to be dissolved (B) Old firm has to be dissolved

   (C) Both old firm and partnership has to be dissolved (D) Neither firm nor partnership need to be dissolved.

2. New profit sharing ratio is calculated at the time of:

   (A) Admission of a partner (B) Retirement of a partner(C) Death of a partner (D) All of the above

3. A, B and C are three partners sharing profits and losses in the ratio of 4:3:2,D is admitted for l/10 share, the new ratio will be:

   (A) 5:4:3:2 (B) 4:4:3:2 (C) 4:3:2: (D) None of these

4. A, B, C and D are equal partners. A, B and D died together in a plane crash. This accident results in: (A) Dissolution of partnershiP (B) Dissolution of firm (C) Dissolution of firm as well as dissolution of partnership (D) Neither dissolution of firm nor dissolution of partnership

5. On dissolution all assets are transferred to reaslisation account at :

   (A) Book value (B) Market value (C) Cost or market value, whatever is less (D) None of the above

6. A partnership firm having more than 20 partners is termed as:

   (A) A company (B) Limited Liability partnership (C) Illegal association (D) Association not for profit.

7) Interest on drawings is:

   A) Debited to partner’s current a/c

   B) Credited to partner’s current a/c

   C) Not shown in current account

8) The written agreement of partnership is most commonly referred to as:

   A) Agreement

B) Partnership deed

C) Partnership contract

D) Partnership Act

9) Where there is no partnership agreement exists between partners, what will be the profit sharing ratio between the partners?

A) Equal

B) Unequal

C) It will depend on a partner's capital

D) It will depend on the experience of a partner

10) Salary of a partner is _________ to current account

A) Debited

B) Credited

Lesson 7
Preparation of Final Accounts for Sole Proprietors

LESSON OUTLINE

- Introduction
- Trading Account
- Profit & Loss Account
- Main Principles for preparation of Trading and Profit & Loss Account
- Difference between Trading and Profit & Loss Account
- Review Questions
- Balance Sheet
- Classification of Assets
- Classification of Liabilities
- Differences between Trading and Profit & Loss Account
- Review Questions
- Differences between Trial Balance and Balance Sheet
- Differences between Profit & Loss A/c & Balance Sheet
- Adjustment Entries
- Closing Entries
- Manufacturing Account
- Limitations of Financial Statements
- Lesson Round Up
- Glossary
- Self-Test Questions

LEARNING OBJECTIVES

A sole trader is the sole owner and manager of the business. At the end of a accounting year the sole trader would like to know the financial results and the financial position of his business. He would be interested to know the profits or losses made by the business. For this purpose, he would prepare income statements i.e. trading and profit and loss accounts. He would also be interested in knowing the financial position of the business which will be ascertained by the preparation of balance sheet. Trading account, profit loss account and balance sheet together are called final accounts.

After recording transactions of a business for an accounting period in subsidiary books, posting to the ledger and testing their accuracy with the help of a trial balance, the last stage in the accounting process is the preparation of final accounts. In this lesson, we will learn in detail about the preparation of final accounts for a sole proprietor.

You have to know accounting. Its the language of practical business life. It was a very useful thing to deliver to civilization. I've heard it came to civilization through Venice which of course was once the great commercial power in the mediterrarean. However, double entry book keeping was a hell of an invention.

Charlie Munger

INTRODUCTION

Final Accounts or Financial Statements are the end products of the financial accounting process which involves the preparation of a summary of the accounts with a view to determine:

(i) net profit from the trading activities in terms of profit made or loss incurred for a given period, and

(ii) its financial position in terms of assets and liabilities as on the last date of the given period.

For the purpose of determining the profit or loss, a statement known as *Trading and Profit and Loss Account (Income Statement)* is prepared which incorporates all items of expenses and losses and all incomes and gains occurring during the accounting period.

In order to show the financial position on the last date of the accounting period, another statement known as Balance Sheet (*Position Statement*) is prepared which consists of all assets, liabilities and capital of the business. These two statements are collectively known as Final Accounts.

Final Accounts are prepared from the balances appearing in the trial balance. Debit balances of assets are transferred on the right hand side of the balance sheet while expenses and losses are debited to the Trading Account or to the Profit and Loss Account, depending upon the nature of expenditure or loss. Credit account balances like capital, liabilities, provisions and reserves are entered on the left hand side of the balance sheet while incomes and gains are credited to Trading Account or Profit and Loss Account.

TRADING ACCOUNT

Trading Account is the first part of income statement which is prepared to ascertain the gross profit or gross loss for a given accounting period.

Trading Account is prepared before the preparation of profit & loss account. It shows the result of trading activities relating to purchases & sales of goods & services. Trading account is prepared to calculate separately the profit from sale & purchase transactions only. The profit or loss is termed as gross profit or gross loss as various other expenses of an organisation like administrative, selling & distribution and maintenance expenses etc. are not deducted. Only the direct expenses which are incurred to bring goods into saleable condition like freight, insurance, carriage inwards, fuel, power, royalties on production, consumption of stores etc. are taken into account to calculate gross profit/loss.

> Gross Profit = Net Sales – Cost of the Goods Sold.
>
> Gross Loss = Cost of the Goods Sold – Sales
>
> Net Sales = Total Sales – Sales Returns (Return Inwards)
>
> Cost of goods sold = Opening stock of goods + net purchases - closing stock of goods at the end + all direct expenses
>
> Net Purchases = Total Purchases – Purchases Returns (Returns Inwards)

SPECIMEN OF TRADING ACCOUNT

Dr. **Trading Account for the year ended......** *Cr.*

Particulars	₹	Particulars	₹
To Opening Stock	XXX	By Sales	XXX
To Purchases	XXX	Less: Returns Inwards	XXX
Less: Returns Outwards	XXX	By Closing Stock	XXX
To Direct Expenses	XXX		
To Gross Profit (Balancing Figure)	XXX		
	XXX		XXX

– In case debit side exceeds the credit side, the balance will be gross loss and that will be shown on the credit side of Trading Account as "By Gross Loss".

– In trading account, closing stock is shown at cost price or net realisable market value whichever is lower.

– While taking stock for the purpose of preparation of trading account, stock in hand on the last day of the accounting year should be adjusted for purchases recorded but goods not yet received, goods sold but not yet delivered and goods that may be out of business premises because of consignment, goods delivered on sale or return basis, etc.
– Gross profit or gross loss revealed by Trading Account is transferred to Profit and Loss Account.

PROFIT AND LOSS ACCOUNT

Net profit = Total Revenues – Total Expenses

Net Loss = Total Expenses – Total Revenues

Profit and Loss Account is prepared to calculate the net profit or loss of the business for a given accounting period. The balance of Trading Account i.e. gross profit/gross loss is transferred to the Profit and Loss Account which is the starting point of the preparation of this account. Thereafter, all those expenses and losses which have not been debited already to the Trading Account are debited to the Profit and Loss Account. Other incomes and gains, if any, are credited to this account, e.g. interest earned or commission received etc. The net profit, thus arrived at is transferred to Capital Account of the proprietor/partners. Specimen of Profit & Loss Account is given on next page. Net profit increases the capital whereas net loss decreases the capital.

MAIN PRINCIPLES FOR PREPARATION OF TRADING AND PROFIT & LOSS ACCOUNT

The following principles must be kept in mind while preparing Trading and Profit & Loss Account:
– Only revenue receipts i.e. sale proceeds and other incomes should be entered.
– Only revenue expenses together with losses should be taken into account.
– Profit or loss is determined by matching revenues and expenses according to the matching principle.

Application of Concept of Matching Principle

A fundamental principle which must be observed while preparing final accounts is that of `matching cost and revenue'. It means that in final accounts, expenses and incomes for the full trading period whether they have been paid or received or not, must be included and no expenditure or income which does not pertain to the period for which final accounts are being prepared be included. The distinction between capital and revenue items is also made on the basis of this principle.

DIFFERENCE BETWEEN TRADING AND ACCOUNT PROFIT & LOSS ACCOUNT

Trading Account	***Profit and Loss Account***
(i) Trading account is prepared to calculate the gross profit (loss) for a particular period.	(i) Profit and loss account is prepared to arrive at the net profit (loss)
(ii) In trading account, cost of goods sold, sales and direct expenses are accounted.	(ii) In profit and loss account, indirect expenses, such as administrative expenses, selling expenses, etc, are charged against the gross profit and other revenues.
(iii) The result of trading account i.e. gross profit (loss) is transferred to profit and loss account.	(iii) The balance in profit and loss account i.e. net profit (loss) is transferred to capital account which will be shown in the balance sheet.

SPECIMEN OF PROFIT & LOSS ACCOUNT

Profit & Loss Account for the year ended......

Dr. *Cr.*

Particulars	*₹*	*Particulars*	*₹*
To Gross Loss b/d	XXX	By Gross Profit b/d	XXX
Management expenses:		Other income:	
To Salaries (administrative)	XXX	By Discount received	XXX
To Office rent, rates and taxes	XXX	By Commission received	XXX
To Printing and stationery	XXX	By Reserve for discount on creditors	
To Telephone charges	XXX	Non-trading income:	
To Postage and telegrams	XXX	By Bank interest	XXX
		By Rent of property let-out	XXX

To Insurance	XXX	By Dividend from shares	XXX
To Audit fees	XXX	By Interest earned on debentures	XXX
To Legal charges	XXX	Abnormal gains:	
To Electricity charges	XXX	By Profit on sale of machinery	XXX
Maintenance expenses:		By Profit in sale of investment	XXX
To Repairs and renewals	XXX	By Net Loss (transferred to Capital A/c)	
To Depreciation on:		(Balancing Figure)	XXX
Office equipment	XXX		
Office furniture	XXX		
Office building	XXX		
Selling and distribution expenses:			
To Salaries (selling staff)	XXX		
To Advertisement	XXX		
To Godown rent	XXX		
To Carriage outwards	XXX		
To Bad debts	XXX		
To Provision for bad debts	XXX		
To Selling commission	XXX		
Financial expenses:			
To Bank charges	XXX		
To Interest on loans	XXX		
To Discount on bills	XXX		
To Discount allowed to customers	XXX		
Abnormal losses:			
To Loss on sale of machinery	XXX		
To Loss on sale of investment	XXX		
To Loss by fire	XXX		
To Net Profit (transferred to Capital A/c) (Balancing Figure)	XXX		
	XXX		XXX

REVIEW QUESTIONS

Fill in the blanks:

(i) Trading account reveals __________ profit or _________ loss.

(ii) Profit and loss account reveals _________ profit or _________ loss.

(iii) Expenses appear on _________ side of trading and profit and loss account.

(iv) Provision for bad debts account shows _________ balance.

(v) Reserve for discount on creditors account shows ________ balance.

(vi) Carriage inwards appears in ____________ account, whereas carriage outwards appears in ___________ account.

Decide whether the following statements are true or false:

(i) Trade expenses account is transferred to trading account.

(ii) Capital account appears on assets side of balance sheet.

(iii) Drawings account is revenue expenditure to be shown on debit side of profit and loss account.

(iv) If trading account reveals gross loss, profit and loss account results in net profit in any case.

(v) Interest on capital and salary to proprietor are incomes and hence are shown on credit side of profit and loss account.

Tick the correct answers:

(i)	What type of account is goodwill?	Fictitious/Intangible
(ii)	What type of account is furniture?	Fixed/Current
(iii)	On which side of balance sheet is unexpired insurance shown?	Assets/Liabilities
(iv)	Which type of items appear in profit and loss account?	Revenue/Capital/Both
(v)	Is balance sheet an account or a statement?	An Account/A Statement
(vi)	Where will amount spent on stationery appear?	In Profit and Loss Account/ In Balance Sheet.

BALANCE SHEET

Balance sheet is a statement which shows the financial position i.e. the balances of assets, liabilities and capital, of a business entity at a given date. It is prepared from the real accounts and personal accounts of trial balance. A debit balance in a real account or personal account represents an asset of the concern/firm. Likewise a credit balance in a personal account represents a liability. There can be some newly opened accounts as well on account of adjustment entries. The assets and liabilities are arranged in a proper way and the resultant statement is the balance sheet. On the right hand side, assets are arranged while on the left hand side, liabilities are recorded. The totals of the two sides of the balance sheet must agree because of the equation, viz. Assets = Liabilities + Capital.

If there is a difference, it means that there is some mistake. The difference, if it does occur, should be placed on the deficit side as Suspense Account to make the two sides agree apparently.

Features of Balance Sheet

– The primary objective of the preparation of balance sheet is to ascertain the financial position of a concern.

– It shows (a) the nature and value of assets, (b) the nature and value of liabilities and (c) the position of capital.

– Balance sheet is always prepared on a certain date, never for a particular period.

– Balance sheet, unlike a trading and profit and loss account, is not an account. It is a statement containing information regarding assets, liabilities and capital.

Marshalling of Balance Sheet

The arrangement of assets and liabilities in accordance with a particular order is known as marshalling of balance sheet. The items in the balance sheet are generally marshalled in two ways-

(i) Liquidity order or according to time: In liquidity order, the assets are stated in the order in which they can be easily converted into cash and the liabilities in the order in which they have to be paid off.

(ii) Permanence order or according to purpose: In permanence order, assets which are to be used permanently in the business and are not meant for sale are shown first and the assets that are liquid are shown last in order. Similarly, liabilities may also be shown according to the permanence arrangement.

Specimen of Balance Sheet in permanence order is given below. The order will be reversed in liquidity order.

SPECIMEN OF BALANCE SHEET

Balance Sheet as at...

Liabilities		₹	Assets	₹
Capital	XXX		Goodwill	XXX
Add : Net profit	XXX		Land and building	XXX
Less : Drawings	XXX	XXX	Plant and machinery	XXX
Loans on mortgages		XXX	Furniture and fixtures	XXX
Outstanding expenses		XXX	Stock	XXX
Bank overdraft		XXX	Sundry debtors	XXX
Sundry creditors		XXX	Investments	XXX
Bills payable		XXX	Bills receivable	XXX
			Cash at bank	XXX
			Cash in hand	XXX
		XXXX		XXXX

REVIEW QUESTIONS

1. Arrange the following assets in order of their liquidity:

Furniture, Goodwill, Stock in trade, Unexpired insurance, Cash in hand, Trade debtors, Readily saleable investments, Cash at bank, Land, Buildings, Machinery, Bills receivable.

2. Arrange the following liabilities in order of permanency:

Capital, Creditors for expenses, Sundry trade creditors, Loan, Bills payable

CLASSIFICATION OF ASSETS

(i) *Fixed Assets* are those which are acquired for long use in the business itself and not for resale. For example, plant and machinery, land and buildings, furniture and fixtures, patents and trade marks are examples of fixed assets.

(ii) *Current or Floating Assets* are those that are meant to be converted into cash as soon as possible. Stock of goods, amount due from customers to whom goods have been sold on credit and balance at bank are examples of current (or floating) assets.

(iii) *Liquid Assets* are those current assets which are already in the form of cash or which can be readily converted into cash, such as Government Securities.

(iv) *Wasting Assets* are those fixed assets which have a fixed content, like coal in a coal mine; the value of the asset goes down as the contents are taken out. When the minerals have been taken out totally, the mine will become useless.

(v) *Intangible Assets* are those fixed assets which cannot be seen or touched or felt. Goodwill (the value of one's name) is an intangible asset because there is no physical form to show it. Intangible assets are not necessarily useless.

(vi) *Fictitious Assets* are valueless assets but shown as assets in the financial statements (such as useless trade marks) or expenses treated as assets (such as expenses incurred to establish a company i.e. preliminary expenses).

CLASSIFICATION OF LIABILITIES

(i) Fixed and Long-term Liabilities: Fixed liabilities are those liabilities which are payable on the termination of the business such as capital of the proprietor, whereas long-term liabilities are those which will be redeemed after a long period of time e.g. long-term loans.

(ii) Current liabilities: These are liabilities which have to be redeemed in the near future, usually within a year. Trade creditors, bank overdraft, bills payable etc. are examples of current liabilities.

(iii) Contingent liabilities: These are not actual liabilities but their becoming actual liability depends on the happening of certain events. If such events do not occur, no liability is incurred. Liability in respect of pending suit is a contingent liability because it is only if and when suit is lost that the liability will be incurred. Bills discounted with a bank are also a contingent liability because if the acceptor fails to meet the bill on due date, the firm will become liable to the bank. Such liabilities are not shown in balance sheet; usually a foot note is appended at the balance sheet for such liabilities.

REVIEW QUESTIONS

1. The following are the names of assets. Classify them: Leasehold premises, Accounting machines, Coal mine, Goodwill, Stock of raw materials, Motor vehicles, Cash in hand, Government securities, Copyright of book (no longer in demand),Amount due from customers, Loose tools and Cost of floating a company.

2. Classify the following assets into fixed, current and fictitious assets, mentioning sub-types, also in the case of fixed assets: Land and buildings, Furniture, Bills receivable, Cash in hand, Cash at bank, Plant and machinery, Coal mine, Loose tools, Preliminary expenses, Stock in trade, Amount due from customers, Copyright of a book no longer in demand, Stone quarries, Livestock, Motor vehicles, Government bonds and Goodwill of a firm incurring heavy losses.

DIFFERENCE BETWEEN TRIAL BALANCE AND BALANCE SHEET

Trial balance	***Balance sheet***
1. It is a statement of debit balances and credit balances taken from the ledger.	1. It is a statement of assets and liabilities
2. It is prepared to test the arithmetical accuracy of books of account.	2. It is prepared to ascertain the financial position of the organization on a particular date.
3. Balances of all types of accounts i.e. personal, real, and nominal accounts are shown.	3. Balances of real and personal accounts only are shown.
4. It is usually prepared at the end of each month, three months, six months or at the end of accounting year before the preparation of trading and profit and loss account.	4. It is usually prepared at the end of the year after the preparation of trading and profit and loss account.
5. Closing stock does not appear in the trial balance.	5. Closing stock is shown on the assets side of the balance sheet.
6. It is prepared for internal use.	6. It is prepared for external use, i.e. for outside parties such as, creditors, shareholders (in case of companies), government authorities, etc.

DIFFERENCE BETWEEN PROFIT & LOSS ACCOUNT AND BALANCE SHEET

Profit & Loss Account	***Balance sheet***
1. Profit and loss account is an account	1. Balance sheet is a statement of assets and liabilities.
2. Profit and loss account shows the profits earned or losses incurred for the accounting period	2. Balance sheet shows financial position of the business.
3. Profit and loss account is prepared for the accounting period	3. Balance sheet is prepared as at the last day of the accounting period.
4. The accounts that are transferred to the profit and loss account are closed and cease to exist.	4. The accounts which are shown in the balance sheet do not lose their identity and become the opening balances in the next accounting period

ADJUSTMENT ENTRIES

Usually, final accounts are prepared from the balances given in the trial balance. However, at times some account balances in the trial balance do not reflect the correct 'amount' when considered in relation to accounting period. For example, payment on account of expense, say, rent, may be less or more than the actual payment that ought to have been made during the accounting period. Similar situation may arise in respect of some revenue items also, say interest on investments.

In order to ensure that the final accounts disclose the true trading results and correct balances, it is necessary that all expenses incurred whether paid or not and the whole amount of loss sustained whether ascertained or estimated should be taken into consideration. Similarly, incomes and gains whether actually received or not during the accounting period should be accounted for. All this requires adjustment entries which are used to establish correct values of account balances at the end of an accounting period. Thus, adjustment entries are those entries which are passed at the end of each accounting period for the purpose of adjusting various nominal and other accounts so that true net profit or loss is indicated in profit and loss account and the balance sheet represents a true and fair view of the financial condition of an enterprise.

The following are the usual adjustment entries which are made while preparing the final accounts.

(I) CLOSING STOCK

The unsold stock at the end of the accounting period is termed as closing stock. There can be two entries for closing stock.

(a) Closing Stock Account *Dr.* *To Trading Account*		When this entry is passed the closing stock at the end appears in trading account and on the assets side of balance sheet. It becomes the opening stock for the next year.
(b) Stock Account *Dr.* *To Purchases Account*		In this case, closing stock will appear in the trial balance, it means that double entry has been completed in the accounting period itself by reducing the purchases. Therefore it will appear as an asset in the balance sheet only.

(II) ACCRUED OR OUTSTANDING EXPENSES

Expenses which have been incurred during the year and whose benefit has been derived during the year but payment in respect of which has not been made are called outstanding or accrued expenses. At the end of the year, all such expenses must be brought into books, otherwise, the profit will be overstated and liability will be understated. The following journal entry is passed:

Expense Account	*Dr.*
To Outstanding/Accrued Expense Account	

– The outstanding expenses are shown on the debit side of the trading account or profit and loss account, as the case may be, by way of addition to the respective expenses.

– These are also shown on the liabilities side of balance sheet.

– In the beginning of the next year, a reverse entry will be passed.

EXAMPLE 1:

Salary for March, 2013 ₹ 7,000 has not been paid. The adjustment entry will be:

		₹	₹
Salary Account	Dr.	7,000	
To Outstanding Salary Account			7,000

The entry will increase the balance in salary account by ₹ 7,000 which will be transferred to the profit and loss account. Outstanding salary account is a liability which will appear in the balance sheet.

(III) UNEXPIRED OR PREPAID EXPENSES

Those expenses which have been paid in advance and whose benefit will be available in future are called unexpired or prepaid expenses e.g. insurance premium and rent paid in advance. An adjustment entry is made whereby the unexpired amount is credited to the appropriate expense account and debited to prepaid (unexpired) account as under:

Prepaid Expense Account	*Dr.*
To Expense Account	

– The amount of prepaid expenses is shown in the profit and loss account by way of deduction from the concerned expenses.

– These are also shown as assets in the balance sheet.

– In the beginning of the next year, a reverse entry will be passed to cancel the effect of adjusting entry.

EXAMPLE 2:

Fire insurance premium of ₹ 2,000, paid for the year ending 30th June 2013. On 31st March, 2013 insurance policy has run only for 9 months and hence only 3/4th of the premium can be said to pertain to 2012-13: 1/4th of the premium amount, i.e. ₹ 500 will be treated as an asset. Entry will be:

		₹	₹
Unexpired Insurance Premium	Dr.	500	
To Insurance Premium Account			500

Unexpired insurance premium will appear as an asset in the balance sheet and insurance premium account will be reduced by ₹ 500.

(IV) ACCRUED OR OUTSTANDING INCOME

Accrued income means income which has been earned by the business during the accounting year but which has not become due and hence has not been received. But outstanding income means any income which has become due during the accounting year but has not been so far received by the firm. Though there is a distinction between the two, for adjustment entry no such distinction is necessary, both the accrued income and outstanding income are added to the given income figure in the trial balance. The following entry is passed:

Accrued /Outstanding Income Account	Dr.
To Income Account	

– The amount of income is transferred to the credit side of profit and loss account as an addition to the respective income account.

– The accrued/outstanding income account also appears as an asset in the balance sheet.

– In the beginning of next year, a reverse entry will be passed.

EXAMPLE 3: Interest earned but not yet received, ₹ 650. The entry will be:

		₹	₹
Interest Accrued Account	Dr.	650	
To Interest Account			650

Interest accrued account will appear as an asset in balance sheet and the amount of interest account to appear on the credit side of profit and loss account will increase by ₹ 650.

(V) UNEARNED INCOME OR INCOME RECEIVED IN ADVANCE

That portion of the revenue which remains received in advance (unearned) at the end of the accounting period is known as unearned income or income received in advance. For example, subscription received in advance by a club, insurance premiums received in advance by and insurance company, rent received in advance, etc. Any income in advance is not actually earned and it rather creates an obligation. The following adjustment entry is made at the end of the accounting year;

Income Account	*Dr.*
To Income Received in Advance Account	

– This item is shown on the credit side of the profit and loss account by way of deduction from the income.

– It is also shown in the balance sheet on the liabilities side as 'Income received in advance'.

EXAMPLE 4: Rent for April, 2013 ₹ 8,000 received in advance

		₹	₹
Rent Received Account	Dr.	8,000	
To Rent Received in Advance Account			8,000

The balance of rent received account appearing on the credit side of profit and loss account will diminish by ₹ 8,000 and rent received in advance account will appear on liabilities side of balance sheet because service for this rent is to be rendered in the year to come.

(VI) DEPRECIATION

Depreciation is the reduction in the value of fixed assets due to a use, wear and tear or obsolescence. When an asset is used for earning purpose, it is necessary that reduction due to its use must be charged to the profit for the year in order to show correct value in the balance sheet. The following journal entry is passed for charging depreciation:

Depreciation Account	*Dr.*
To Fixed Asset Account	

– The amount of depreciation is debited to the profit and loss account.

– Again it is shown on the assets side of the balance sheet by way of deduction from the concerned asset.

When depreciation is given in the trial balance, it means that the asset(s) has(ve) been credited with the amount of depreciation and the necessary debit to depreciation account has been made. The only entry then would be to transfer the depreciation account to profit and loss account and no adjustment entry would be needed.

Note: There are various methods of providing depreciation, but in questions on final accounts, it is most likely asked to be calculated at a fixed percentage on opening balance of the assets. If there are additions, depreciation is provided only for that part of the year for which the new asset has been used.

EXAMPLE 5: If furniture stood at ₹ 1,00,000 on 1st April, 2012 and additional furniture was purchased for ₹15,000 on 1st October, 2012, total depreciation @5% per annum would amount to ₹ 5,375 calculated as under:

		₹
Depreciation on 1,00,000 @ 5% for full year		5,000
Depreciation on Rs. 15,000 @ 5% for 6 months i.e., from 1st October, 2012 to 31st March, 2013		375
$\frac{₹\ 15{,}000 \times 5 \times 6}{10 \times 12}$		
	Total	5,375

Entry will be:

		₹	₹
Depreciation Account	Dr.	5,375	
To Furniture Account			5,375

Depreciation account will appear on the debit side of profit and loss account and the book value of furniture will be reduced by ₹ 5,375 in the balance sheet.

WHEN PROVISION FOR DEPRECIATION ACCOUNT IS MAINTAINED:

Depreciation Account	*Dr.*
To Provision for Depreciation Account	
Profit and Loss Account	*Dr.*
To Depreciation Account	

(VII) BAD DEBTS

Debts which cannot be recovered or become irrecoverable are called bad debts. It is a loss to the business and is brought into account by debiting bad debts account and crediting debtors' accounts who are not able to pay the amount. The adjustment entry is as follows:

Bad Debts Account	*Dr.*
To Sundry Debtors Account	

– The bad debts account is debited to profit and loss account.

– The debtors balance is reduced by the same amount in the balance sheet.

– When the amount of bad debts is given in the trial balance itself no adjusting entry is required. It should only be transferred to profit and loss account.

(VIII) PROVISION FOR BAD DEBTS

A firm may make a provision at the end of the accounting year for likely bad debts which may take place during the course of the next year. This is for the simple reason that if out of credit sales made during a particular year, some sales are likely to become bad in the course of the next year, the proper course would be to charge in the same accounting year with such likely bad debts in which the sales have been made. The following journal entry is passed for creating provision for bad debts:

Profit and Loss Account	*Dr.*
To Provision for Bad Debts Account	

– The provision for bad debts is charged to profit and loss account.

– It is also deducted from debtors in the balance sheet.

– Provision for bad debts created out of profit of the current year should be carried forward to the next period. Bad debts occurring during that period would be debited to bad debts account as usual, but total debits given to this account should be transferred to provision for bad debts account. At the end of the next year suitable adjustment entry is passed for keeping the provision for bad debts at an appropriate amount to be carried forward.

– Sometimes the balance brought down from the previous year is so large that even after debiting the current year's bad debts and leaving the desired balance at the end of the year, a surplus is left. This surplus is transferred to the credit side of profit and loss account.

EXAMPLE 6: If debts of 2011-12, prove to be bad in 2012-13 the loss is to be treated as one for 2011-12. But on 31st March, 2012 when final accounts are be prepared, it will not be possible to know accurately, which debts will prove bad in 2012-13. Hence, only an estimate is made on the basis of past experience. If it is estimated that 6% of the debts may prove bad and on 31st March, 2012 debtors amount to ₹ 40,000, then ₹2,400 will be provided for future bad debts. The entry is:

		₹	₹
Profit and Loss Account	Dr.	2,400	
To Provision for Bad Debts Account			2,400

It will reduce the profit for 2011-12 by ₹2,400. Provision for bad debts will appear in the balance sheet as a deduction from sundry debtors on assets side although it is a separate account showing credit balance.

In the next year, the actual amount of bad debts will be debited to provision for bad debts account which will then stand reduced. On 31st March, 2013 the amount of the provision will be brought up by an appropriate debit to profit and loss account depending on the amount of sundry debtors as at that date.

(IX) PROVISION FOR DISCOUNT ON DEBTORS

This is a charge made against profits in order to provide for an expected loss in the form of discounts which are likely to be allowed to the debtors, for encouraging them to make prompt payments. In order to incorporate such provision for discount on debtors, the following journal entry is passed:

Profit and Loss Account	*Dr.*
To Provision for Discount on Debtors Account	

– This provision is shown on the debit side of the profit and loss account.

– It is also shown in the balance sheet by way of deduction from sundry debtors.

Note: Provision for discount is always calculated on the amount of debtors left after deducting the provision for bad debts i.e. provision should be calculated on good debts. It is because no discount will be allowed on amounts which are not recovered and hence no provision for discount on such amounts is required.

For example, if 2% discount is allowed, debtors are of ₹ 10,000 and 5% provision for bad debts is required then provision for discount will be made @2% on ₹ 9,500, i.e., on ₹ 10,000 less 5% for provision for bad debts amounting to ₹ 500.

(X) RESERVE FOR DISCOUNT ON CREDITORS

A firm may like to create reserve for discount on its creditors to record discounts expected to be received from them. The adjustment entry for this purpose is as follows:

Reserve for Discount on Creditors Account	*Dr.*
To Profit and Loss Account	

- The reserve for discount on creditors account is credited to the profit and loss account.
- It should also be deducted from the sundry creditors in the balance sheet. Keeping with the principle of conservatism, the provision for discount on creditors is often not made in actual practice.

(XI) INTEREST ON CAPITAL

It is a normal practice to charge business with interest on the capital employed in the business. The purpose is to know whether the profits of the business are more than what could be earned from simple investments outside business. Interest charged is an expense to the business but it is a gain to proprietor. The following adjustment entries are passed:

(i)	*Interest on Capital Account*	*Dr.*
	To Capital Account	
(ii)	*Profit and Loss Account*	*Dr.*
	To Interest on Capital Account	

- Interest on capital is debited to the profit and loss account and
- It is shown on the liabilities side of the balance sheet by way of addition to the capital.

(XII) INTEREST ON DRAWINGS

As business allows interest on capital, it also charges interest on drawings made by the proprietor. This is a gain to the business and an expense for the proprietor. The following adjustment entries are made:

(i)	*Capital Account*	*Dr.*
	To Interest on Drawings Account	
(ii)	*Interest on Drawings Account*	*Dr.*
	To Profit and Loss Account	

- It is credited to the profit and loss account and
- Shown on the liabilities side of the balance sheet by way of deduction from capital.

(XIII) ACCIDENTAL LOSS OF AN ASSET

When asset is not insured:

Sometimes asset of the organization may be destroyed due to earthquake, fire or accidents. The firm has to bear the entire loss if the asset is not insured. The following entries are passed to make adjustments for loss:

(a)	*When loss is incurred due to accident*	
	Accidental Loss Account	*Dr.*
	To Asset Account	

(b) When loss is transferred to profit and loss account

Profit and Loss Account	*Dr.*
To Accidental Loss Account	

When asset is insured:

When the asset destroyed by accident is insured, then the firm will not have to bear the entire loss. The insurance company will pay certain amount on loss of the asset. The amount of loss will be reduced to the extent of amount recovered from the insurance company. The difference in the book value of asset on the date of accident and the amount of claim admitted by the insurance company is the loss suffered by the company. This loss will be transferred to the profit and loss account.

On admission of claim:

Insurance Company	*Dr.*
To Asset Account	

On receipt of money claimed:

Bank	*Dr.*
To Insurance Company	

On transfer of loss:

Profit and Loss Account	*Dr.*
To Asset Account	

(XIV) ACCIDENTAL LOSS OF STOCK

Sometimes, stock in trade is lost due to fire or theft. If the firm has insured the stock, then loss can be made good fully or partly by the insurance company. The following adjustment entries are passed:

(a) If the stock is fully insured, the whole loss is fully recoverable from the insurance company. The journal entry is:

Insurance Company Account	*Dr.*
To Trading Account	

Insurance company account is shown on the credit side of the trading account and in the balance sheet it is treated as an asset until the amount is received.

(b) If the stock is not fully insured, the loss of stock covered by the insurance policy will be claimed from the insurance company and the rest will be treated as a loss. The journal entry in this case is:

Insurance Company Account	*Dr.*
Profit and Loss Account	*Dr.*
To Trading Account	

(c) If the stock is not insured, nothing is recoverable from insurance company and the whole loss will be borne by the firm. The journal entry is:

Profit and Loss Account	*Dr.*
To Trading Account	

In all cases, trading account is credited with the gross amount of stock lost.

(XV) MANAGER'S COMMISSION ON NET PROFITS

Sometimes, the manager of a business is given a commission based on a fixed percentage of the net profit of the business. The adjustment entry for such commission payable is as follows:

Profit and Loss Account	*Dr.*
To Commission Payable Account	

– The commission payable is shown on the debit side of the profit and loss account and on the liabilities side of the balance sheet.

Calculation of Commission: It can be calculated in following two ways.

(a) Commission as a percentage of net profits before charging such commission

$$\text{Manager's commission} = \frac{\text{Profit before commission x Rate of commission}}{100}$$

(b) Commission as percentage of net profits after charging such commission

$$\text{Manager's commission} = \frac{\text{Profit before commission x Rate of commission}}{100 + \text{Rate of commission}}$$

(XVI) GOODS DISTRIBUTED AS FREE SAMPLES

Sometimes, in order to promote the sale of goods, some of the produced goods are distributed as free samples. It may be treated like an expenditure on advertisement and the following adjustment entry is passed:

Free Samples/Advertisement Account	*Dr.*
To Trading/Purchases Account	

– It is shown on the credit side of the trading account or deducted from the purchases and

– It is also shown on the debit side of profit and loss account as free samples or advertisement expense.

(XVII) DRAWINGS OF GOODS BY THE PROPRIETOR FOR PERSONAL USE

If goods have been withdrawn by the proprietor for personal use and no entry has been passed during the year, the following adjustment entry should be passed:

Drawings Account	*Dr.*
To Purchases Account/ Trading Account	

– Goods are deducted from the purchases on the debit side of the trading account or shown on the credit side of trading account and

– They are included in proprietor's drawings which are ultimately deducted from the capital shown on the liabilities side of the balance sheet.

(XVIII) DEFERRED REVENUE EXPENDITURE

The expenditure which is incurred in one year but the benefit of which is available in a few subsequent years also is called deferred revenue expenditure. Part of such expenditure is written off each year and the rest is capitalized. The adjustment entry to write off this expenditure is as follows:

Profit and Loss Account	*Dr.*
To (Respective) Expense Account	

The written off amount is debited to profit and loss account and shown as a deduction from the capitalized expense in the balance sheet.

(XIX) GOODS ON SALE ON APPROVAL BASIS

Sometimes goods are sold to customers on approval basis. If consent is not received during the accounting period, it cannot be treated as sale. In such a case, the following adjustment entries are passed:

(i)	*Sales Account*	*Dr.*	
	To Debtors Account		*(with sale price)*
(ii)	*Stock Account*	*Dr.*	
	To Trading Account		*(at cost price)*

Thus, this item is shown on the credit side of trading account by way of deduction from the sales at sale price and added to the closing stock at cost price. At the same time, it is shown on the asset side as a deduction from sundry debtors at sale price and added to the closing stock at cost price.

(XX) GOODS RECEIVED BUT NOT RECORDED IN BOOKS

Often, goods may have been received but invoice has not been received or omitted to be recorded. In such a case, the following adjustment entry should be passed.

Purchases Account	*Dr.*
To Supplier/Creditors	

This item is shown as addition to the purchases in the trading account and added to sundry creditors on the liabilities side of the balance sheet.

(XXI) SALARY TO PROPRIETOR

If the proprietor charges salary for the work done by him, proprietor's salary account is debited and capital account is credited. If there are a number of proprietors called the partners, and salary is charged by them, salary to partners account will be debited and the respective capital accounts will be credited with the respective amounts of salary charged by them.

(XXII) GENERAL RESERVE

General Reserve is created out of the Profit and Loss Account as appropriation of net profit for strengthening the financial position of the business.

Profit and Loss Account	*Dr.*
To General Reserve	

- General Reserve is shown on the debit side of Profit and Loss (Appropriation) Account and
- It is shown on the liabilities side of the Balance Sheet.

(XXIII) CASH DISCOUNT

Cash discount is allowed and received for prompt payment. When cash discount is allowed to a cuctomer, a less amount is accepted as a full payment of a debt. Similarly when cash discount is received, a less amount is paid in full discharge of a liability. Discount allowed is debited to discount allowed account, cash received is debited to cash account and the total amount is credited to debtor making the payment. Discount received is credited to discount received account, cash paid is credited to cash account and the total of the two is debited to the creditor to whom the payment is made.

(XXIV) TRADE DISCOUNT

Trade discount is a deduction from the list (or catalogue) price allowed by the manufacturers to the wholesalers or by the wholesalers to the retailers for various reasons. The rate of trade discount allowed varies considerably. From accounting point of view no entries are made either in seller's books or in the purchaser's books for such a discount. Entries for purchases and sales are made at net price i.e. after deducting trade discount from the list price.

DIFFERENCE BETWEEN CASH DISCOUNT AND TRADE DISCOUNT

Cash Discount	Trade Discount
(i) It is a reduction granted by a supplier from the invoice price in consideration of immediate or prompt payment.	(i) It is a reduction granted by a supplier from the list price of goods or services on business consideration.
(ii) It is allowed to encourage the prompt payment.	(ii) It is allowed to promote sales.
(iii) It is not shown in the invoice	(iii) It is shown by way of deduction in the invoice itself.
(iv) Cash discount account is opened in the ledger.	(iv) Trade discount account is not opened in the ledger.
(v) It is allowed on payment of money	(v) It is allowed on purchase of goods
(vi) It may vary with the time period within which payment is received	(vi) It may vary with the quantity of goods purchased or amount of purchases made.

MAIN PRINCIPLES FOR PREPARATION OF FINAL ACCOUNTS:

The list of adjustment entries given above is not exhaustive. The student may analyse each transaction and pass necessary journal entries for adjustments considering following principles:

(i) The items given in the trial balance will appear in only one of the statements i.e. the Trading Account, the Profit and Loss Account or the Balance Sheet.

(ii) The amount in respect of adjustments will appear in two of the above mentioned statements, normally in the Balance Sheet and in the Trading Account or in the Profit and Loss Account.

The reason being that for items appearing in the trial balance, the double entry has already been completed but in respect of adjustments, the double entry has yet to be completed, hence two accounts will be affected.

CLOSING ENTRIES

In order to prepare final accounts, all nominal accounts have to be transferred to Trading and Profit and Loss Account. It is done by passing journal entries which are called closing entries as they close the nominal accounts. The entry to transfer the balance of profit and loss account itself is also one of the closing entries. Some of the closing entries are given below:

(i)	*Trading Account*	*Dr.*
	To Stock	
	To Purchases	
	To Sale Returns	
	To Carriage Inwards	
	(Transfer of various accounts to Trading Account)	
(ii)	*Sales Account*	*Dr.*
	Purchase Returns	*Dr.*

Closing Stock *Dr.*

To Trading Account

(Transfer of sales account and purchases returns account to trading account and recording of closing stock)

(iii) Trading Account *Dr.*

To Profit and Loss Account

(Transfer of gross profit from trading account to profit and loss account)

or

Profit and Loss Account *Dr.*

To Trading Account

(Transfer of gross some loss from trading account to profit and loss account)

(iv) Profit and Loss Account *Dr.*

To Rent

To Salaries

To Sundry Expenses

To Depreciation

(Transfer of various nominal accounts to profit and loss account)

(v) Interest Received *Dr.*

To Profit and Loss A/c

(Transfer of credit balance of interest received account to profit and loss account)

(v) Profit and Loss Account *Dr.*

To Capital Account

(Transfer of net profit to capital account)

In case of no loss, the above mentioned entry will be the reversed one.

MANUFACTURING ACCOUNT

A manufacturing concern may like to ascertain the cost of goods during the accounting period and may prepare Manufacturing Account for this purpose. Trading Account is not capable of showing the cost of goods manufactured because it deals with stock of finished goods also and because some of the expenses connected with manufacture of goods (such as depreciation and repairs of machinery and factory) are debited to the Profit and Loss Account. Manufacturing Account is debited with all expenses incurred in the factory on production of goods. This means that depreciation and repairs to plant and machinery and factory building, salary to works manager, etc. are also debited to this account. The total of such expenses plus cost of raw material used gives cost of goods manufactured during the period. This is transferred to Trading Account which deals with stock of finished goods and sales also. The remaining nominal accounts appear in Profit and Loss Account.

In fact, there is no prescribed format for the presentation of Manufacturing Account. However, a format covering various elements is given below. The Trading Account and Profit and Loss Account should be prepared in the same way as discussed earlier.

SPECIMEN OF MANUFACTURING ACCOUNT

Manufacturing Account for the year ended......

Dr. *Cr.*

Particulars	₹	*Particulars*	₹
To Work in progress (opening)	XXX	By Work in progress (closing)	XXX
To Raw material consumed:		By Sale of scrap	XXX
Opening stock	XXX	By Cost of production of finished goods transferred to Trading Account	
Add: Purchases	XXX		
Less: Closing stock	XXX		XXX
To Direct wages	XXX		
To Direct expenses	XXX		
To Factory expenses:			
Factory rent	XXX		
Plant repairs	XXX		
Indirect wages	XXX		
Depreciation on factory building	XXX		
	XXX		XXX

LIMITATIONS OF FINANCIAL STATEMENTS

Financial statements are the result of the accounting process which begins with recording of transactions. Accounting process involves recording, classifying and summarizing business transactions. Financial statements are the result of the third process viz. summarizing. The financial statements are based on certain accounting concepts and conventions which cannot be said to be foolproof.

The following are the limitations of the financial statements:

(i) Financial statements are essentially interim reports and therefore, cannot be final because the final gain or loss can be computed only at the termination of the business. Financial statements only reflect the progress and position of the business at frequent intervals during its life.

(ii) Financial statements though expressed in exact monetary terms, are not absolutely final and accurate. As the balance sheet is prepared on the basis of the going concern concept, asset valuation represents neither the realizable value nor replacement costs. Further, they depend on the judgment of the management in respect of various accounting policies.

(iii) The values ascribed to the assets presented in the statements depend upon the standards of the persons dealing with them. For instance, the method of depreciation, mode of amortization of fixed assets, treatment of deferred revenue expenditure, all depend on the personal judgment of the accountant.

(iv) Financial statements take into consideration only the financial factors. They fail to bring out the significance of non-financial factors which may have considerable bearing on the operating results and financial conditions of an enterprise. For example, public image of the enterprise, the caliber of its management, efficiency and loyalty of its workers etc.

(v) It is not always possible to discover false figures in financial statements. Unscrupulous managements generally resort to 'window dressing' in the preparation of such statements.

(vi) Financial statements are prepared primarily for shareholders. Other interested parties have to generally make many adjustments before they use them profitably.

(vii) Quite often, financial statements do not disclose current worth of the business. Only historical facts are presented and the true current worth is not reflected.

(viii) Owing to the fact that financial statements are compiled on the basis of historical costs, while there is a marked decline in the value of the monetary unit and resultant rise in prices, the balance sheet loses its function as an index on current economic realities. Again, the financial statements contain both historical and current costs items, hence figures are distorted.

ILLUSTRATIONS

Illustration 1:

A business house maintains provision of 5% against bad debts and 3% for discount on debtors and a reserve for discount on creditors at 2%. On 1st April, 2014 it had the following balances:

Provision for Bad and Doubtful Debts	...	*₹ 5,000*
Provision for Discount on Debtors	...	*₹ 2,850*
Provision for Discount on Creditors	...	*₹ 4,800*

During the year 2014-15, bad debts, discount allowed to debtors and discount received from creditors amounted to ₹ 3,950, ₹ 8,800 and ₹ 9,840 respectively while for 2015-16 they amounted to ₹ 1,800, ₹ 7,000 and ₹ 6,800 respectively. Sundry Debtors were ₹ 1,20,000 on March 31, 2015 and ₹ 80,000 on March 31, 2016. Sundry Creditors on these two dates were ₹ 2,10,000 and ₹ 1,95,000 respectively.

Show provision for bad debts account, provision for discount on debtors account and reserve for discount on creditors account along with relevant portions of profit and loss account.

Solution:

Provision for Bad Debts Account

Dr. *Cr.*

Date	*Particulars*	₹	*Date*	*Particulars*	₹
2015			2014		
March 31	To Bad Debts	3,950	April 1	By Balance b/fd	5,000
March 31	To Balance c/d	6,000			
			2015		
			March 31	By Profit & Loss A/c (Balancing Figure)	4,950
		9,950			9,950
2016			2015		
March 31	To Bad Debts	1,800	April 1	By Balance b/d	6,000
March 31	By Profit & Loss A/c (Balancing Figure)	200			
March 31	To Balance c/d	4,000			
		6,000			6,000
			2016		
			April 1	By Balance b/d	4,000

Provision for Discount on Debtors A/c

Dr. *Cr.*

Date	*Particulars*	₹	*Date*	*Particulars*	₹
2015			2014		
March 31	To Discount Allowed	8,800	April 1	By Balance b/fd	2,850
March 31	To Balance c/d	3,420	2015		
			March 31	By Profit & Loss A/c (Balancing Figure)	9,370
		12,220			12,220
2016			2015		
March 31	To Discount Allowed	7,000	April 1	By Balance b/d	3,420
March 31	To Balance c/d	2,280	2016		
			March 31	By Profit & Loss A/c (Balancing Figure)	5,860
		9,280			9,280
			2016		
			April 1	By Balance b/d	2,280

Reserve for Discount on Creditors A/c

Dr. *Cr.*

Date	*Particulars*	₹	*Date*	*Particulars*	₹
2014			2015		
April 1	To Balance b/fd	4,800	March 31	By Discount Received	9,840
2015 March 31	To Profit & Loss A/c (Balancing Figure)	9,240	March 31	By Balance c/d	4,200
		14,040			14,040
2015			2016		
April 1	To Balance b/d	4,200	March 31	By Discount Received	6,800
2016			March 31	By Balance c/d	
March 31	To Profit & Loss A/c (Balancing Figure)	6,500			3,900
		10,700			10,700
2016					
April 1	To Balance b/d	3,900			

Profit and Loss Account for the year ended 31st March, 2015

Dr. *Cr.*

Particulars	₹	₹	*Particulars*	₹	₹
To Bad Debts:	3,950		By Discount Received	9,840	
Add: New Provision for Bad and Doubtful Debts	6,000		Add: New Reserve for Discount on Creditors	4,200	
				14,040	
	9,950		Less: Old Reserve	4,800	9,240
Less: Old Provision	5,000	4,950			
To Discount Allowed	8,800				
Add: New Provision for Discount	3,420				
	12,220				
Less: Old Provision	2,850	9,370			

Profit and Loss Account for the year ended 31st March, 2016

Dr. *Cr.*

Particulars	₹	₹	*Particulars*	₹	₹
To Discount Allowed	7,000		By Old Provision for bad and doubtful debts	6,000	
Add: New Provision for Discount	2,280				
	9,280				
Less: Old Provision	3,420	5,860	Less: Bad Debts	1,800	
			Less: New Provision	4,200	200
			By Discount Received	4,000	
			Add: New Reserve for	6,800	
			Discount on Creditors	3,900	
				10,700	
			Less: Old Reserve	4,200	6,500

Illustration 2:

Following is the trial balance of Amar as on 31st March, 2016:

	₹	₹
Capital Account		*8,00,000*
Drawing Account	*60,000*	
Stock (1.4.2015)	*4,50,000*	
Purchases	*26,00,000*	
Sales		*31,00,000*
Furniture	*1,00,000*	
Sundry Debtors	*4,00,000*	
Freight and Octroi	*4,6,000*	
Trade Expenses	*5,000*	
Salaries	*55,000*	

Rent	*24,000*	
Advertising Expenses	*50,000*	
Insurance Premium	*4,000*	
Commission		*13,000*
Discount	*2,000*	
Bad Debts	*16,000*	
Provision for Bad Debts		*9,000*
Creditors		*2,00,000*
Cash in hand	*52,000*	
Bank	*58,000*	
Goodwill (at cost)	*2,00,000*	
	41,22,000	*41,22,000,*

Adjustments:

(a) *Stock on 31st March, 2016 was valued at ₹ 5,30,000.*

(b) *Salaries have been paid only for 11 months.*

(c) *Unexpired insurance included in the figure of ₹ 4,000 appearing in trial balance is ₹ 1,000.*

(d) *Commission earned but not yet received amounting to ₹ 1,220 is to be recorded in books of account.*

(e) *Provision for bad debts is to be brought upto 3% of sundry debtors.*

(f) *Manager is to be allowed a commission of 10% of net profits after charging such commission.*

(g) *Furniture is depreciated @10% per annum.*

(h) *Only 1/4th of advertising expenses is to be written off.*

Prepare trading and profit and loss account for the year ended 31st March, 2016 and balance sheet as on that date. Also show adjustments entries and closing entries.

Solution:

Mr. Amar

Trading and Profit and Loss Account

for the year ended 31st March, 2016

Dr. Cr.

Particulars	₹	₹	Particulars	₹	₹
To Stock (1.4.2015)		4,50,000	By Sales		31,00,000
To Purchases		26,00,000	By Closing Stock		5,30,000
To Freight & Octroi		46,000			
To Gross Profit transferred to P&L a/c		5,34,000			
		36,30,000			36,30,000
To Trade Expenses		5,000	By Gross Profit transferred from trading A/c		534,000
To Depreciation		10,000			
To Salaries	55,000		Commission	1,300	
Add: Outstanding	5,000	60,000	Add: Commission earned but not received	1220	14,220
To Rent		24,000			
To Advertising Expenses	50,000				
Less: Amount C/f	37,500	12,500			

Particulars	₹	₹	*Particulars*	₹	₹
To Insurance Premium	4,000				
Less: Unexpired Insurance	1,000	3,000			
To Discount		2,000			
To Provision for Bad Debts @3% on ₹ 40,000	12,000				
Add: Bad Debts	16,000				
Less: Old provision	9,000	19,000			
To Commission payable to Manager		37,520			
To Net Profit transferred to Capital Account		3,75,200			
		5,48,220			5,48,220

Balance Sheet as on 31st March, 2016

Liabilities	₹	₹	*Assets*	₹	₹
Capital			Fixed Assets:		
Opening Balance	800,000		Goodwill		2,00,000
Add: Net profit	3,75,200		Furniture	100,000	
Less: Drawings	60,000	11,15,200	Less: Depreciation	10,000	90,000
Creditors		2,00,000	Current Assets:		
Outstanding Salary		5,000	Unexpired Insurance		1,000
Commission Payable to Managers		37,520	Unexpired advertising expenses		37,500
			Commission earned but not received		1,220
			Stock		5,30,000
			Sundry Debtors	4,00,000	
			Less: Provision for bad debts	12,000	3,88,000
			Cash at bank		58,000
			Cash in hand		52,000
		13,57,220			1,35,7220

Journal Book

Adjustment Entries

Particulars		₹	₹
Stock Account	Dr.	530,000	
To Trading Account			5,30,000
(Being closing stock credited to trading account)			
Salaries Account	Dr.	5,000	
To Salaries Outstanding Account			5,000
(Being the amount of salaries outstanding on 31st March, 2013)			
Unexpired Insurance	Dr.	1,000	
To Insurance Premium Account			1,000
(Being the amount of unexpired insurance premium as on 31st March, 2013)			
Commission Earned But not Received	Dr.	1,220	
To Commission Account			1,220
(Being the amount of commission earned but not received till 31st March, 2013)			
Bad Debts Account	Dr.	16,000	
To Provision for Bad Debts Account			16,000
(Transfer of bad debts to provision for bad debts)			
Profit and Loss Account	Dr.	19,000	
To Provision for Bad Debts Account			19,000
(Being credit given to provision for bad debts to make its balance 3% of ₹ 40,000)			
Profit and Loss Account	Dr.	37,520	
To Commission Payable to Manager			37,520
(Being commission payable to manager @10% of net profits remaining after charging such commission)			
Depreciation Account	Dr.	10,000	
To Furniture Account			10,000
(Being the amount of depreciation provided on furniture @10% per annum)			
Unexpired Advertising Expenses Account	Dr.	37,500	
To Advertising Expenses Account			37,500
(For advertising expenses carried forward to next year)			

Closing Entries:

Particulars		₹	₹
Trading Account	Dr.	30,96,000	
To Stock Account (1.4.2012)			4,50,000
To Purchases Account			26,00,000
To Freight & Octroi Account			46,000
(Transfer of various nominal accounts showing debit balances to trading account)			
Sales Account	Dr.	31,00,000	
To Trading Account			31,00,000
(Transfer of sales account to trading account) Note: Entry for closing stock has already been passed by way of adjustment			
Trading Account	Dr.	5,34,000	
To Profit and Loss Account			5,34,000
(Transfer of gross profit from trading account to profit and loss Account)			
Profit and Loss Account	Dr.	1,16,500	
To Trade Expenses Account			5,000
To Salaries Account			60,000
To Rent Account			24,000
To Advertising Expenses Account			12,500
To Insurance Premium Account			3,000
To Discount Account			2,000
To Depreciation Account			10,000
(Transfer of various nominal accounts showing debit balances to profit and loss account)			
Commission Account	Dr.	14,220	
To Profit and Loss Account			14,220
(Transfer of credit balance in commission account to profit and loss Account)			
Profit and Loss Account	Dr.	3,75,200	
To Capital Account			3,75,200
(Transfer of net profit to capital account)			

Note: Profit and Loss Account has already been debited in respect of provision for bad debts and commission payable to manager. Refer to adjustments entries.

Illustration 3:

Following are the balances in the ledger of Mr. Patel for the year ended 31st March, 2016:

	₹
Stock (1.4.2015):	
Raw materials	*1,00,000*
Semi-finished goods	*50,000*
Finished goods	*2,60,000*
Purchases:	
Raw materials	*8,00,000*
Finished goods	*1,70,000*

Carriage inwards on raw materials	*30,000*
Manufacturing wages	*1,00,000*
Salary of the supervisor	*36,000*
Rent of the factory	*70,000*
Gas and water	*30,000*
Return of raw materials	*13,000*
Fuel and coal	*33,000*
Factory power	*1,25,000*
Fire insurance	*13,000*
Sales returns	*1,20,000*
Depreciation on factory building	*12,000*
Stock on 31.3.2016:	
Raw materials	*80,000*
Semi-finished goods	*1,30,000*
Finished goods	*2,20,000*
Sales	*22,00,000*
Carriage outwards	*35,000*
Office salaries	*1,50,000*

Prepare manufacturing account and trading and profit and loss accounts for the year ended March, 2016.

Manufacturing Account

for the year ended 31st March, 2016

Dr. *Cr.*

Particulars	₹	₹	*Particulars*	₹	₹
To Opening stock:			By Closing stock:		
Raw materials	1,00,000		Raw materials	80,000	
Semi-finished Goods	50,000	1,50,000	Semi-finished goods	1,30,000	2,10,000
To Purchases	8,00,000		By Cost of production transferred to Trading Account		11,76,000
Less : Returns	13,000	7,87,000			
To Carriage on raw materials		30,000			
To Manufacturing wages		1,00,000			
To Factory expenses:					
Salary of supervisor	36,000				
Rent of factory	70,000				
Gas and water	30,000				
Fuel and coal	33,000				
Factory power	1,25,000				
Fire insurance	13,000				
Depreciation	12,000	3,19,000			
		13,86,000			13,86,000

Trading and Profit and Loss Account

for the year ended 31st March, 2016

Dr. Particulars	₹	Particulars		*Cr.* ₹
To Opening stock of finished goods	2,60,000	By Sales	22,00,000	
		Less: Returns	1,20,000	20,80,000
To Cost of production transferred from Manufacturing Account	11,76,000	By Closing Stock of finished goods		2,20,000
To Purchases	1,70,000			
To Gross Profit c/d	6,94,000			
	23,00,000			23,00,000
To Carriage outwards	35,000	By Gross Profit b/d		6,94,000
To Office salaries	1,50,000			
To Net Profit transferred to Capital A/c	5,09,000			
	6,94,000			6,94,000

Illustration 4:

From the following particulars of Mr. Murthy, prepare Manufacturing, Trading and Profit and Loss Accounts for the year ended 31.3.2016 and the Balance Sheet as on the date after making necessary adjustments:

	₹'000
Capital (1.4.2015)	*2,500*
Drawings account	*700*
Sundry creditors	*800*
Discount received	*702*
Bank overdraft	*4,000*
Provision for bad and doubtful debts	*60*
Purchases returns	*53*
Sales	*6,750*
Sales returns	*8.6*
Stock of finished goods (1.4.2015)	*900*
Plant and machinery (including machinery for ₹ 50,000 purchased on 1.1.2016)	*1,700*
Furniture	*1,500*
Building	*1,500*
Purchases	*302,3*
Sundry debtors	*1,100*
Manufacturing wages	*6,000*
Manufacturing expenses	*5,000*
Carriage inwards	*400*
Carriage outwards	*420*
Bad debts	*150*
Salaries	*280*

Interest and bank charges (Dr.)	*12.6*
Discount allowed	*15*
Insurance (Dr.)	*30*
Cash at bank	*14*
Cash in hand	*3*
Stock of finished goods (31.3.2016)	*755*

The following adjustments are to be made:

(i) *Interest on capital at 10% p.a. (no interest is to be provided on drawings)*

(ii) *Outstanding expenses:*

	₹
(a) Salaries	*100*
(b) Manufacturing wages	*5*
(c) Interest on bank loan	*100*

(iii) *Depreciation on:*

(a) Machinery at 10%

(b) Furniture at 10%

(c) Building at 2.5%

(iv) *Pre-paid expenses:*

	₹
(a) Insurance	*100*
(b) Salary	*5*

(v) *Provision for bad and doubtful debts at 10% on debtors.*

Furniture costing ₹ 50,000 was sold for ₹ 35,000 on 1.4.2015 and this amount was later credited to furniture account.

Solution:

Mr. Murthy

Manufacturing, Trading and Profit and Loss Account as on 31st March, 2016

Dr. *Cr.*

Particulars	*₹000*	*₹000*	*Particulars*	*₹000*	*₹000*
To Purchases	3,023		By Trading Account (transfer of cost of goods produced)		
Less : Returns	53	2,970			4,247.5
To Carriage inwards		40			
To Manufacturing wages	600				
Add: Outstanding	5	605			
To Manufacturing expenses		500			
To Depreciation on Machinery		132.5			
		4,247.5			4,247.5
To Opening stock		90,000	By Sales	6,75,000	
			Less: Returns	860	6,741.4

Particulars	*₹000*	*₹000*	*Particulars*	*₹000*	*₹000*
To Manufacturing A/c (cost of goods produced)		4,247.5	By Closing Stock		755
To Gross profit c/d		2,348.9			
		7,496.4			7,496.4
To Salaries	28,000		By Gross Profit b/d		2,348.9
Add : Outstanding	10		By Discount		70.2
	290				
Less : Pre-paid	5	28.5			
To Interest and bank charges	12.6				
Add : Outstanding	100	22.6			
To Discount allowed		15			
To Insurance	300				
Less : Pre-paid	100	200			
To Carriage outwards		42			
To Provision for bad Debts		65			
To Loss on sale of furniture		15			
To Depreciation on:					
Building	3,750				
Furniture	1,350	51			
To Interest on capital		250			
To Net profit transferred to capital account		1,653.5			
		2,419.1			2,419.1

Mr. Murthy
Balance Sheet as on 31st March, 2016

Liabilities	*₹'000*	*₹'000*	*Assets*	*₹'000*	*₹'000*
Capital	2,500		Fixed Assets:		
Add: Profit	1,653.5		Building	1,500	
Interest	250		*Less:* Depreciation	37.5	1,462.5
	4,403.5		Plant and machinery	1,200	
Less: Drawings	700	3,703.5	*Add:* Additions	500	
Current Liabilities:				1,700	
Bank overdraft		400	*Less:* Depreciation	132.5	1,56705
Sundry creditors		800	Furniture	185	
Outstanding expenses:			*Less:* Cost of furniture disposed of during the year	50	
Salaries	10				
Manufacturing wages	5				
Interest on bank loan	10	25	*Less:* Depreciation	13.5	121.5
			Current Assets:		
			Stock		755
			Debtors	1,100	
			Less: Provision for bad and doubtful debts	110	990
			Cash at bank		14
			Cash in hand		3
			Pre-paid expenses:		
			Insurance	10	
			Salary	5	15
		4,928.5			4,928.5

Working Note:

(i) Provision for bad and doubtful debts:

	₹'000
Provision required	11,000
Add: Bad debts	1,500
	12,500
Less: Existing provision	6,000
	6,500

(ii) Book value of furniture sold has been deducted for calculating depreciation.

LESSON ROUND UP

- Final accounts are the end product of financial accounting process. It consists of trading and profit loss account and balance sheet
- Manufacturing account shows cost of production; trading account shows the gross profit or gross loss while profit and loss account shows the net profit earned or net loss suffered by the organization during a particular period.
- Balance sheet discloses the financial position i.e. the balances of assets, liabilities, and capital of the business as on a particular date.
- Balance sheet is prepared with assets on the right hand side and liabilities on the left hand side.
- Assets and liabilities are classified into fixed and current and are shown in the balance sheet either in the order of liquidity or permanence
- Adjustment entries are passed at the end of the accounting period in order to adjust various nominal accounts to find out the correct profit or loss.
- Closing entries are journal entries required for transferring all accounts relating to expenses and gain to trading and profit loss account.

GLOSSARY

Closing Stock	Unsold stock at the end of the accounting period
Contingent Liabilities	These liabilities depend on the happening of certain events.
Intangible Assets	Fixed assets which cannot be seen or touched.
Outstanding or Accrued Expenses	Expenses which have been incurred during the year but payment in respect of which has not been made.
Unexpired or Prepaid Expenses	Expenses which have been paid in advance and whose benefit will be available in future.
Accrued Income	Income which has been earned by the business during the accounting year but which has not become due and hence has not been received.
Income Received in Advance	The revenue which remains received in advance (unearned) at the end of the accounting period.

SELF-TEST QUESTIONS

1. The following are the balances taken from the books of Mr. Atma Ram:

Balances on 31st March, 2016

	₹000
Atma Ram's capital	300
Atma Ram's drawings	50
Furniture and fittings	26
Bank overdraft	42
Creditors	133

Business premises	200
Stock on 1st April, 2015	220
Debtors	186
Rent from tenants	10
Purchases	1,100
Sales	1,500
Sales returns	20
Discount-debit	16
Discount-credit	20
Taxes and insurance	20
General expenses	40
Salaries	90
Commission-debit	22
Carriage on purchases	18
Provision for bad and doubtful debts	6
Bad debts written off	8

Stock on hand on 31st March, 2016 was estimated at ₹ 200 thousand. Rent ₹ 3 thousand, is still due from the tenant. Salaries, ₹ 7.5 thousand are as yet unpaid. Write off bad debts ₹ 6 thousand and depreciate business premises by ₹ 300 and furniture and fittings by ₹ 266. Make a provision of 5% on debtors for bad and doubtful debts and provision of 2% for discounts. Allow interest on capital at 5 per cent and carry forward ₹ 7 for unexpired insurance. The manager is entitled to a commission of 10% on profits remaining after charging his commission.

Prepare Trading Account, Profit and Loss Account and Balance Sheet on 31st March, 2016.

Hints: Suspense Account (difference in trial balance) = 500.

[Ans : G.P = 342 thousand, N.P. = 132.2 thousand, B/s Total = 597.92 thousand].

2.Below is the trial balance of Suresh as at 31st March, 2016.

Debit Balance	₹'000	Credit Balance	₹'000
Suresh's Current Account	150	Capital Account	5,000
Adjusted purchases	69,920	Loan from Mohan @9%	
Salaries	420	(taken on 1st October, 2013)	2,000
Carriage on purchases	40	Sales	72,000
Carriage on sale	50	Discount	50
Lighting	30	Sundry creditors	2,000
Rates and insurance	40		
Buildings	2,700		
Sundry debtors	800		
Furniture	600		
Cash in hand	25		
Cash at bank	150		
Stock (31st March, 2014)	6125		
	81,050		81,050

Rates have been prepaid to the extent of ₹17.5 thousand. Bad debts totaling ₹ 50 thousand have to be written off. A provision for doubtful debts @5% on debtors is necessary. Buildings have to be depreciated at 2% and furniture @10%. The manager is entitled to a commission of 5% of net profits before charging such commission.

You are required to prepare the profit and loss account for the year ended 31st March, 2016 and the balance sheet as on that date.

[*Hints*: (a) The trial balance gives “Adjusted Purchases”. It means that the opening stock has already been transferred to the Purchases Account and has thus been closed. Further, entry for closing stock has already been passed by debiting the Closing Account and crediting Purchases Account. That is why closing stock appears in the trial balance. It will now be shown in the Balance Sheet and not in the Trading Account since Purchases already stand reduced.

(b) There is a loan of Mohan @ 9% taken in October, 2015. The trial balance makes no mention of any interest being paid to him. Hence, interest @ 9% must be provided for six months i.e. from October 2015 to March 2016.]

[Ans.: G.P. = 2,040 thousand, N.P. =1212.2 thousand, Total B/S =10,216 thousand].

3.The following figures were taken from the books of Amar on 31st March, 2014.

	₹' 000		*₹'000*
Cash at bank	2640	Royalties received	40
Cash in hand	3	Trade and general expenses	502
Sales	26,123	Reserve on patents	500
Stock (1st April, 2010)	2,741	Interest on loan	124
Sales returns	330	Repairs	84
Discount (Dr.)	638	Sundry creditors	2,078
Bills receivable	182	Buildings	95,82
Sundry debtors	5,272	Patent rights	5,000
Depreciation	478	Loan (raised on	
Purchases	18,403	mortgage of buildings)	4,500
Discount on purchases	3,90	Agent's commission	650
Wages	1,404	Bad debts	190
Provision for bad debts	540	Plant and machinery	3,000
Provision for discounts		Capital	20,000
on debtors	197	Drawings	3,000
		Advertising	100
		Carriage	45

In addition, the following information is given:

(a) Stock on 31st March, 2014 was ₹ 3225 thousand.

(b) The stock includes materials worth ₹ 225 thousand for which bills had not been received and, therefore, not accounted for yet.

(c) During the year, a sum of ₹ 300 thousand was paid as ground rent for 2015-16 and 2015-16. This sum stands debited to buildings account.

(d) Included in sales is an amount of ₹ 750 thousand representing goods on sale or return, the customers still having the right to return the goods. The goods invoiced were showing a profit of 20% on sales.

(e) A customer's bill for ₹ 278 thousand had been discounted with bank. The bank has sent intimation that the bill has been dishonored. No entry has yet been passed in respect of this.

(f) A provision for bad debts is to be maintained at 5% of the debtors and a provision for discounts on debtors is also to be maintained at 2% of the debtors.

Prepare trading and profit and loss account of Amar for the year ended 31st March, 2014 and his balance sheet as on that date.

[Ans.: G.P. = ₹ 6,050 thousand; N.P. = ₹ 39,698; Total of B/S =₹ 27,772.8 thousand].

4. Mr. T.P.'s trial balance as on 31st March, 2016 is as under:

Debit Balance	₹'000	*Credit Balance*	₹'000
Land and building	2,000	Capital	8,000
Machinery	5,000	Sundry creditors	800
Furniture and fixtures	400	Discounts received	40
Opening stock	1,630	Outstanding expenses	155
Purchases	8,000	Sales	15,050
Salaries	600	Repairs and renewals	
Carriage on sales	150	provision	200
Freight on purchase	800		
Advertising	540		
Wages	1,500		
Rent	300		
Postage and stationery	150		
General expenses	320		
Loan to Santhanam @			
9% (given on 1st Oct., 2012)	500		
Prepaid insurance	20		
Sundry debtors	2,000		
Cash in hand	25		
Cash in bank	310		
	24,245		24,245

The following further information is given:

(a) Stock on 31st March, 2016 was ₹ 1490 thousand.

(b) Machinery was purchased on 31st October, 2015 for ₹ 1,000 thousand and was installed by own workmen. The wages for this purpose amounted to ₹ 50 thousand. This amount is included in wages account.

(c) Depreciation is to be written off @
3% on land and buildings;
10% on machinery; and
5% on furniture and fixtures.

(d) Provision for repairs and renewals is credited with ₹ 150 thousand every year.

(e) A reserve of 2% is to be made on creditors for discount.

From the information given above, prepare trading account and profit and loss account for the year ended 31st March, 2016 and balance sheet as at that date.

[*Hints:*

(a) Prepaid insurance and outstanding expenses are given in trial balance. This means double entry in respect of these of items has been completed. Therefore, they will appear in balance sheet only.

(b) There is a provision for repairs and renewals. Actual repairs will, therefore, be debited to this account and not to the profit and loss account, the provision for repairs and renewals account will be credited with ₹ 150 thousand by debiting profit and loss account.]

5. On 31st March 2016, the following Trial Balance was extracted from the books of Ghosh:

	Dr.(₹'000)	*Cr. (₹'000)*
Capital Account		9,000
Plant and Machinery	8,000	
Sales		40,700
Purchases	26,000	
Returns	600	575
Opening Stock	3,000	
Discount	35	80
Bank Charges	7.5	
Sundry debtors	4,500	
Sundry Creditors		25,00
Salaries	2,680	
Manufacturing wages	4,000	
Carriage Inwards	75	
Carriage Outwards	120	
Bad Debts Provision		5.05
Rent, Rates and Taxes	1,000	
Advertisements	200	
Cash in Hand	90	
Cash in Bank	600	
Furniture & Fittings	2,000	
	52,907.5	52,907.5

Prepare the final accounts for the year ended 31st March, 2016 and the Balance Sheet as on that date. The following adjustments are required:

(i) Clocking Stock ₹ 3,500 thousand.

(ii) (i) Depreciation on Plant and Machinery @ 15% p.a. and on furniture & Fittings @ 10% p.a. to be provided.

(iii) Bad Debts Provision to be adjusted to ₹ 50 thousand.

(iv) Interest on Capital to be allowed at 10% per annum.

15% of the profits remaining after providing interest on capital is to be carried to General Reserve.

[Ans.: G.P. = ₹ 1,1,100 thousand; N.P. = ₹ 4,114 thousand; Total of B/S =₹ 1,7,240 thousand].

6. From the following, prepare the Trading and Profit and Loss Accounts for the year ended 1st March 2016 and Balance Sheet of Niyati as at 31st March, 2016:

	₹'000
Capital	3,000
Trade Creditors	600
Bills Payable	200
General Reserve	500
Provision for Bad and Doubtful Debts	20
Profit and Loss Account, 1st April, 2015	109
Sales	11,500
Discount Allowed	95
Stocks at 1st April, 2015	1,100
Purchases	8,960
Discount Received	88

Buildings	1,000
Machinery, Plant and Furniture (Cost ₹ 2,500 thousand)	1,500
Book Debts	728
Bank Balance (Dr.)	488
Investment, 9% Government Loan at par	200
Bills Receivable	450
Salaries a Wages	660
Audit Fees	100
Office Expenses	440
Repairs and Renewals	236
Interest Paid	14
Bad Debts Recovered	5

The value of stocks on hand as at 31st March, 2016 was ₹1,360 thousand including goods costing ₹18 thousand received on 30th March, 2016 in respect of which supplier's bill had not yet been received. Goods of the cost of ₹ 30 thousand were sent to a customer on sale or approval basis. The invoice for ₹ 40 thousand was entered in the Sales Book. Provision is to be made for bad debts to the extent of ₹ 8 thousand, and for depreciation of buildings at 2% per annum: Machinery, Plant and Furniture have been depreciated at 20% of the diminishing value; Niyati, however, considers that the proper method is 8% of the original cost and wishes to adopt it with effect from 1st April, 2012.

[Ans.: G.P. = ₹ 1,386 thousand; N.P. = ₹ 652.5 thousand; Total of B/S =₹ 2,866 thousand].

Lesson 8
Partnership Accounts

LESSON OUTLINE

- Basic Concepts of Partnership
- Goodwill
- Methods of Valuation of Goodwill
  - Average Profit Method
  - Super Profit Method
  - Capitalization Method
- Preparation of Final Accounts of Partnership
- Profit & Loss Appropriation Account
  - Interest on Capital
  - Interest on Drawings
  - Salary or Commission payable to Partners
  - Past Adjustments of Profit
  - Guarantee of Profit to a Partner
- Reconstitution of Partnership
  - Change in Profit Sharing Ratio
  - Admission of a Partner
  - Retirement of a Partner
  - Death of a Partner
- Dissolution of Partnership Firm
- Lesson Round-Up
- Glossary
- Self Test Questions

LEARNING OBJECTIVES

As we know, sole proprietorship form of business organisation has limited financial and managerial resources. It is also not possible to expand the business activities beyond a certain limit. So, in order to overcome these drawbacks, another form, i.e., partnership form of business has come into existence. When two or more persons come together to share profits of the business carried on by them, it is called partnership form of organIsation. Accounting for partnership firm is different from sole proprietorship in certain aspects as there are more than one contributor to capital who share profits and losses.

Further, there is an another form partnership called limited liability partnership (LLP) wherein some or all partners (depending upon the jurisdiction) have limited liability. In an LLP, one partner is not responsibility or liable for another partner's misconduct or negligence.

Here in this lesson, we will study about partnership form of business and preparation of accounts under various situations like admission of new partner, retirement and death of partner and dissolution of partnership firm. We would also cover the concept of goodwill and valuation of goodwill for partnership firms under various situations.

"The main reason businesses should care now is because they need to account for the liability and in order to account for a liability in a year's time you need to start accounting for it now."

Steve Nathan

BASIC CONCEPTS OF PARTNERSHIP

Partnership: Partnership is defined in Section 4 of the Indian Partnership Act, 1932 as "the relation between persons who have agreed to share the profits of a business carried on by all or any of them acting for all".

Partners and Firm: Persons who have entered into partnership with one another are individually known as 'partners' and collectively a 'firm'. The name under which the business is carried on is called 'firm's name'. In other words, a firm is a collection of the partners. The assets of the firm are joint property of the partners and the partners are personally liable for all liabilities of the firm.

Essential features of Partnership: The following features must exist in order to constitute a partnership -

(i) There must be an agreement and for an agreement, at least two persons are required. The agreement must be entered into by all the persons concerned. The persons must be competent to contract.

(ii) The Partnership Act does not lay down any maximum number of partners. But according to Section 464, Rule 10 of Companies Miscellaneous Rules, 2014, maximum number of partners is 100. But according to section 11 of the Companies Act, a partnership for a banking business must not have more than ten partners and that for any other business it must not have more than twenty partners.

(iii) There must be a 'business' and for this purpose business would include any trade, profession or occupation; For example, the jobs of medical practitioners or lawyers are covered under profession and can form partnership. There can be a partnership between doctors or lawyers.

(iv) The business must be carried on for the purpose of earning profits which would be divided among the partners i.e. there must be an agreement among the partners to share the profits (including negative profits, i.e., losses) of a business.

(v) The business must be carried on by some or all of the partners for the benefit of all of them. Consequently in partnership, there is a mutual agency among the partners and in the ordinary course of business acts of one partner are considered to be the acts of the firm.

Partnership Deed: A contract for partnership need not necessarily be in writing although it is advisable to reduce it in writing to minimize the disputes among the partners. But when the contract is put in black and white, the written contract is called a partnership deed. It is a legal document signed by all the partners and mostly contains the following:

The name of the partners; name of the firm; nature of the business to be carried on by the firm; the powers of the partners; when termination is certain, the term of duration of partnership; the amount of capital to be contributed by each partner, the restrictions on working of each partner; methods of division of profits or losses; salary; commission, interest on capital etc. payable to the partners; interest on drawings to be charged on withdrawals; interest on loan payable to a partner; valuation of goodwill when there is a change in the constitution of the firm; methods of accounting and the arbitration clause, etc.

If there is no partnership deed or if there is no provision in it indicating a contrary intention, the following provisions of the Partnership Act, apply.

(i) Every partner has a right to take part in the conduct of the business of the firm and also the right of free access to all records, books and accounts of the firm.

(ii) Partners share profits and losses equally. It is so, even when partners contribute capital unequally.

(iii) Partners are not entitled to any interest on capital contributed by them nor can they claim any salary for the work done by them for the firm. In case a partnership deed provides for payment of interest on capital or salary, it is payable only if there is a profit.

(iv) On amounts advanced by a partner to the firm in excess of his agreed share of capital, the partner is entitled to receive interest on such excess at the rate of 6% per annum. Such interest is payable even if there is a loss.

(v) No interest is to be charged on drawings.

REVIEW QUESTION

1. State whether the following statements are true or false?

(i) There can be a partnership between two chartered accountants.

(ii) At the most, there can be fifty partners in a firm.

(iii) In every partnership, there must be a partnership deed.

(iv) Unless provided otherwise, partners are deemed to be sharing profits and losses in the ratio of their capitals.

2. Fill in the blanks:

(i) If partnership deed is silent on the profit sharing ratio; interest @_______ per annum is allowed on loans advanced by partners.

(ii) At the most there can be ____________ partners is partnership firm.

(a) 10 (b) 20 (c) 50 (d) 100

DIFFERENCE BETWEEN PARTNERSHIP AND JOINT VENTURE

Partnership	*Joint Venture*
(i) It is not limited to a specific venture.	(i) It is limited to a specific venture.
(ii) It is a continuing profit seeking enterprise.	(ii) It is a terminable profit-seeking venture.
(iii) It is carried on under firm's name.	(iii) There is no common firm's name in joint venture.
(iv) Persons carrying on partnership business are called partners.	(iv) Parties are called co-venturers.
(v) Profit or loss is ascertained on an annual basis.	(v) Profit or loss is ascertained only after the end of the specific venture.
(vi) Partnership firms are governed by Indian Partnership Act, 1932.	(vi) There is no specific act for joint ventures.
(vii) The doctrine of implied authority is applicable to partners.	(vii) The doctrine of implied authority is not applicable to co-venturers.

Loan Account: If a partner advances to the firm a sum over and above the amount of capital required to be contributed by him under the partnership contract, the amount is credited to a loan account opened in his name. In the event of dissolution of partnership, a partner is entitled to receive the amount of loan advanced by him in priority to repayment of capital to the partners. However, if capital is insufficient to meet losses on dissolution, the amount of the loan can be used to meet losses.

Capital Accounts: There are only a few points of difference between the accounts of a partnership firm and those of a sole proprietorship concern. One difference is that in a sole proprietorship concern there is only one capital account, whereas, in the firm's ledger there are as many capital accounts as there are partners in the firm (unless some partner is not required to contribute capital at all). Amount contributed by a partner whether in cash or in the form of some other asset or assets is credited to his capital account.

Types of Capital Account: The capital account of a partner may be either a Fixed Capital Account or a Fluctuating Capital Account.

(i) Fixed Capital Account : Under Fixed Capital Account method, there will be two accounts for each partner, i.e. (i) Partner's Capital Account – recording only capital of the partner and (ii) Partner's Current Account – recording the transactions relating to drawings, interest on capital, commission, salary, share of profit or loss, etc of the partner. Under this method, capital accounts are not touched at all and debits and credits for interest on capital, interest on drawings, profits, losses, drawings, etc., are made in separate accounts called current accounts or drawing accounts. Capital account is credited only when fresh (or further) capital is introduced or debited when capital is withdrawn.

If there is no addition or withdrawal of capital during the year, the capital account does not change and it remains fixed through-out the year. Sometimes, there may be current accounts as well as drawings accounts. Drawing accounts are used to record only the withdrawals made by partner; and transferred to the respective current accounts at the end of the year. Such drawings accounts are maintained when drawings are irregular and extensive to facilitate calculation of interest on drawings.

(ii) Fluctuating Capital Account : Just as in a sole proprietorship concern, in partnership also, profits or losses, drawings, interest on capital, interest on drawings, salary (to partners), commission, additional capital introduced, etc., may all be recorded in the capital accounts. Such capital accounts are called Fluctuating Capital Accounts because the balances of these accounts continue to fluctuate due to various debits and credits. Under this method, there is no need to maintain respective current accounts because all transactions passing through current accounts are passed through capital accounts.

DIFFERENCE BETWEEN FIXED & FLUCTUATING CAPITAL METHODS

Fixed Capital Method	***Fluctuating Capital Method***
(i) Two accounts of each partner are maintained, i.e. capital account and current account	(i) Only one account of each partner i.e. capital account is maintained.
(ii) Balance in capital account remains the same except when capital is introduced or capital is withdrawn.	(ii) The balance in capital account changes every year because of profits/losses, drawings, interest on capital, interest on drawings, etc.
(iii) All adjustments in respect of profit, loss, drawings, interest on capital, interest on drawings, salary, commission, etc. are made in the current account.	(iii) All adjustments in respect of profit, loss, drawings, interest on capital, interest on drawings, salary, commission, etc. are made in the capital account.
(iv) The capital account will always have a plus or credit balance while the current account may have a debit (negative) balance.	(iv) Fluctuating capital account may sometimes show a debit (negative) balance.

GOODWILL

Goodwill is the value of reputation of a business house in respect of the profits expected in future over and above the normal level of profits earned by undertakings belonging to the same class of business. In other words, goodwill is the present value of a firm's anticipated super normal earnings. The term super normal earnings means the earnings over and above the normal rate of return earned by representative firms in the same industry. Goodwill refers to the reputation of a business enterprise acquired by it over the period of time through its successful operations and customers' satisfaction. It is an attribute of business which enables it to earn more than other firms in the industry. Goodwill is an intangible asset but not a fictitious one. The following are some of the factors that generally contribute to the value of goodwill of a firm:

– Quality of goods sold by the firm

– Location of the business unit

– Reputation of the owners of the firm

– Monopolistic nature of the business

– Risk involved in the business

– Efficiency of management

- Possibility of competition
- Government attitude
- Possession of special contracts for availability of materials
- Trends of profits, etc.

Need for valuation of goodwill

Whenever there is any change in the existing relationship of the partners, some partners may have to sacrifice their future profits and some other partners may gain. Those who are sacrificing future profit should be compensated by others who are gaining. As a result, the need for the valuation of goodwill in a firm may arise in the following circumstances:

- Where the profit sharing ratio amongst the partners is changed.
- When a new partner is admitted.
- When a partner retires or dies.
- When the business is sold, and
- When a firm is amalgamated with another firm.

METHODS OF VALUATION OF GOODWILL

One of the main factors contributing to the value of goodwill is the earning capacity of the business. Following are the usual methods of calculating the value of goodwill:

(i) Average Profit Method:

Under this method, goodwill is valued on the basis of a certain number of years' purchase of the average profits of the past few years.

Example: Suppose on 1st April, 2016 on the admission of a new partner, it is agreed that goodwill of the firm is valued at three years purchase of average profits for the last five years. Further, suppose the profits for last five years have been as follows:

	₹
For the year ended 31st March 2016	10,740
For the year ended 31st March 2015	7,900
For the year ended 31st March 2014	5,430
For the year ended 31st March 2013	400 (loss)
For the year ended 31st March 2012	8,500

Value of goodwill will be calculated as follows:

Total profits for the last 5 years = ₹ (10,740 + 7,900 + 5,430 – 400 + 8,500)

= ₹ 32,170

Average profits = ₹ $\frac{32{,}170}{5}$ = ₹ 6,434

Three years' purchase of the above mentioned average profit= ₹ 6,434 x 3 = ₹ 19,302

Hence, value of goodwill = ₹ 19,302

(ii) Super Profit Method

In this case the future maintainable profits of the firm are compared with the normal profits for the firm. Normal earnings of a business can be judged only in the light of normal rate of earning and the capital employed in the business. Hence, this method of valuing goodwill would require the following information:

(i) A normal rate of return for representative firms in the industry.

(ii) The fair value of capital employed.

(iii) Estimated future maintainable profits.

> *Note: Normal rate of earning is that rate of earning which investors in general expect on their investments in the particular type of industry. Normal rate of earning depends upon the risk attached to the investment, bank rate, market need and the period of investment.*
>
> *Capital employed is the aggregate of capital and reserves less the amount of non-trading assets such as investments. The capital employed may also be ascertained by adding up the present values of trading assets and deducting all liabilities therefore. Super profit is the simple difference between future maintainable operating profit and normal profit.*

There are three methods of calculating goodwill based on super profit:

(a) Purchase of super profit

As per this method, value of goodwill is obtained by multiplying super profit by a certain number of years.

Goodwill = Super profit x *No. of year purchase.*

(b) Annuity method

Goodwill according to the annuity method is the present value of a terminal annuity of super profit for a reasonable period during which the super profit is likely to occur. It is calculated as:

Super profit x *Annuity rate.*

(c) Capitalization of super profit

In this method, the value of goodwill is arrived at by capitalizing the super profit at the normal rate of return. It is calculated as:

$$\frac{\text{Super profit x 100}}{\text{Normal rate of return}}$$

Example: A firm of X, Y and Z has a total capital investment of ₹ 2,25,000. The firm earned net profit during the last four years as ₹ 35,000, ₹ 40,000, ₹ 60,000 and ₹ 50,000. The fair return on the net capital employed is 15%. Find out the value of goodwill if it is based on 3 years' purchase of the average super profits of past four years.

Solution:

	₹
Total Profits earned during four years	1,85,000
Average annual profit ₹ 1,85,000 / 4	46,250
Fair return on capital employed: 15% of ₹ 2,25,000	33,750
Super Profit: ₹ 46,250 – ₹ 33,750	12,500
Value of goodwill being 3 years' purchases of the average Super profit = ₹ 12,500 x 3	37,500

(iii) Capitalization Method

The capitalization of profit method values goodwill at the excess of capital that should have been employed for earning the average profit over the capital which has been actually employed. In this method, the value of whole business is found by using the formula:

$$\frac{\text{Average annual profit x 100}}{\text{Normal rate of return}}$$

From this figure, the net assets (excluding goodwill) of the firm are deducted and the resultant figure will be the goodwill.

Example: Average profit of a firm is ₹ 48,000. The rate of capitalization is 12%. Assets and liabilities of the firm are ₹ 4,00,000 and 1,70,000 respectively.
Value of goodwill be:

$$= ₹\frac{48,000 \times 100}{12} - (400,000-1,70,000)$$

= ₹ 4, 00,000 – ₹ 2, 30,000
= ₹ 1, 70,000

REVIEW QUESTION

On the admission of a new partner, it is decided that goodwill of the firm be calculated at 2 years' purchase of average profits for the past three years which amounted to ₹ 8,620, ₹ 9,430 and ₹ 11,800 respectively. What is the value of goodwill?

PREPARATION OF FINAL ACCOUNTS OF PARTNERSHIP FIRM

Final accounts of a partnership firm are prepared in the usual way in which they are prepared for a sole proprietorship concern except that the profits in the partnership have to be distributed among the various partners according to the terms of the partnership contract and the amount of profit may be arrived at after making adjustments for interest on capital, interest on drawings, salaries to partners, etc. for this another account "Profit & Loss Appropriation Account" is prepared after preparing Profit & Loss Account.

PROFIT AND LOSS APPROPRIATION ACCOUNT

As against the proprietorship business, the profits of the partnership firm are divided among partners in a given ratio. The profit has to be divided among the partners in the agreed profit sharing ratio after making necessary adjustments stated in the partnership deed such as interest on capitals, interest on drawings, salaries or/commission to partners, etc. For this purpose, an additional account is prepared, known as Profit and Loss Appropriation Account in which the net profit is transferred from Profit and Loss Account and necessary adjustments are made therein before the profit is divided among the partners. Following are the adjustments to be made in the profit & loss appropriation account:-

1. Interest on Capital

Where the profit sharing ratio is different from the ratio of capitals contributed by the partners, interest on capitals may be allowed to partners and charged against the profits of the firm to make the distribution of profits equitable. Interest on capital being an appropriation of profits, should be charged only out of the profits available. In case of loss, no interest on capital is provided. Interest is mostly calculated on the capitals at the commencement of the year. Where fresh capital has been introduced during the course of the year, interest is also allowed on this additional amount for the period for which the amount has been in business. Journal entry for interest on capital will be:

Profit and Loss Appropriation Accounts Dr.
To Partners Capital/Current accounts

2. Interest on Drawings

Interest may be charged on drawings made by partners to make distribution of profit more equitable. Interest on drawings should be charged on different amounts withdrawn for different periods. Journal entry for interest on drawing will be:

Partners Capital/Current Accounts Dr.
To Profit and Loss Appropriation A/c

Note: If a partner withdraws a fixed sum at the end of each month, the interest on his drawings for the year will be equal to the interest on his total drawings for a period of 5½ months.

If a partner withdraws the fixed amount in the middle of each month, interest will be calculated on his total drawings for a period of 6 months.

If he withdraws the amount at the beginning of each month, interest will be calculated on his total drawings for the period of 6½ months.

REVIEW QUESTION

P, a partner withdraws the following sums during the year ended 31st March 2017:

On 1st May 2016	₹ 3,000
On 1st August 2016	₹ 9,000
On 1st January 2017	₹ 6,000
On 1st March 2017	₹ 4,000

Calculate interest on his drawing @ 10% p.a.

3. Salary or Commission Payable to Partners

If in a firm there are some active partners and some sleeping partners, the active partners may be allowed salary for the work. The payment of salaries is regarded as a distribution of part of the profit of the firm. Thus, the amount of profit is reduced before it is divided in the agreed profit sharing ratio. The accounting treatment is same when a partner is paid commission or bonus. Journal entry will be as follows:

Profit and Loss Appropriation A/c Dr.
To Partners Capital/Current Accounts

Commission as a % of Net Profit before charging such commission

$$= \text{Net Profit before Commission} \times \frac{\text{Rate of Commission}}{100}$$

Commission as a % of Net Profit after charging such commission

$$= \text{Net Profit before Commission} \times \frac{\text{Rate of Commission}}{100 + \text{Rate of Commission}}$$

A pro-forma of profit and Loss account is as follows: (It is assumed that there are two partners X & Y)

SPECIMEN OF PROFIT AND LOSS APPROPRIATION ACCOUNT

Profit and Loss Appropriation Account

Dr. Cr.

Particulars	₹	₹	Particulars	₹	₹
To Interest on Capital :			By Profit and Loss Account		
X's Capital/ Current A/c	XXX		(profit of the current year)		XXX
Y's Capital / Current A/c	XXX	XXX	By Interest on drawings:		
To Partners' Salary:			X's Capital /Current A/c	XXX	
X's Capital/ Current A/c	XXX		Y's Capital/Current A/c	XXX	XXX
Y's Capital / Current A/c	XXX	XXX	By Loss transferred to:		
To Partners' Commission:			X's Capital/ Current A/c	XXX	
X's Capital/ Current A/c	XXX		Y's Capital/ Current A/c	XXX	XXX
Y's Capital / Current A/c	XXX	XXX	(In case of loss)		
To Transfer to Reserve		XXX			
To Profit transferred to:					
X's Capital/ Current A/c	XXX				
Y's Capital/ Current A/c (In case of profit)	XXX	XXX			

Note: - Interest on loan is charged against profit in Profit & Loss Account only. It is not the appropriation of profits.

4. Past Adjustments of Profit

Sometimes, amounts already distributed among the partners as profits or losses for a particular year require to be readjusted after the close of accounts for the year either due to discovery of some mistakes subsequent to the closing of the books or due to revision of certain condition of the partnership contract with retrospective effect. In such a case, the revenue accounts which have already been closed off are not reopened. Amounts already debited or credited to various partners are compared with the amounts which should have been debited or credited and an entry is passed for the difference to adjust the various accounts.

5. Guarantee of Profit to a Partner

Sometimes to induce a person to become a partner, a guarantee is given to him by other partners that his share of profits will not be below a certain figure. Usually when such a guarantee is given, it is also agreed that if in a year his share of profit exceeds the minimum limit, he would have to refund the excess in repayment of amount previously credited to him in excess of his normal share of profits. When such an agreement exists, first profits should be divided as if no guarantee has been given. Then, the amount by which the actual share falls short of the guaranteed share should be credited to the partner to whom the guarantee has been given and debited to other partners in their mutual profit sharing ratio. For recoupment of excess in subsequent years, a reverse entry will be passed.

Instead of all the partners, one partner may give the guarantee to a new partner that should the share of profits to the new partner fall below a certain figure; guarantor will make up the difference. In such case, the capital account of the partner in whose favour the guarantee is given will be credited and the capital account of the guarantor partner will be debited for the excess of the guaranteed amount over the actual share of the partner in whose favor guarantee has been given.

There can also be an arrangement that should profit due to the new partner exceed a certain figure, a particular partner, may bear the burden of such excess. It is really a guarantee to the other partners that the share of the new partner will not exceed a stipulated figure.

REVIEW QUESTION

On 1st April 2016, X's Capital Account showed a balance of ₹ 2,50,000 while Y's Capital Account showed a balance of ₹ 1,000. In 2016-17 the firm earned a profit of ₹ 15,000 before adjustment for salary to Y amounting to ₹ 30,000 for the year and interest on capital @ 10% per annum. Show how the profits would be distributed between X and Y assuming that they are equal partners.

Illustration 1:

On 1st April, 2016 P and Q started business in partnership agreeing to share profits and losses equally. P contributed ₹ 3,00,000 while Q contributed ₹ 2,00,000 by way of capital. It was agreed that interest be allowed on capital @ 6% per annum and charged on drawing @ 8% per annum. P withdrew ₹ 2,000 at the end of every month whereas Q withdrew ₹ 4,500 in the middle of every month.

Profits before the above noted adjustments for the year ended 31st March, 2017 amounted to ₹ 89,700. Show the necessary ledger accounts assuming:

(a) capital accounts are fluctuating

(b) capital accounts are fixed.

Solution:

Working Notes:

Interest on P's Capital = ₹ $\frac{3,00,00 \times 6}{100}$

= ₹ 18,000

Interest on Q's Capital = ₹ $\frac{2,00,000 \times 6}{100}$

= ₹ 12,000

Total drawing by P = ₹ 2,000 x 12

= ₹ 24,000

Total drawings by Q = ₹ 4500 x 12 = ₹ 54,000

Interests on P's drawings = ₹ $\frac{24,000}{12}$ x $\frac{11 \times 8}{12 \times 100}$ = ₹ 880

Interest on Q's drawings = ₹ $54,000 \frac{\times 6}{12} \times \frac{8}{100}$

= ₹ 2,160

(a) When capital accounts are fluctuating:

Profit and Loss Appropriation Account

Dr. *Cr.*

Particulars	₹	*Particulars*	₹
To Interest on Capital:		By Profit and Loss Account	89,700
P's Capital A/c	18,000	By Interest on drawings:	
Q's Capital A/c	12,000	P's Capital A/c	880
To Profit transferred to:		Q's Capital A/c	2,160
P's Capital A/c (1/2 of Profit)	31,370		
Q's Capital A/c (1/2 of Profit)	31,370		
	92,740		92,740

P's Capital Account

Dr. *Cr.*

Date	*Particulars*	₹	*Date*	*Particulars*	₹
2017			2016		
Mar. 31	To P's Drawings A/c	24,000	Apr.1	By Cash A/c	3,00,000
Mar. 31	To Profits and Loss Appropriation A/c (Interest on Drawings)	880	2017 Mar. 31	By Profits and Loss Appropriation A/c (Interest on Capital)	18,000
Mar. 31	To Balance c/d	3,24,490	Mar. 31	By Profits and Loss Appropriation A/c	31,370
		3,49,370			3,49,370
			2017 Apr. 1	By Balance b/d	3,24,490

Q's Capital Account

Dr. *Cr.*

Date	*Particulars*	₹	*Date*	*Particulars*	₹
2017			2016		
Mar. 31	To Q's Drawings A/c	54,000	Apr.1	By Cash A/c	2,00,000
Mar. 31	To Profits and Loss Appropriation A/c (Interest on Drawings)	2,160	2017 Mar. 31	By Profits and Loss Appropriation A/c (Interest on Capital)	12,000
Mar. 31	To Balance c/d	1,87,210	Mar. 31	By Profits and Loss Appropriation A/c	31,370
		2,43,370			2,43,370
			2017 Apr. 1	By Balance b/d	1,87,210

(b) When capital accounts are fixed:

Profit and Loss Appropriation Account

Dr. *Cr.*

Particulars	₹	*Particulars*	₹
To Interest on Capital :		By Profit and Loss Account	89,700
P's Current A/c	18,000	By Interest on drawings:	
Q's Current A/c	12,000	P's Current A/c	880
To Profit transferred to:		Q's Current A/c	2,160
P's Current A/c (1/2 of Profit)	31,370		
Q's Current A/c (1/2 of Profit)	31,370		
	92,740		92,740

P's Capital Account

Dr. *Cr.*

Date	*Particulars*	₹	*Date*	*Particulars*	₹
2017			2016		
Mar. 31	To Balance c/d	3,00,000	Apr.1	By Cash A/c	3,00,000
			2017		
			Apr.1	By Balance b/d	3,00,000

Q's Capital Account

Dr. *Cr.*

Date	*Particulars*	₹	*Date*	*Particulars*	₹
2017			2016		
Mar. 31	To Balance c/d	2,00,000	Apr.1	By Cash A/c	2,00,000
			2017		
			Apr.1	By Balance b/d	2,00,000

P's Current Account

Dr. *Cr.*

Date	*Particulars*	₹	*Date*	*Particulars*	₹
2017			2017		
Mar. 31	To P's Drawings A/c	2,400	Mar. 31	By Profits and Loss	
Mar. 31	To Profits and Loss			Appropriation A/c	
	Appropriation A/c			(Interest on Capital)	18,000
	(Interest on Drawings)	880	Mar. 31	By Profits and Loss	
				Appropriation A/c	31,370
Mar. 31	To Balance c/d	24,490			
		49,370			49,370
			2017	By Balance b/d	24,490
			Apr. 1		

Q's Current Account

Dr. *Cr.*

Date	*Particulars*	₹	*Date*	*Particulars*	₹
2017			2017		
Mar. 31	To Q's Drawings A/c	54,000	Mar. 31	By Profits and Loss	
Mar. 31	To Profits and Loss			Appropriation A/c	
	Appropriation A/c			(Interest on Capital)	12,000
	(Interest on Drawings)	2,160	Mar. 31	By Profits and Loss	
				Appropriation A/c	31,370
			Mar. 31	By Balance c/d	12,790
		56,160			56,160
2017					
Apr.1	To Balance b/d	12,790			

Illustration 2:

On 1st April, 2016 the capital accounts of A, B and C stood at ₹ 30,000, ₹ 20,000 and ₹ 10,000 respectively. They shared profits and losses equally. Profit and Loss account for the year ended 31 March, 2017 revealed a net profit of ₹12, 000 which was transferred to capital accounts of the partners equally.

It was decided in April 2017 that profits should be distributed equally after allowing interests on capital @ 6%

per annum with effect from 1st April, 2016. While going through the books of account for 2016-17 it was discovered that repair charges for A's personal scooter amounting to ₹ 90 had been charged to Repairs Account.

Show the journal entries necessary to adjust the current account of the partners.

Solution:

	₹	₹
Profits as already distributed		12,000
Add: Repair charges to be charged to A's Current Account		90
		12,090
Less : Interest on:		
A's Capital	1,800	
B's Capital	1,200	
C's Capital	600	3,600
Net profit after adjustment		8,490

Each partner will get ₹ $\frac{8,490}{3}$ = ₹ 2,830

Revised Distribution

	A ₹	*B* ₹	*C* ₹
Net Profit	2,830	2,830	2,830
Interest of Capital	1,800	1,200	600
	4,630	4,030	3,430
Less : Repair charges	90	–	–
	4,540	4,030	3,430
Distribution as already made of ₹ 12,000	4000	4000	4000
Net Adjustment to be made	+540	+30	– 570

Journal Entry

Particulars	*Dr. (₹)*	*Cr. (₹)*
C's Current Account Dr.	570	
To A's Current Account		540
To B's Current Account		30
(Adjustment effected for change on the basis of distribution of profit for 2016-17 and error located in the accounts for 2016-17)		

Illustration 3:

C and D were sharing profits in the ratio of 3:1. Profits as per books for 2015-16 amounted to ₹ 40,000. In April 2016, they agreed to change the profit sharing ratio to 5:3 with retrospective effect from 1st April, 2015. It was found that outstanding expenses of ₹ 4,000 as on 31st March, 2015 and outstanding expenses of ₹ 3,000 as on 31st March, 2016 had not been taken into account while drawing up the final accounts for 2014-15 and 2015-16. Also by mistake interest on drawings had been ignored while preparing the accounts for 2015-16 such interest being ₹ 600 on C's drawings and ₹ 300 on D's drawings. Pass the necessary journal entries to adjust the capitals of partners.

Solution:

Working Notes:

		C		D
Old ratio	3:1 or	6	:	2
New Ratio		5	:	3

D gets 1/8 more

	C	D
	₹	₹
Old distribution of ₹ 40,000 (A)	30,000 Cr.	10,000 Cr.
New distribution of ₹ 40,000 + ₹ 600 + ₹ 300 or ₹ 40,900 in the ratio of 5 : 3	25,562.50 Cr.	15,337.50 Cr.
Interest on Drawings	600 Dr.	300 Dr.
(B)	24,962.50 (Net) Cr.	15,037.50 (Net) Cr.
Difference (A) – (B)	5,037.50 Dr.	5,037.50 Cr.

Outstanding expenses of ₹ 4,000 as on 31st March, 2015 will be debited to partners' capital accounts in the old ratio (to raise Outstanding Expenses Account) and then will be credited to partners' capital accounts in the new ratio (to write off Outstanding Expenses Account). Outstanding Expenses of ₹ 3,000 will be debited to capital accounts in the new ratio and credited to Outstanding Expenses Account. In the entry shown below, only the net effect has been recorded:

Journal Entries

Particular		*Dr. (₹)*	*Cr. (₹)*
C's Capital Account	Dr.	2,375*	
D's Capital Account	Dr.	625*	
To Outstanding Expenses Account			3,000
(Adjustment entry for outstanding expenses of ₹ 4,000 as on 31st March, 2015 and of ₹ 3,000 as on 31st March, 2016)			
C's Capital Account	Dr.	5,037.50	
To D's Capital Account			5,037.50
(Entry to adjust capital accounts on redistribution of profit for 2015-16)			

		C	*D*
*	31.3.2015 (Ratio 3 : 1)	Dr. 3,000	Dr. 1,000
	1.4.2015 (Ratio 5 : 3)	Cr. 2,500	Cr. 1,500
	31.3.2016 (Ratio 5 : 3)	Dr. 1,875	Dr. 1,125
		Dr. 2,375	Dr. 625

Note: If capital accounts are fixed, current accounts will be debited and credited instead of capital accounts.

Illustration 4:

With effect from 1st April, 2016, D, the manager in the firm of A,B, and C who were sharing profits and losses in the ratio of 5:3:2 respectively was admitted as a partner in the firm with 1/11th share of profit. It was agreed that should D' share of profits exceed his remuneration as the manager, A will bear the burden of such an excess. The manager D was entitled to a salary of ₹ 10,000 p.m. plus a commission of 2% of net profit remaining after charging his salary but before charging his commission.

Profit and Loss Account for the year ended 31st March, 2017 showed a profit of ₹ 22,00,000. Show how the profit will be distributed among the four partners.

Solution:

The main point is that B and C are not to suffer due to D's becoming a partner. Suppose, D is still the manager; then:

	₹
Profit as given	22,00,000
Less: Salary which D would have received	1,20,000
	20,80,000
Less: D's commission @ 2% on ₹ 20,80,000	41,600
Net profit	20,38,400

	A (5/10)	B (3/10)	C (2/10)	D (as Manager)
Distribution	10,19,200	6,11,520	4,07,680	1,61,600

Under the new arrangement D will receive 1/11th of ₹ 22,00,000 i.e., ₹ 2,00,000. It means that D will get ₹ 38,400 more than what he would have got as manager. This will be deducted from A's share. Hence, the profit of ₹ 22,00,000 will be distributed as follows:

A	₹ 9,80,800
B	₹ 6,11,520
C	₹ 4,07,680
D	₹ 2,00,000

Illustration 5:

P and S were in partnership sharing profits and losses in the ratio of 7:3 respectively. As a mark of appreciation of the services of their manager Z, they admitted him into partnership on 1st April, 2016 giving him 1/10th share of the future profits; the mutual ratio between P and S remaining unchanged. Before becoming a partner, Z was getting a salary of ₹ 4,000 per month and a commission of 5% on the net profits remaining after charging his salary and commission. It was agreed that any excess over his former remuneration to which Z as a partner becomes entitled will be provided out of P's share of profit.

The net profit for the year ended 31st March, 2017 amounted to ₹ 19,80,000. Prepare the profit and loss appropriation account for the year ended 31st March, 2017 showing the distribution of the profits of the net profits amongst the partners. Show your working notes clearly.

Solution:

In the books of P, S and Z
Profits and Loss Appropriation Account
Dr. **for the year ended 31st March, 2017** *Cr.*

Particulars	₹	*Particulars*	₹
To Profit transferred to Capital Accounts:		By Net profit b/d	19, 80,000
P	12, 30,000		
S	5, 52,000		
Z	1, 98,000		
	19, 80,000		19, 80,000

Working Notes:

		₹	₹
(1)	Z's share: 1/10 of ₹ 19, 80,000		1, 98,000
	Less: Z's share as manager:		
	Salary: ₹ 4,000 x 12	48,000	
	Commission: $\left(\frac{5}{105} \text{ of ₹ } 1{,}98{,}000\text{-}48{,}000\right)$	92,000	1, 40,000
	Excess amount chargeable to P		58,000
(2)	When Z acted as manager, divisible profit of the old partner would have been (₹ 19,80,000 – ₹ 1,40,000)		18,40,000
	P's share of profit would have been ($\frac{7}{10}$ of ₹ 18,40,000)		12,88,000
	S's share of profits would have been ($\frac{3}{10}$ of ₹ 18,40,000)		5,52,000
(3)	When Z becomes a partner, share of profit of each:		
	P (₹ 12,88,000 – ₹ 58,000)		12,30,000
	S		5, 52,000
	Z		1, 98,000
			19, 80,000

Alternatively, the final distribution of profit can be arrived at as follows:

Profit and Loss Appropriation Account

Dr. *Cr.*

Particulars	₹	*Particulars*	₹
To Z's Capital A/c (1/10)	1, 98,000	By Net Profit b/d	19, 80,000
To Balance c/d	17, 82,000		
	19, 80,000		19, 80,000
To P's Capital A/c (7/10)	12, 88,000	By Balance c/d	17, 82,000
To S's Capital A/c (3/10)	5, 52,000	By P's Capital A/c	58,000
	18, 40,000		18, 40,000

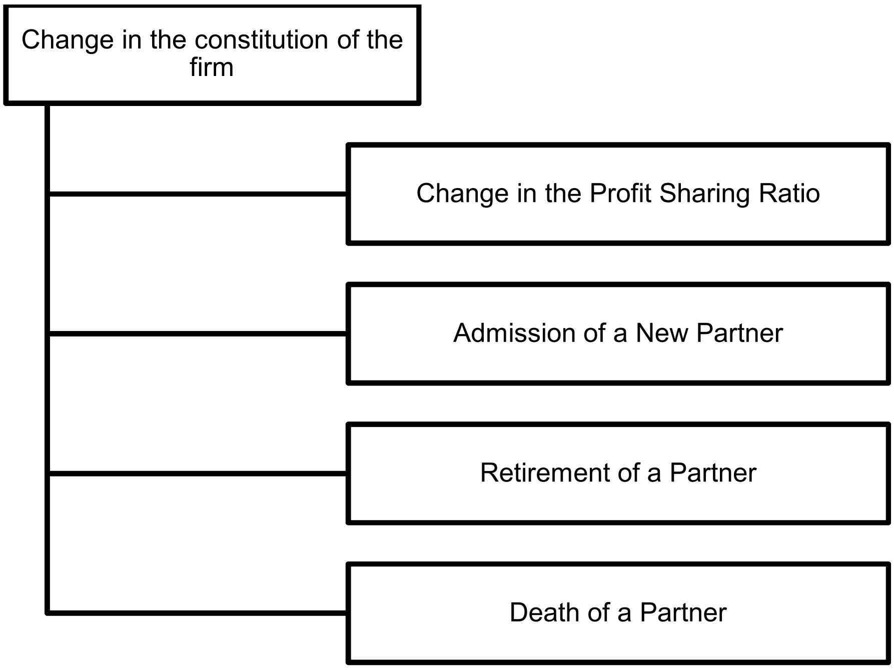
Final Distribution

		₹
P=₹ 12,88,000 - ₹58,000	=	12,30,000
S	=	5,52,000
Z	=	1,98,000
		19,80,000

RECONSTITUTION OF PARTNERSHIP

When there is any change in the existing agreement of partnership, it is reconstitution of partnership. As a result of reconstitution, the existing agreement of partnership comes to an end and a new agreement is formed. The firm continues its business in usual manner. Some special adjustments are to be made in the accounts of partnership firm in cases of change in the constitution of the firm.

There may be changes in the constitution of the firm due to following reasons:



CHANGE IN THE PROFIT SHARING RATIO

Whenever there is a change in the profit sharing ratio of the existing partners, there arises the need for valuation of goodwill. A change in the profit sharing ratio results in gain to one partner and loss to the other. As a result, the partner who gains from the new ratio has to compensate the partner who loses. The gaining partner, in respect of share of profit, may buy his share of profits from any one or two partners, as the case may be. The partners who sell the shares may sacrifice in equal or unequal proportions. The amount of goodwill credited to partner(s) from whom the gaining partner purchases his share is always in proportion to the sacrifice made. The journal entry for this purpose is to debit the partner's capital account (one who gains) with the proportionate share of goodwill and credit the capital account or accounts of the partners (who lose) with the same amount.

Illustration 6:

On 1st April, 2016 A, B and C who were sharing profits and losses in the ratio of 5:3:2 respectively decided to become equal partners. Goodwill of the firm was valued at ₹ 4,50,000. It was also decided to appreciate the book value of land and buildings by ₹ 1,40,000. No goodwill account appeared in the books of the firm and none was opened on change in profit sharing ratio. Pass journal entries to make the necessary adjustments.

Solution:

Journal Entries

Particulars		*Dr. (₹)*	*Cr. (₹)*
Land and Buildings Account	Dr.	1,40,000	
To Revaluation Account			1,40,000
(Appreciation in the value of land and buildings)			
Revaluation Account	Dr.	1,40,000	
To A's Capital Account			70,000
To B's Capital Account			42,000
To C's Capital Account			28,000
(Transfer of profit on revaluation to partners' capital accounts in old profit sharing ratio)			
B's Capital Account	Dr.	15,000	
C's Capital Account	Dr.	60,000	
To A's Capital Account			75,000
(Adjustment for goodwill on change in profit sharing ratio)			

Working Notes:

Old profit sharing ratio = $\frac{5}{10}:\frac{3}{10}:\frac{2}{10}$

New profit sharing ratio = $\frac{1}{3}:\frac{1}{3}:\frac{1}{3}$

A loses = $\frac{5}{10} - \frac{1}{3} = \frac{15 - 10}{30} = \frac{5}{30}$

B gains = $\frac{1}{3} - \frac{3}{10} = \frac{10 - 9}{30} = \frac{1}{30}$

C gains = $\frac{1}{3} - \frac{2}{10} = \frac{10 - 6}{30} = \frac{4}{30}$

A will be credited with $\frac{5}{30}$ ₹ 4,50,000 or ₹ 75,000 for goodwill

B will be debited with $\frac{1}{30}$ ₹ 4,50,000 or ₹ 15,000

and

C will be debited with $\frac{4}{30}$ ₹ 4,50,000 or ₹ 60,000

REVIEW QUESTION

On 1st April, 2016 A and B who are sharing profits and losses in the ratio of 3:2 decided to become equal partners with effect from 1st April, 2015 with the additional provision that interest on capitals will be allowed @ 7% per annum. A and B started the firm on 1st April, 2015 with a capital of ₹ 90,000 and ₹ 60,000 respectively. The profit for the year ended 31st March, 2016 amounted to ₹ 54,000. Pass the necessary adjustment entry.

ADMISSION OF A NEW PARTNER

A new partner can be admitted with the consent of all existing partners. The various reasons for admission of a new partner may be requirement of more capital, influence or managerial skill of the new partner etc.

A new partner may either purchase his share of profits from one or more of the existing partners or he may contribute to a share in the assets of the firm. In the former case, the total capital of the firm does not change; the amount brought in by the new partner is paid to the partners from whom share is purchased. In the latter case, however, the total capital of the firm is increased by the amount brought in by the new partner.

Suppose, A and B share profits and losses in the ratio of 2:1 respectively and their capitals stand at ₹ 10,000 and ₹ 5,000 respectively. If C is admitted and he buys 1/5th share from A, C will bring ₹ $15{,}000 \times \frac{1}{5} =$ or ₹ 3,000 in cash which will be withdrawn by A. The new balances of the capital accounts of A, B and C will be ₹ 7,000, ₹ 5,000 and 3,000 respectively. If C contributes to the capital for 1/5th share of profits, he will bring ₹ $15{,}000 \times \frac{5}{4} \times \frac{1}{5} =$ ₹ 3,750. Total capital of the new firm will be ₹ 18,750.

Admission of new partner results in the reconstitution of partnership firm, as a new agreement to carry on the business as a partnership firm comes into existence. When there is a change in the constitution of partnership, the profit sharing ratio of the existing partners may be revised. When a new partner is admitted, he is entitled to a share in the assets of the firm and in the future profits of the firm.

For acquiring shares in the assets of the firm partner has to → Contribute Capital

For acquiring right to future profits in the firm new partner has to → Contribute towards Goodwill of the firm

When a new partner is admitted, the amount may be contributed to the capital of the firm in the form of assets other than cash also. Journal entry will be :

Bank	*Dr.*
Any other Asset	*Dr.*
To New Partner's Capital A/c	

<u>Example:</u> X and Y are carrying on business in partnership. Z is admitted as a new partner who brings in ₹ 8,000 in cash and trademarks and patents valued at ₹ 2,000. The journal entry will be:

Bank	Dr.	8,000	
Patents and Trade Marks	Dr.	2,000	
To Z's Capital Account			10,000
(Capital brought in by Z in the form of cash, patents & and trade marks)			

When a new partner is admitted, a number of things have to be done. Some of the major adjustments to be made are as follows:

– Calculation of new profit sharing ratio

– Calculation of sacrificing ratio

– Transfer of accumulated profits and reserves to existing partners

– Revaluation of assets and liabilities

– Treatment of goodwill

Calculation of New Profit Sharing Ratio

Case 1: When the new profit sharing ratio is not specially mentioned but only the share given to the new partner is mentioned, the assumption is that the old partners among themselves continue to share profits in the same relative ratio in the which they were sharing profits prior to admission of the new partner. In such a case, the share given to the new partner should be deducted from 1 and then the remainder should be divided among the old partners in the old ratio. Suppose, A and B are partners sharing profits and losses in the ratio of 3:2 and they admit C as a new partner giving him 1/5 share in future profits. Then the new ratio will be calculated as follows:

C's share $= \frac{1}{5}$

Remaining share $= 1 - \frac{1}{5} = \frac{4}{5}$

A's share $= \frac{4}{5} \times \frac{3}{5} = \frac{12}{25}$

B's share $= \frac{4}{5} \times \frac{2}{5} = \frac{8}{25}$

C's share $= \frac{1}{5} = \frac{5}{25}$

New ratio for A, B, and C is 12: 8: 5

Case II: Sometimes the new partner purchases his share from the other partner in different proportions. Suppose, in the above example C purchases $4/25^{ths}$ share from A and $1/25^{th}$ share from B. Then the new ratio will be calculated as follows:

A's share $= \frac{3}{5} - \frac{4}{25} = \frac{15 - 4}{25} = \frac{11}{25}$

B's share $= \frac{2}{5} - \frac{1}{25} = \frac{10 - 1}{25} = \frac{9}{25}$

C's share $= \frac{4}{25} + \frac{1}{25} = \frac{5}{25}$

Hence, the new ratio = 11: 9: 5.

REVIEW QUESTION

1. P and Q are equal partners. R is admitted as a new partner and he is given 1/5th share in the profit of the firm. What will be the new profit sharing ratio?

2. A & B are partners sharing profits in the ratio of 3:2. They admit C, a new partner who acquires $1/5^{th}$ share from A and $4/25^{th}$ share from B. Calculate new profit sharing ratio.

Calculation of Sacrificing Ratio

In partnership business when a partner is admitted into a firm, the old partners have to surrender a portion of their shares of profits in favour of the new partner. Sacrificing ratio is the difference between old profit sharing ratio and the new profit sharing ratio of the old partners. In this case, sacrifice made by the existing partners may either be in the ratio in which they were sharing profits prior to the admission or in some other ratio :

(i) Besides the old ratio of old partners, if the new ratio of the incoming partners has been given without mentioning the details of the sacrifice made by the old partners, then the presumption is that the old partners have made sacrifice in the old ratio.

(ii) Sometimes, the new ratio of all the partners and old ratio of old partners are given. In that case sacrificing ratio must be calculated by deducting the new share from the old share of the old partners.

For example, if A and B share profits in the ratio of 5:3 respectively and on admission of C the new ratio among A, B and C is agreed upon as 7:5:4 respectively, the ratio of sacrifice will be calculated as follows:

Sacrifice by A = A's old share – A's new share $= \frac{5}{8} - \frac{7}{16} = \frac{3}{16}$

Sacrifice by B = B's old share – B's new share $= \frac{3}{8} - \frac{5}{16} = \frac{1}{16}$

Hence ratio of sacrifice between A and B $= \frac{3}{16} : \frac{1}{16}$ or $3 : 1$

Transfer of Reserves to Existing Partners

Reserves created out of profits or balance in Profit and Loss Account at the time of admission of a new partner must be transferred to the capital accounts of the old partners in the old profit sharing ratio. It is done because the new partner is not entitled to any share of the accumulated profits and similarly, he is not liable to bear any part of the past losses. So, the accumulated losses should also be transferred to the capital accounts of the old partners in the old profit sharing ratio. Transfer of reserves is done even when no new partner is admitted but the partners change their profit sharing ratio. The journal entry will be:

Reserves Account/Profit and Loss Account Dr.
To Old Partners' Capital/Current Accounts

Example: A and B are partners in a business sharing profits and losses in the ratio of 3:2 respectively. The Profit and Loss Account shows an undistributed profit of ₹ 5,000 and the General Reserve is ₹ 10,000. They admit a new partner 'N' with 1/4th share in the profits. The journal entry will be:

Profit and Loss A/c	Dr.	5,000	
General Reserve A/c	Dr.	10,000	
To A's Capital A/c			9,000
To B's Capital A/c			6,000
(Being the amount of Profit and Loss A/c and the General Reserve distributed among the old partners in the old profit sharing ratio.)			

Revaluation of Assets and Liabilities on Admission of a Partner

A new partner is not to be benefitted by any appreciation in the values of assets of the firm or by any decrease in the values on liabilities of the firm. Similarly, he is not to bear any part of the loss that is due to decrease in the values of the assets or increase in the values of the liabilities of the firm till the date of his admission. Therefore, before a new partner is admitted, the assets and liabilities of the firm are revalued and any profit or loss resulting from such a revaluation is transferred to old partners' capital accounts in the old profit sharing ratio. For this purpose, the following entries are passed:

Revaluation Account Dr.
To Assets (individually)
To Liabilities (individually)
(To record decrease in the book values of assets and increase in the book values of liabilities as agreed upon on admission of the new partner).

Assets (individually) Dr.
Liabilities (individually) Dr.
To Revaluation Account
(To record increase in the book values of assets and decreases in the book value of liabilities as agreed upon on admission of the new partner).

Revaluation Account Dr.
To Old Partners' Capital/Current Accounts (individually)
(Transfer of profit on revaluation to old partners capital accounts in their old profit sharing ratio)

OR

Old Partners' Capital/Current Accounts (individually) Dr.
To Revaluation Account
(Transfer of loss on revaluation to old partners capital accounts in their old profit sharing ratio).

Sometimes, all the partners including the new partner may agree not to alter the book value of assets and liabilities even when they agree to revalue them. In order to record this, ***Memorandum Revaluation Account*** is opened. It has two parts. In the first part, the entries for revaluation of assets and liabilities are made in the usual manner. But no record of revaluation of assets and liabilities is made through the respective ledger accounts. The resultant profit or loss on revaluation in the first part is transferred to the capital accounts of old partners in the old profit sharing ratio. In order to complete the double entry, entries regarding assets and liabilities made in the first part are reversed in the second part so that the values of assets and liabilities remain unchanged. The balance in the second part is transferred to the capital accounts of all the partners including the new partner in their new profit sharing ratio. If there is a profit, the following entries are passed.

Memorandum Revaluation Account Dr.
To Old Partners' Capital/Current Accounts (individually)
(Profit on revaluation transferred to old partners' capital accounts in old profit sharing ratio.)

All Partners' (including new) Capital Accounts/Current Accounts (individually) Dr.
To Memorandum Revaluation Account
(Transfer of Memorandum Revaluation Account to all the partners' (including the new partner's) capital accounts in the new profit sharing ratio).

Note: If there is a loss on revaluation, the above entries will be reversed.

DIFFERENCE BETWEEN REVALUATION A/C AND MEMORANDUM REVALUATION A/C

Revaluation account	*Memorandum revaluation account*
(i) Revaluation account is prepared to find out the profit or loss on revaluation of assets and liabilities which appear in the new balance sheet at the revalued figures.	(i) Memorandum revaluation account is also prepared to record the effect of revaluation of assets and liabilities but they are recorded at their old figures in the new balance sheet.
(ii) Revaluation account is not divided in parts. The profit or loss of goes to old partners only.	(ii) Memorandum revaluation account has two parts. The profit or loss of first part goes to old partners while the profit or loss of the second part goes to all the partners including the new partner.

Treatment of Goodwill on Admission

Whenever a new partner is admitted, he/she is generally expected to pay cash to old partners for his/her share of goodwill for the right acquires to share in profits of the firm in future. Strictly, such a payment should be made only when there are super profits but in actual practice, some premium or goodwill may have to be paid by the new partner on his admission even when the business of the firm is not unusually profitable and consequently there are no super profits. The payment is made to the old partners for the sacrifice they make on their shares of profits for future. It is not necessary that the new partner must bring cash for his share of goodwill, only adjustment may be made for goodwill. The various alternative courses for the accounting treatment of goodwill on admission of a partner are as follows:

Important Note: Concept of accounting treatment of Goodwill

1) Goodwill should be recorded in the books of account only when some consideration in money or money's worth has been paid for it. Whenever a business is acquired for a price (payable in cash or in shares or otherwise) which is in excess of the value of the net assets of the business taken over, the excess should be treated as goodwill. For example, when a partnership firm of X and Y purchases the net assets of Z amounting to ₹ 6,00,000 for ₹ 6,50,000 in cash, the additional payment of ₹ 50,000 is a payment for goodwill in cash. It is a case of purchased goodwill (an asset) and can be recorded in the books of account of X and Y. Thus, only purchased goodwill is recorded in the books of account when the payment is made directly in cash or money's worth.

2) When no payment is made for the purchase of goodwill, it is a case of internally, generated goodwill or inherent goodwill. For instance, in the event of reconstitution of the firm as a result of admission, retirement, death or change in profit sharing ratio, goodwill of the firm is evaluated. In such cases, the value of goodwill should not be brought into books of account as it is an inherent or self generated goodwill and no money or money's worth has been paid for it. The goodwill is calculated as per any of the methods of valuation of goodwill and adjusted through the capital accounts of the partners. No goodwill account is raised in the books of accounts on reconstitution of the firm or change in the profit sharing ratio among the partners. Therefore, the internally generated or inherent goodwill is not raised in the books of account. It is adjusted through the capital accounts of the concerned partners. Always remember that in this case the goodwill raised will not be shown in the balance sheet.

(i) When the incoming partner brings in the required amount of goodwill in cash and this amount is retained in the business:

- The amount of goodwill brought in by the incoming partner along with his share of capital is credited to his capital account and
- Then this amount of goodwill is debited to the new partner's capital account and credited to the old partners' capital account in the sacrificing ratio.

JOURNAL ENTRIES:

(a) Bank Dr.
To New Partner's Capital A/c
(Being amount of goodwill and capital brought by the new partner)

(b) New Partner's Capital A/c Dr.
To Old Partners' Capital Accounts
(Being the amount of goodwill brought in by the new partner shared by the old partners in the sacrificing ratio)

(ii) When the required amount of goodwill brought in by the new partner in cash is immediately withdrawn by the old partners

In this case the amount of goodwill is withdrawn by the partners in the sacrificing ratio and the entry for withdrawal will be:

JOURNAL ENTRIES:

(a) Bank Dr.
To New Partner's Capital A/c
(Being amount of goodwill and capital brought by the new partner)

(b) New Partner's Capital A/c Dr.
To Old Partners' Capital Accounts
(Being the amount of goodwill brought in by the new partner is shared by the old partners in the sacrificing ratio)

(c) Old Partners' Capital Accounts Dr.
To Bank
(Being the amount of goodwill brought in by the new partner is withdrawn by the old partners in the sacrificing ratio)

(iii) Where the new partner pays amount of goodwill privately to the old partners

In this case, no entry is passed in the books of the firm. The amount to be paid to each partner should be calculated as per the profit-sacrificing ratio.

(iv) Where the partner is unable to bring anything for goodwill

In this case, the value of goodwill should not be raised in the books. Since it is inherent goodwill, it is preferable that such value of goodwill should be adjusted through partners' capital accounts. The new partner's capital is debited with his share of goodwill and the amount is credited to old partners' capital accounts in the ratio in which they make sacrifice of profits. The journal entry will be:

New Partner's Capital A/c Dr.
To Old Partners' Capital Accounts
(Being the share of new partner's goodwill credited to old partners' capital accounts in the sacrificing ratio and debiting the new partners' capital account)

(v) When the new partner brings a portion of the required amount of goodwill

In this case, the amount brought in by the new partner will be shared by the old partners in the sacrificing ratio and the portion of amount of goodwill not brought in by the new partner is adjusted through the capital accounts of partners by debiting, new partner's capital account with the amount and crediting the old partners' capital accounts in their sacrificing ratio.

(vi) When the goodwill is already appearing in the books of accounts:

When the goodwill is already appearing in the firm's books, first of all goodwill is to be written off from the books by debiting old partners' capital accounts in their profit sharing ratio and crediting goodwill account. Then new partner's capital account is debited with his difference in share of goodwill not brought in cash and this amount is credited to old partners' capital accounts in sacrificing ratio.

JOURNAL ENTRIES

(a) Old Partners' Capital Accounts Dr.
To Goodwill A/c
(Being goodwill written off from the books)

(b) Bank Dr. (Cash brought in)
New Partner's Capital A/c Dr. (Difference not brought in cash)
To Old Partners' Capital Account
(Being the amount of goodwill brought in by the new partner is shared by the old partners in the sacrificing ratio)

(vii) Hidden goodwill:

Sometime the value of goodwill has to be inferred from the agreement of capitals and profit sharing ratio among the partners.

(a) Suppose, A and B share profits in the ratio 2:1 and their capitals stand at ₹ 20,000 and ₹ 10,000 and they admit C who brings ₹ 14,000 and is given 1/4th share in future profits. Now C's capital should be 1/4th of the total capital.

For $1/4^{th}$ share, the capital of C = ₹14000

Therefore, total capital of the firm should be = ₹ 56,000

Total capital of A, B and C= ₹20,000 + ₹10 000 + ₹14,000 = ₹44,000

Value of Goodwill= Total Estimated Capital- Actual Capital

₹ 56,000- ₹44,000 = ₹12,000

REVIEW QUESTIONS

X and Y are sharing profits and losses in the ratio of 7:4. They admit Z as new partner and the new profit sharing ratio is agreed upon to be X $\frac{5}{11}$, Y $\frac{3}{11}$ and Z $\frac{3}{11}$. Z brings in ₹ 20,000 by way of his share of goodwill. How will this amount be distributed between X and Y?

Adjustment Regarding Capitals of Partners

It is often agreed that after the admission of a new partner, capitals of all the partners should be in proportion to their respective shares in profit. The basis may be the amount of capital brought in by the new partner or the new partner himself may be required to bring in capital equal to his share in the firm. If the new partner's capital is given, the total capital of the firm should be ascertained on that basis. Then, the capital required for each one of the old partners should be ascertained and it should be compared with the actual balances in the accounts of the partners concerned, adjustments may then be made in cash or through current accounts to bring the balances of capital accounts of all the old partners to the desired figures. Suppose, C brings in ₹ 10,000 for 1/5th share of profits. Total capital of the firm should be ₹ 10,000 x 5 or ₹ 50,000. If A and B are to share profits as to A $\frac{1}{2}$ and B $\frac{3}{10}$, then A's capital account should show a balance of ₹ 50,000 $\times\frac{1}{2}$ or ₹ 25,000 and B's capital should show a balance of ₹ 50,000 $\times\frac{3}{10}$ or ₹ 15,000. If A's capital account shows a balance of ₹ 24,000 and the capital account of B shows a balance of ₹ 16,500, A will bring in ₹ 1,000 and B will withdraw ₹ 1,500.

Alternatively, the new partner may be required to bring capital on the basis of capital of old partners. Suppose, the capital accounts A and B after all adjustments are ₹ 32,000 and ₹ 18,000 respectively and C is admitted as a new partner to whom 1/5th share of profits is given. Then

C's Share = $\frac{1}{5}$

Remaining share = $1-\frac{1}{5}=\frac{4}{5}$

Combined capital of A and B = ₹ 32,000 + ₹ 18,000 = ₹ 50,000

Total Capital = $50{,}000\times\frac{5}{4}$ = ₹ 62,500

C's Capital = ₹ $62{,}500\times\frac{1}{5}$ = ₹ 12,500

If A and B are to share profits as to A 1/2 and B 3/10, then

A's Capital = ₹ $62{,}500\times\frac{1}{2}$ = ₹ 31,250

B's Capital = ₹ $62{,}500x\frac{3}{10}$ 62,500 = ₹ 18,750

A will withdraw ₹ 750 and B will bring in ₹ 750.

Illustration 7:

On 31st March, 2017 the following was the Balance Sheet of A and B who were equal partners:

Liabilities	₹	*Assets*		₹
Sundry Creditors	*8,940*	*Cash in hand*		*950*
General Reserve	*10,000*	*Stock*		*32,710*
A's Capital Account	*35,000*	*Debtors*	*11,000*	
B's Capital Account	*20,000*	*Less: Provision*		
		for Bad Debts	*220*	*10,780*
		Furniture and Fittings		*9,500*
		Land and Buildings		*20,000*
	73,940			*73,940*

On 1st April 2017, C was admitted as a new partner on the following conditions:

(i) A, B and C share profits and losses in the ratio 4:3:2 respectively.

(ii) Prior to C's admission appreciation of ₹ 15,000 in the value of land and buildings would be recorded and provision for bad debts would be brought upto ₹ 820.

(iii) C would bring ₹ 20,000 in cash as his capital.

Pass journal entries to record the abovementioned transactions and show the balance sheet of firm immediately after C's admission.

Solution :

Journal Entries

Particulars		*Dr.* (₹)	*Cr.* (₹)
General Reserve	Dr.	10,000	
To A's Capital Account			5,000
To B's Capital Account			5,000
(Transfer of general reserve to old partners in old profit sharing ratio)			
Land and Building Account	Dr.	15,000	
To Revaluation Account			15,000
(Appreciation in the value of land and buildings as agreed on admission of C as a new partner).			
Revaluation Account	Dr.	600	
To Provision for Bad Debts			600
(Increase in provision for bad Debts by ₹ 600)			
Revaluation Account	Dr.	14,400	
To A's Capital Account			7,200
To B's Capital Account			7,200
(Transfer of net profit on revaluation to old Partners' capital accounts in old profits sharing ratio)			
Bank	Dr.	20,000	
To C's Capital Account			20,000
(Amount brought in by C as in his capital)			

Balance Sheet of A, B and C as on 1st April, 2017

Liabilities	₹	*Assets*		₹
Sundry Creditors	8,940	Cash		20,950
A's Capital Account	47,200	Stock		32,710
B's Capital Account	32,200	Debtors	11,000	
C's Capital Account	20,000	*Less:* Provision for		
		Bad Debts	820	10,180
		Furniture and Fittings		9,500
		Land and Buildings		35,000
	1,08,340			1,08,340

Revaluation Account

Dr. *Cr.*

Particulars	₹	*Particulars*	₹
To Provision for Bad Debts	600	By Land and Buildings	15,000
To A's Capital Account	7,200		
To B's Capital Account	7,200		
	15,000		15,000

Dr. **Capital Accounts** *Cr.*

Particulars	*A* ₹	*B* ₹	*C* ₹	*Particulars*	*A* ₹	*B* ₹	*C* ₹
To Balance c/d	47,200	32,200	20,000	By Balance b/fd	35,000	20,000	
				By General Reserve	5,000	5,000	
				By Revaluation	7,200	7,200	
				By Cash			20,000
	47,200	32,200	20,000		47,200	32,200	20,000
				By Balance b/d	47,200	32,200	20,000

If the values of assets and liabilities were not to be changed, the following would have been the solution:

Journal Entries

Particulars		*Dr.* (₹)	*Cr.* (₹)
General Reserve	Dr.	10,000	
To A's Capital Account			5,000
To B's Capital Account			5,000
(Transfer of general reserve to old partners in old profit sharing ratio)			
Memorandum Revaluation Account	Dr.	14,400	
To A's Capital Account			7,200
To B's Capital Account			7,200
(Record of profit on revaluation)			
Bank	Dr.	20,000	
To C's Account			20,000
(Amount brought in by C as his capital)			
A's Capital Account	Dr.	6,400	
B's Capital Account	Dr.	4,800	
C's Capital Account	Dr.	3,200	
To Memorandum Revaluation Account			14,400
(Transfer of Memorandum Revaluation Account after C's admission to all the partners' capital accounts in the new profit sharing ratio)			

Balance Sheet of A, B and C on 1st April, 2017

Liabilities	₹	*Assets*		₹
Sundry Creditors	8,940	Cash		20,950
A's Capital account	40,800	Stock	₹	32,710
B's Capital Account	27,400	Debtors	11,000	
C's Capital Account	16,800	*Less:* Provision		
		for Bad Debts	220	10,780
		Furniture and Fittings		9,500
		Land and Buildings		20,000
	93,940			93,940

Working Notes:

Dr. **Memorandum Revaluation Account** *Cr.*

Particulars	₹	*Particulars*	₹
To A's Capital Account	7,200	By A's Capital account	6,400
To B's Capital Account	7,200	By B's Capital Account	4,800
		By C's Capital Account	3,200
	14,400		14,400

Dr. **Capital Accounts** *Cr.*

Particulars	*A (₹)*	*B (₹)*	*C (₹)*	*Particulars*	*A (₹)*	*B (₹)*	*C (₹)*
To Memorandum Revaluation A/c	6,400	4,800	3,200	By Balance b/fd	35,000	20,000	
To Balance c/d	40,800	27,400	16,800	By General Reserve	5,000	5,000	
				By Revaluation memorandum	7,200	7,200	
				By Bank			20,000
	47,200	32,200	20,000		47,200	32,200	20,000
				By Balance b/d	40,800	27,400	16,800

Illustration 8:

On 31st March, 2017 the following was the balance sheet of P and Q who were carrying on business in partnership sharing profits and losses in the ratio of 5:3 respectively.

Liabilities	₹	*Assets*	₹
Sundry Creditors	*10,900*	*Furniture and Fittings*	*15,000*
Capital Accounts		*Stock*	*48,000*
P	*45,000*	*Sundry Debtors*	*16,500*
Q	*27,000*	*Cash*	*3,400*
	82,900		*82,900*

On 1st April, 2017 R is admitted to the firm as a new partner, the new profit sharing ratio among P, Q and R is agreed upon as 7:5:4 respectively. R brings in ₹ 24,000 as his capital. R's share of goodwill is fixed at ₹ 5,000.

Show journal entries and balance sheet immediately after R's admission in each of the following cases:

(a) R brings cash for his share of goodwill and the old partners withdraw half of the amounts credited to their accounts for goodwill brought in by R.

(b) R does not bring anything by way of his share of goodwill.

(c) R brings ₹ 3,000 as his share of goodwill and an adjustment in capital accounts is made for the balance amount.

Solution:

Case (a):

Journal Entries

Particulars		*Dr. (₹)*	*Cr. (₹)*
Bank	Dr.	24,000	
To R's Capital A/c			24,000
(Amount brought in by R as his capital)			
Bank	Dr.	5,000	
To P's Capital Account			3,750
To Q's Capital Account			1,250
(Goodwill brought in by R credited to old partners in their ratio of sacrifice i.e., 3:1)			
P's Capital Account	Dr.	1,875	
Q's Capital Account	Dr.	625	
To Bank			2,500
(Half of the amount of goodwill credited to old partners withdrawn by them in cash)			

Balance Sheet of P, Q and R as on 1st April, 2017

Liabilities	₹	*Assets*	₹
Sundry Creditors	10,900	Furniture and Fittings	15,000
Capital Accounts		Stock	48,000
P	46,875	Sundry Debtors	16,500
Q	27,625	Bank	29,900
R	24,000		
	1,09,400		1,09,400

Case (b):

Journal Entries

Particulars	₹	₹
Bank Dr.	24,000	
To R's Capital Account		24,000
(Capital brought in by R)		
R's Capital Account Dr.	5,000	
To P's Capital Account		3,750
To Q's Capital Account		1,250
(Being R's share of goodwill credited to old partners' capital account in the sacrificing ratio on his admission, credit being given to old partners in their ratio of sacrifice).		

Balance Sheet of P,Q and R as on 1st April, 2013

Liabilities	₹	*Assets*	₹
Sundry Creditors	10,900	Furniture and Fittings	15,000
Capital Accounts		Stock	48,000
P	48,750	Sundry Debtors	16,500
Q	28,250	Cash	27,400
R	19,000		
	1,06,900		1,06,900

Case (c):

Journal Entries

Particulars	*Dr. (₹)*	*Cr. (₹)*
Bank Dr.	24,000	
To R's Capital Account		24,000
(Capital brought in by R)		
Bank Dr.	3,000	
To P's Capital Account		2,250
To Q's Capital Account		750
(Being the amount of goodwill brought in by R credited to old partners in sacrificing ratio)		

Particulars		₹	₹
R's Capital Account	Dr.	2,000	
To P's Capital Account			1,500
To Q's Capital Account			500
(Being portion of R's share of goodwill adjusted through the capital accounts by debiting new partner's capital account and credited to old partners' capital accounts in the sacrificing ratio.)			

Balance Sheet of P, Q and R
as on 1st April, 2017

Liabilities	₹	*Assets*	₹
Sundry Creditors	10,900	Furniture and Fittings	15,000
Capital Accounts		Stock	48,000
P	48,750	Sundry Debtors	16,500
Q	28,250	Bank	30,400
R	22,000		
	1,09,900		1,09,900

Illustration 9:

A and B sharing profits in proportion of three-fourth and one-fourth showed the following as their Balance Sheet as on 31st March, 2017:

Liabilities	₹	*Assets*	₹
Creditors	*375,000*	*Cash at Bank*	*2,25,000*
General Reserve	*40,000*	*Bills Receivable*	*30,000*
Capital Account:		*Debtors*	*1,60,000*
A ₹3,00,000		*Stock*	*2,00,000*
B ₹1,60,000	*4,60,000*	*Office Furniture*	*10,000*
		Land and Buildings	*2,50,000*
	8,75,000		*8,75,000*

They admit C into partnership on 1st April, 2017 on the following terms:

(1) *That C pays ₹ 1,00,000 as his capital for a fifth share in the future profits.*

(2) *That goodwill of the new firm is valued at ₹ 2,00,000 and C brings his share of goodwill in cash.*

(3) *That a stock and furniture be reduced by 10% and a 5% provision for doubtful debts is created on debtors.*

(4) *That the value of land and buildings be appreciated by 20%.*

(5) *That the capital accounts of all the partners be re-adjusted on the basis of their profits-sharing arrangement and any additional amount be immediately withdrawn by them.*

Pass the journal entries; prepare the Profit and Loss Adjustment Account (Revaluation Account), Partners' capital accounts and the opening Balance Sheet of the new firm.

Solution:

Journal Entries

Particulars		*Dr. (₹)*	*Cr. (₹)*
Profit and Loss Adjustment Account	Dr.	29,000	
To Stock			20,000
To Office Furniture			1,000
To Provision for doubtful debts			8,000
(Adjustment for writing down the values of assets)			
Land and Buildings Account	Dr.	50,000	
To Profit and Loss Adjustment Account			50,000
(Adjustment for appreciation in the value of Land and Buildings)			
General Reserve Account	Dr.	40,000	
To A's capital Account			30,000
To B's Capital Account			10,000
(Transfer of General Reserve to partners' capital accounts in the profit sharing ratio)			
Profit and Loss Adjustment Account	Dr.	21,000	
To A's Capital Account			15,750
To B's Capital Account			5,250
(Transfer of profit arising from adjustments to partners' capital accounts in their profit-sharing proportions)			
Bank	Dr.	1,40,000	
To C's Capital Account			1,40,000
(Amount brought in by C as his share capital and 1/5th share of goodwill)			
C's Capital Account	Dr.	40,000	
To A's Capital Account			30,000
To B's Capital Account			10,000
(Share of goodwill brought in by the incoming partner credited to old partners in their sacrificing ratio)			
A's Capital Account	Dr.	75,750	
To Bank			75,750
(Withdrawal of excess of capital over profit-sharing proportion)			
B's Capital Account	Dr.	85,250	
To Bank			85,250
(Withdrawal of excess of capital over his profit sharing proportion)			

Profit and Loss Adjustment account

Dr. *Cr.*

Particulars	₹	*Particulars*	₹
To Stock	20,000	By Land and Buildings	50,000
To Office Furniture	1,000		
To Provision for Doubtful Debts	8,000		
To Transfer of Profits of Capital Accounts: ₹			
A 3/4th 15,750			
B 1/4th 5,250	21,000		
	50,000		50,000

Dr. **A's Capital Account** *Cr.*

Particulars	₹	*Particulars*	₹
To Bank	75,750	By Balance b/fd	3,00,000
To Balance c/d	3,00,000	By General Reserve	30,000
		By Profit and Loss Adjustment A/c	15,750
		By C's Capital A/c	30,000
	3,75,750		3,75,750
		By Balance b/d	3,00,000

Dr. **B's Capital Account** *Cr.*

Particulars	₹	*Particulars*	₹
To Bank	85,250	By Balance b/fd	1,60,000
To Balance c/d	1,00,000	By General Reserve	10,000
		By Profit and Loss Adjustment A/c	5,250
		By C's Capital A/c	10,000
	1,85,250		1,85,250
		By Balance b/d	1,00,000

C's Capital Account

Particulars	₹	*Particulars*	₹
To A's Capital A/c	30,000	By Bank	1,40,000
To B's Capital A/c	10,000		
To Balance c/d	1,00,000		
	1,40,000		1,40,000
		By Balance b/d	1,00,000

Balance Sheet of A, B and C
as at 1st April, 2017

Liabilities	₹	₹	*Assets*	₹	₹
Sundry Creditors		3,75,000	Cash at Bank		2,04,000
Capital Account:			Bills Receivable		30,000
A	30,0,000		Office Furniture		9,000
B	1,00,000		Sundry Debtors	1,60,000	
C	1,00,000	5,00,000	*Less:* Provision for Doubtful Debts @ 5%	8,000	1,52,000
			Stock		1,80,000
			Land and Building		3,00,000
		8,75,000			8,75,000

Note: from the above balance sheet, it is clear that the capitals of the partners now bear the same proportions as their profit sharing arrangement.

Illustration 10:

Ajay and Binoy are partners in a firm sharing profits and losses in the ratio of 2:1 respectively. On 31st March, 2017 their balance sheet stood as follows:

Liabilities	(₹)	Assets	(₹)
Bills payable	*6,000*	*Cash at bank*	*90,000*
Sundry creditors	*90,000*	*Bills receivable*	*20,000*
General reserve	*42,000*	*Sundry debtors*	*1,00,000*
Ajay's capital	*2,82,000*	*Stock*	*1,60,000*
Binoy's capital	*2,40,000*	*Furniture*	*40,000*
		Machinery	*2,50,000*
	6,60,000		*6,60,000*

On 1st April 2017, a new partner Harry is admitted into partnership on the following terms:

(i) That Harry brings in cash ₹ 60,000 as goodwill for his one-third share in future profits.

(ii) That Harry brings such an amount that his capital will be one-third of total capital of the new firm.

(iii) That the value of stock be raised to ₹ 1,68,000.

(iv) That furniture and machinery be depreciated by 5% and 10% respectively.

(v) That a provision for doubtful debts be created at 5% on sundry debtors.

(vi) That the capital accounts of the partners be re-adjusted on the basis of their profit sharing ratio through their current accounts.

Prepare the necessary ledger accounts and the opening balance sheet of the new firm.

Solution:

Revaluation Account

Dr. | *Cr.*

Particulars	₹	*Particulars*	₹
To Furniture A/c	2,000	By Stock A/c	8,000
To Machinery A/c	25,000	By Ajay's Capital A/c(2/3 loss)	16,000
To Provision for doubtful debts A/c	5,000	By Binoy's Capital A/c (1/3 loss)	8,000
	32,000		32,000

Capital Accounts

Dr. | *Cr.*

Particulars	*Ajay* ₹	*Binoy* ₹	*Harry* ₹	*Particulars*	*Ajay* ₹	*Binoy* ₹	*Harry* ₹
To Revaluation A/c (Loss)	16,000	8,000	--	By Balance b/fd	2,82,000	2,40,000	–
To Ajay's Capital A/c (Goodwill)	–	–	40,000	By General Reserve	28,000	14,000	–
To Binoy's Capital A/c (Goodwill)	–	–	20,000	By Bank (Goodwill)	–	–	60,000
To Binoy's Current A/c	–	66,000	–	By Harry's Capital A/c (Goodwill)	40,000	20,000	
To Balance c/d	4,00,000	2,00,000	3,00,000	By Bank	–	–	3,00,000
				By Ajay's Current A/c	66,000	–	–
	4,16,000	2,74,000	3,60,000		4,16,000	2,74,000	3,60,000

Balance Sheet of Ajay, Binoy and Harry as on 1st April, 2017

Liabilities	₹	*Assets*		₹
Bills Payable	6,000	Cash at Bank		4,50,000
Sundry Creditors	90,000	Bills Receivables	₹	20,000
Binoy's Current A/c	66,000	Sundry Debtors	1,00,000	
Ajay's Capital A/c	4,00,000	Less : Provision for		
Binoy's Capital A/c	2,00,000	Doubtful Debts	5,000	95,000
Harry's Capital A/c	3,00,000	Stock		1,68,000
		Furniture		38,000
		Machinery		2,25,000
		Ajay's Current Account		66,000
	10,62,000			10,62,000

Working Notes:

(i) Calculation of Harry's Capital

Total capital:

Ajay's capital: ₹ (2,82,000 + 28,000 + 40,000 – 16,000) = ₹ 3,34,000

Binoy's capital: ₹ (2,40,000 + 14,000 + 20,000 – 8,000) = ₹ 2,66,000

Total capital of Ajay and Binoy before Harry's Admission = ₹ 6,00,000

This capital is for 1-(1/3) = 2/3 share

So total capital of new firm (₹6,00,000 x 3/2) = ₹ 9,00,000

Harry's Capital = 1/3 x ₹9, 00,000 = ₹ 3,00,000

(ii) Calculation of new profit sharing ratio and capital of Ajay and Binoy:

Harry's share	=	1/3
Balance	=	1-(1/3) = 2/3 to be shared by Ajay and Binoy
Ajay's new share	=	2/3 x 2/3 = 4/9
Binoy's new share	=	2/3 x 1/3 = 2/9
New profit share ratio	=	4 : 2 : 3
Ajay's capital in new firm	=	4/9 x ₹9,00,000 = ₹4,00,000
Binoy's capital in new firm	=	2/9 x ₹9,00,000 = ₹2,00,000

Adjustment of capitals is made through partners' current accounts

Sacrifice by Ajay	=	(2/3) – (4/9) = 2/9
Sacrifice by Binoy	=	(1/3) – (2/9) = 1/9
Sacrificing ratio	=	2 : 1

So goodwill is distributed between Ajay and Binoy in the ratio of 2 : 1 respectively.

Illustration 11:

Bansal and Chandar were partners in a firm sharing profits and losses equally. Their balance sheet as on 31st March, 2017 was as follows:

Liabilities	₹	₹	*Assets*	₹
Sundry Creditors		*1,26,000*	*Cash at Bank*	*14,000*
General Reserve		*70,000*	*Debtors*	*1,40,000*
Capital Accounts:			*Stock*	*1,68,000*
Bansal	*2,10,000*		*Furniture*	*28,000*
Chander	*1,68,000*	*3,78,000*	*Buildings*	*2,24,000*
		5,74,000		*5,74,000*

Sagar was admitted as a partner and was given one-fourth share of profits on the following terms:

- *He would bring ₹ 2,10,000 in cash as his capital.*
- *His share of goodwill was valued at ₹70,000 but he was unable to bring it in cash.*
- *Stock and furniture be depreciation by 10%.*
- *A provision of 5% on debtors be created for doubtful debts.*
- *An amount of ₹14,000 included in creditors not to be treated as a liability.*
- *A provision of ₹7,000 be created against bills discounted.*
- *The buildings be treated as worth ₹2,80,000.*

It was agreed that except cash, the other assets and liabilities were to be shown at old figures in the balance sheet. Give journal entries to record the transactions and prepare Memorandum Revaluation Account and capital accounts of the partners. Also prepare the balance sheet after admission of Sagar.

Solution:

Journal Entries

Particulars		***Dr.* *(₹)***	***Cr.* *(₹)***
General Reserve Account	Dr.	70,000	
To Bansal's Capital Account			35,000
To Chander's Capital Account			35,000
(The transfer of general reserve to capital accounts of old partners in the old ratio)			
Bank	Dr.	2,10,000	
To Sagar's Capital Account			2,10,000
(The Amount brought in by Sagar as his capital)			
Sagar's Capital Account	Dr.	70,000	
To Bansal's Capital Account			35,000
To Chander's Capital Account			35,000
(Sagar's share of goodwill credited to old partners' capital accounts in the ratio of sacrifice which is 1: 1)			
Memorandum Revaluation A/c	Dr.	36,400	
To Bansal's Capital Account			18,200
To Chander's Capital Account			18,200
(Profit on revaluation credited to the old partners in the old ratio)			
Bansal's Capital Account	Dr.	13,650	
Chander's Capital Account	Dr.	13,650	
Sagar's Capital Account	Dr.	9,100	
To Memorandum Revaluation Account			36,400
(Memorandum Revaluation Account closed by debiting all the partners in the new profit sharing ratio)			

Dr. **Memorandum Revaluation Account** *Cr.*

Particulars		₹	*Particulars*	₹
To Provision for Doubtful Debts		7,000	By Buildings	56,000
To Stock		16,800	By Sundry Creditors	14,000
To Furniture		2,800		
To Provision for Bills Discounted		7,000		
To Profit transferred to :	₹			
Bansal ½	18,200			
Chander ½	18,200	36,400		
		70,000		70,000
To Buildings		56,000	By Provision for Doubtful Debts	7,000
To Sundry Creditors		14,000	By Stock	16,800
			By Furniture	2,800

Particulars	₹	*Particulars*	₹
		By Provision for Bills Discounted	7,000
		By Loss transferred to: ₹	
		Bansal (3/8) 13,650	
		Chander (3/8) 13,650	
	70,000	Sagar(1/4) or (2/8) 9,100	36,400
			70,000

Dr. **Capital Accounts** *Cr.*

Particulars	*Bansal (₹)*	*Chander (₹)*	*Sagar (₹)*	*Particulars*	*Bansal (₹)*	*Chander (₹)*	*Sagar (₹)*
To Bansal's Capital A/c	–	–	35,000	By Balance b/fd	2,10,000	1,68,000	–
To Chander's Capital A/c	–	–	35,000	By General Reserve	35,000	35,000	–
To Memorandum Revaluation A/c	13,650	13,650	9,100	By Bank	–	–	2,10,000
To Balance c/d	2,84,550	2,42,550	1,30,900	By Sagar's Capital A/c	35,000	35,000	–
				By Memorandum Revaluation A/c	18,200	18,200	–
	2,98,200	2,56,200	2,10,000		2,98,005	2,56,200	2,10,000
				By Balance b/d	2,84,550	2,42,550	1,30,900

Balance Sheet of Mr. Bansal, Chander and Sagar

as on 31st March, 2017

Liabilities	₹	*Assets*	₹
To Sundry Creditors	1,26,000	By Cash at Bank	2,24,000
To Capital Accounts: ₹		By Debtors	1,40,000
Bansal 2,84,550		By Stock	1,68,000
Chander 2,42,550		By Furniture	28,000
Sagar 1,30,900	6,58,000	By Buildings	2,24,000
	7,84,000		7,84,000

RETIREMENT OF A PARTNER

According to Section 32(1) of the Indian Partnership Act, a partner may retire:

(a) with the consent of all the partners;

(b) in accordance with an express agreement by the partners;

(c) where the partnership is at will, by giving notice in writing to all the other partners of his intention to retire.

Generally, the business of the partnership firm may not come to an end when one of the partners retires. Other partners continue to run the business of the firm. Just as a number of adjustments have to be made on the admission of a partner, a number of similar adjustments have to be made before a partner retires. These adjustments may be as regard to reserves and undistributed profits, revaluation of assets and liabilities, profits sharing ratio, goodwill etc.

Calculation of New Profit Sharing Ratio on Retirement

Unless an intention to the contrary is expressed, the assumption should be made that on the retirement of a partner, the remaining partners continue to share profits and losses in the same relative ratio in which they were sharing profits and losses prior to retirement of the partner.

The absolute share of the remaining partners may increase but the ratio between the increased shares does not change because the increase itself is in that very ratio.

Example 1: A, B and C share profits and losses in the ratio of 7:4:3 respectively and B retires.

Now in the absence of an agreement to the contrary, A and C will continue to share profits and losses in the ratio of 7:3 respectively.

However, their absolute shares will go up. New shares will be: 7/10 and 3/10.

Previously, A and C got 7/14ths and 3/14ths of the profit respectively.

Example 2: If the remaining partners decide to distribute among themselves the share left by the retiring partner in a different ratio, the relative profit sharing ratio between the remaining partners will also change. Suppose, A and C agree that one half of B's share be added to A's share and the other half of B's share be added to C's share.

Then A's share will be $\frac{7}{14}+\left(\frac{1}{2}\times\frac{4}{14}\right)$ or $\frac{9}{14}$

and C's share will be $\frac{3}{14}+\left(\frac{1}{2}\times\frac{4}{14}\right)$ or $\frac{5}{14}$.

The new ratio between A and C will be 9:5 respectively.

Calculation of Ratio of Gain (Gaining Ratio)

On retirement of a partner, the shares of profit to other partners increase. In order to find ratio in which the remaining partners have gained, old shares should be deducted from the new shares of remaining partners.

Example: If A, B and C share profits and losses in the ratio of 7:5:3 respectively and after B's retirement A and C decide to share profits and losses in the ratio of 3:2 respectively, then the ratio of gain will be calculated as follows:

A's old share = $\frac{7}{15}$

A's new share = $\frac{3}{5}$

A's gain = $\frac{3}{5}-\frac{7}{15}=\frac{9-7}{15}=\frac{2}{15}$

C's old share = $\frac{3}{15}$

C's new share = $\frac{2}{5}$

C's gain = $\frac{2}{5}-\frac{3}{15}=\frac{6-3}{15}=\frac{3}{15}$

Hence, ratio of gain between A and C is 2:3 respectively.

Treatment of Reserves and Undistributed Profits on Retirement

Before a partner retires, reserves created out of profits or balances in profit and loss account must be transferred to the capital accounts of all the partners in the ratio in which they share profits and losses at the time of retirement (old ratio). It is done so that the retiring partner may get his share of accumulated profits and may contribute his share of the loss that has not been transferred to capital accounts so far.

The journal will be:

Reserve/Profit and Loss A/c	Dr.
To All Partners' Capital Accounts	
(Reserves/balance in profit and loss account transferred to the capital accounts of all the partners in old profit sharing ratio)	

Alternative Method: Only the share of the retiring partner is credited to his capital account for his share of profit.

Reserve/Profit and Loss A/c	Dr.
To Retiring Partner's Capital A/c	
(Retiring partner's share in reserve/balance in profit and loss account transferred to the capital account of retiring partner)	

Revaluation of Assets and Liabilities on Retirement of a Partner

Before a partner retires, all the assets and liabilities of the firm are revalued as in the case of admission of a partner. Any profit or loss resulting from such revaluation is transferred to all the partners' capital accounts in their profit sharing ratio. A Revaluation Account or Profit and Loss Adjustment Account is opened which is debited for all decrease in the book values of assets and all increases in liabilities and is credited for all increases in the values of assets and all decreases in liabilities. The balance is transferred to the capital accounts of all the partners.

If adjustments have to be made for profit or loss on revaluation without altering the values of assets and liabilities, a Memorandum Revaluation Account is opened. In this case, besides the entries required for recording the profit or loss on revaluation of assets and liabilities some additional entries are necessary. These additional entries are made by reversing the original entries. The profit or loss disclosed by the original entries is transferred to all partners' capital accounts in the old ratio, but the profit or loss disclosed by the reversed entries is transferred to remaining partners' capital accounts in the new ratio. Hence, revaluation account under this method is called memorandum revaluation account.

If there is a loss on revaluation, first all the partners' capital accounts are debited and Memorandum Revaluation Account is credited with the amount of such a loss. Then after retirement has taken place, Memorandum Revaluation Account is closed by transfer of the amount to the remaining partners' capital accounts in the new profit sharing ratio.

<u>Illustration 12:</u>

A, B and C are partners sharing profits and losses in the ratio of 3:2:1 and on the retirement of C, the various assets and liabilities are revalued as under:

	Book Value	*Revalued Value*
	₹	₹
Plant and machinery	*35,000*	*43,000*
Sundry creditors	*10,000*	*9,000*
Stock	*15,000*	*13,000*

Pass journal entries on revaluation of these assets and liabilities.

Solution:

Journal Entries

Particulars	*Dr. (₹)*	*Cr. (₹)*
Revaluation Account Dr. To Stock (Fall in value of stock debited to revaluation account)	2,000	 2,000
Plant and machinery A/c Dr. Sundry creditors Dr. To Revaluation A/c (Gain on revaluation of plant and machinery and sundry creditors credited to revaluation account)	8,000 1,000	 9,000
Revaluation Account Dr. To A's Capital A/c To B's Capital A/c To C's Capital A/c (Revaluation profit transferred to all partners in the old profit sharing ratio.)	7,000	 3,500 2,333 1,167

Treatment of Goodwill on Retirement

In case of retirement of a partner, goodwill is valued in the same manner in which it is valued in case of admission of a partner.

In this case, the continuing partners will gain in terms of profit sharing ratio. Hence, the continuing partners have to share the goodwill of the retiring partner in the gaining ratio. In this case, the retiring partner's capital account is credited with his share of goodwill and the continuing partners' capital accounts are debited with the amount in the gaining ratio.

Goodwill Account is not opened; only capital accounts of the partners may be debited and credited with the necessary amounts

REVIEW QUESTIONS

1. Mahesh, Ramesh and Dinesh were sharing profits and losses in the ratio of 3:2:1 respectively. On 31st March, 2016 Ramesh decides to retire. Mahesh agrees to purchase 1/3rd Ramesh's share while Dinesh purchases the balance of Ramesh's share. Find out the new profit sharing ratio between Mahesh and Dinesh.

2. P, Q and R, partners sharing profits and losses in the ratio of 7:4:3 respectively. On 31st March, 2016 Q retires and P and R decide to become equal partners. Goodwill of the firm is valued at ₹ 28,000. What adjustment will you make if no Goodwill Account is to be opened and none already exist. What will be the entry if Goodwill Account already appears at ₹ 21,000 and it is desired that Goodwill Account be allowed to show the same balance?

Capitals in Profit Sharing Ratio

After the retirement of a partner, the remaining partners may decide that their capitals be in their new profit sharing ratio. For this purpose, the total capital of the new firm may be fixed which will then be divided among the remaining partners in their new profit sharing ratio. Alternatively, the total of the balance of capital accounts of the remaining partners after all the adjustments in respect of retirement have been made may be considered to be the total capital of the firm which may then be reallocated to the different partners in their new profit sharing ratio. The adjustments in the capital accounts for this purpose may be made either by bringing in or payment of cash or through current accounts.

Computation of Retiring Partner's Interest in the Firm

The terms of the partnership agreement are to be observed while ascertaining the amount due to the retiring partner. Usually, following items are taken into consideration while calculating the total amount due to the retiring partner:

(a) Balance of the capital account of the retiring partner appearing in the ledger on the date of retirement;

(b) Share of undistributed reserve and profit (loss) in the firm;

(c) Share in firm's goodwill;

(d) Share in the profit and loss on the revaluation of assets and liabilities;

(e) Share of profit or loss in the current year till the date of retirement,

(f) Salary and interest on capital and drawing till the date of his retirement.

Payment of Retiring Partner's Interest

The amount due to the retiring partner can be paid as per the terms of the partnership agreement. In case the terms of the agreement are silent, the payment may be made as mutually agreed. The payment can be made by any of the following methods:

(i) ***Lump Sum Payment Method:*** If the firm has adequate funds, the amount due to the retired partner may be paid forthwith. His Capital Account will be debited and Bank will be credited.

(ii) ***Installment Payment Method:*** In order to avoid financial difficulties, a part or full payment due to the retired partner, may be deferred, In this case, the balance of his Capital Account will be transferred to his Loan Account which will be credited periodically with interest at the agreed rate on the outstanding balance and debited with payment on account until the balance is extinguished. The arrangement of installments may take the following two forms.

   (a) ***Decreasing Payment Method:*** In this method, the total amount due is divided in a number of equal installments and the installment amount plus interest on the outstanding balance is paid out.

   (b) ***Equal Payment Method:*** In this method, the total amount to be paid is divided in a number of equal installments in such a way that the amount after including interest on the outstanding balance is always equal.

Example: On 31st March, 2014 D retired from a partnership firm leaving ₹ 15,000 in the firm as a loan to be repaid in three annual installments of ₹ 5,000 each plus interest at 8%p.a. on outstanding balances. Show D's Loan Account

Solution:

D's Loan Account

Dr. *Cr.*

Date	*Particulars*	₹	*Date*	*Particulars*	₹
2014			*2014*		
Mar.31	To Balance c/d	15,000	Mar.31	By D's Capital A/c	15,000
2015			2014		
Mar. 31	To Bank	6,200	Apr. 1	By Balance b/d	15,000

Mar. 31	To Balance c/d	10,000	2015		
			Mar. 31	By Interest @ 8% on ₹ 15,000	1,200
		16,200			16,200
2016			2015		
Mar. 31	To Bank	5,800	Apr.1	By Balance b/d	10,000
Mar. 31	To Balance c/d	5,000	2016		
			Mar.31	By Interest @ 8%	800
		10,800			10,800
2017			2016		
Mar. 31	To Bank	5,400	Apr.1	By Balance b/d	5,000
			2017		
			Mar. 31	By Interest @ 8% on ₹ 5,000	400
		5,400			5,400

Purchase of Retiring Partner's Share by Remaining Partners

The retiring partner's share may be purchased by the remaining partners in an agreed ratio. In such a case, retiring partner's capital account is closed by transfer to the remaining partners' capital accounts in the ratio in which they agree to purchase his share. When the remaining partners purchase the retiring partner's share, the retiring partner has to look to the remaining partners' in individual capacities for the satisfaction of his claim; the new firm as such will not be responsible.

Note: In the examination, if the question states that the remaining partners purchase the retiring partner's share but does not specify the proportion in which they purchase his share, the candidate should assume that it is done in the relative profit sharing ratio between the remaining partners; and if the new profit sharing ratio is given, the purchase should be taken to be in the ratio of gain.

Illustration 13:

On 31st March, 2016 the following was the balance sheet of A, B and C who were equal partners:

Liabilities	*₹*	*Assets*		*₹*
Sundry Creditors	*89,400*	*Cash in hand*		*1,800*
General Reserves	*1,50,000*	*Cash at Bank*		*39,700*
A's Capital Account	*2,40,000*	*Investments*		*50,000*
B's Capital Account	*1,90,000*	*Debtors*	*2,10,000*	
C's Capital Account	*1,75,000*	*Less:*		
		Provision for Bad debts	*(2,200)*	*2,07,800*
		Stock		*3,70,100*
		Furniture and Fittings		*1,75,000*
	8,44,400			*8,44,400*

On that date, A decided to retire due to ill health and the following adjustments were agreed upon by the partners:

– Investments be appreciated by ₹ 15,000

- *Provision for bad debts be brought upto 5% of debtors.*
- *Furniture be depreciated by 10%*
- *Stock be depreciated by ₹ 7,200*

A was paid the amount due to him by means of cheque, the bank agreed to allow the necessary overdraft. Pass journal entries to record the above mentioned transactions and show the balance sheet of the firm immediately after A's retirement.

Solution:

JOURNAL ENTRIES

Particulars		*Dr.(₹)*	*Cr.(₹)*
General Reserve	Dr.	1,50,000	
To A's Capital Account			50,000
To B's Capital Account			50,000
To C's Capital Account			50,000
(Transfer to general reserve to capital accounts)			
Investments	Dr.	15,000	
To Revaluation Account			15,000
(Increase in the value of investments)			
Revaluation Account	Dr.	33,000	
To Provision for Bad Debts			8,300
To Furniture			17,500
To Stock			7,200
(Various adjustments as agreed upon by partners)			
A's Capital Account	Dr.	6,000	
B's Capital Account	Dr.	6,000	
C's Capital Account	Dr.	6,000	
To Revaluation Account			18,000
(Transfer of loss on revaluation to partners' capital account)			
A's Capital Account	Dr.	2,84,000	
To Bank			2,84,000
(Payment of the amount due to A on his retirement)			

Balance Sheet of B and C as on 1st April, 2016

Liabilities	₹	*Assets*		₹
Bank Overdraft	2,44,300	Cash in Hand		1,800
Sundry Creditors	89,400	Investment	₹	65,000
B's Capital Account	2,34,000	Debtors	2,10,000	
C's Capital Account	2,19,000	*Less:*		
		Provision for Bad Debts	10,500	1,99,500
		Stock		3,62,900
		Furniture and Fittings		1,57,500
	7,86,700			7,86,700

Alternative Method:

If the values of assets and liabilities were not being changed, the following would have been the journal entries:

JOURNAL ENTRIES

Particulars		*Dr.(₹)*	*Cr.(₹)*
General Reserve	Dr.	1,50,000	
To A's Capital Account			50,000
To B's Capital Account			50,000
To C's Capital Account			50,000
(Transfer of general reserve to capital accounts)			
A's Capital Account	Dr.	6,000	
B's Capital Account	Dr.	6,000	
C's Capital Account	Dr.	6,000	
To Memorandum Revaluation Account			18,000
(Transfer of loss on revaluation to all the partners' capital accounts)			
A's Capital Account	Dr.	2,84,000	
To Bank			2,84,000
(Payment to A on his retirement)			
Memorandum Revaluation Account	Dr.	18,000	
To B's Capital Account			9,000
To C's Capital Account			9,000
(Transfer to memorandum revaluation account to remaining partners' capital accounts in new profit sharing ratio)			

Balance Sheet of B and C as on 1st April, 2016

Liabilities	₹	*Assets*		₹
Bank Overdraft	2,44,300	Cash in Hand		1,800
Sundry Creditors	89,400	Investments	₹	50,000
B's Capital Account	2,43,000	Debtors	2,10,000	
C's Capital Account	2,28,000	*Less:* Provision for		
		Bad Debts	2,200	2,07,800
		Stock		3,70,100
		Furniture and Fittings		1,75,000
	8,04,700			8,04,700

Illustration 14:

Following is the balance sheet of A, B and C who share profits and losses in the ratio of 7:5:3 respectively.

Balance Sheet of A, B and C as on 31st March, 2016

Liabilities	*₹*	*Assets*	*₹*
Sundry Creditors	*15,400*	*Furniture and Fittings*	*12,000*
Capital Accounts:		*Sundry Debtors*	*16,000*
A	*40,000*	*Stock*	*44,000*
B	*25,000*	*Cash at Bank*	*18,400*
C	*10,000*		
	90,400		*90,400*

On 31st March, 2016 C retires on the condition that he be immediately paid the amount due to him after making adjustment for goodwill which is valued at ₹22,500. A and B agree to share profits and losses in the ratio of 8:7 respectively in future.

Show journal entries and balance sheet in each of the following cases:

(a) Goodwill Account is raised only with C's share of goodwill.

(b) No Goodwill account is raised but adjustments are made in the capital accounts with retiring partner's share of goodwill.

(c) A and B pay privately to C for goodwill.

Solution:

Case (i)

Journal Entries

Particulars		*Dr. (₹)*	*Cr. (₹)*
Goodwill Account	Dr.	4,500	
To C's Capital Account			4,500
(Credit given to C for his share of goodwill)			
C's Capital Account	Dr.	14,500	
To Bank			14,500
(Payment to C)			
A's Capital Account	Dr.	1,500	
B's Capital Account	Dr.	3,000	
To Goodwill Account			4,500
(Transfer of Goodwill Account to the remaining partners in the ratio of gain which turns out to be 1:2)*			

*The ratio of gain in this case has been calculated as under:

A's old share $= \frac{7}{15}$

A's new shares $= \frac{8}{15}$

A's gain = $\frac{8}{15} - \frac{7}{15} = \frac{1}{15}$

B's old share = $\frac{5}{15}$

B's new share = $\frac{7}{15}$

B's gain = $\frac{7}{15} - \frac{5}{15} = \frac{2}{15}$

Hence ratio of gain between A and B is 1:2

Balance Sheet of A and B as on 1st April, 2016

Liabilities	₹	*Assets*	₹
Sundry Creditors	15,400	Furniture and Fittings	12,000
A's Capital Account	38,500	Sundry Debtors	16,000
B's Capital Account	22,000	Stock	44,000
		Cash at Bank	3,900
	75,900		75,900

Case (ii)

Journal Entries

Particulars		*Dr. (₹)*	*Cr. (₹)*
A's Capital Account	Dr.	1,500	
B's Capital Account	Dr.	3,000	
To C's Capital Account			4,500
(Retiring partner being credited with his share of goodwill which is debited to remaining partners in the ratio of gain 1:2)			
C's Capital Account	Dr.	14,500	
To Bank			14,500
(Payment to C)			

Balance Sheet will be the same as in cases (i).

Case (iii)

Journal Entries

C's Capital Account	Dr.	10,000	
To Bank			10,000
(Payment to C)			

Balance Sheet of A and B as on 1st April, 2016

Liabilities	₹	*Assets*	₹
Sundry Creditors	15,400	Furniture and Fittings	12,000
A's Capital Account	40,000	Sundry Debtors	16,000
B's Capital Account	25,000	Stock	44,000
		Cash at Bank	8,400
	80,400		80,400

Illustration 15:

The balance sheet of Anil, Bashin and Chaman who were sharing profits in proportion to their capitals stood as follows on 31st March, 2016.

Liabilities	₹	*Assets*	₹	₹
Sundry Creditors	*69,000*	*Cash in Bank*		*55,000*
General Reserve	*1,80,000*	*Sundry Debtors*	*50,000*	
Capital Accounts:		*Less : Provision for Bad Debts*	*(1,000)*	*49,000*
Anil	*2,00,000*	*Stock*		*2,60,000*
Bashin	*1,50,000*	*Plant and Machinery*		*1,35,000*
Chaman	*1,00,000*	*Land and Buildings*		*2,00,000*
	6,99,000			*6,99,000*

Bashin retired on the above date and the following was agreed upon:

- *That the provision for bad debts be brought upto 5% on debtors.*
- *That land and buildings be appreciated by 25%.*
- *That a provision of ₹ 3,500 be made in respect of outstanding legal charges.*
- *That the goodwill of the entire firm be fixed at ₹ 1,08,000 and Bashin's share of it be adjusted into the accounts of Anil and Chaman who are going to share future profits in the ratio of 5:3 respectively.*
- *That the entire capital of the new firm be fixed at ₹ 4,80,000 and the capital accounts of the partners be made in their new profit sharing ratio; actual cash to be brought in or paid off as the need be.*

Pass journal entries, show profit and loss adjustment account and capital accounts and prepare balance sheet of Anil and Chaman.

Solution:

Journal Entries

Particulars		₹	₹
General Reserve	Dr.	1,80,000	
To Anil's Capital Account			80,000
To Bashin's Capital Account			60,000
To Chaman's Capital Account			40,000
(Transfer of general reserve to capital accounts)			
Profit and Loss Adjustment Account	Dr.	5,000	
To Provision for Bad Debts			1,500
To Outstanding Legal Expenses			3,500
(Increase in provision for bad debts and record of outstanding legal expenses)			
Land and Building	Dr.	50,000	
To Profit and Loss Adjustment Account			50,000
(Appreciation in the value of land and buildings)			

Particulars		₹	₹
Profit and Loss Adjustment Account	Dr.	45,000	
To Anil's Capital Account			20,000
To Bashin's Capital Account			15,000
To Chaman's Capital Account			10,000
(Transfer of profit on revaluation)			
Anil's Capital Account	Dr.	19,500	
Chaman's Capital Account	Dr.	16,500	
To Bashin's Capital Account			36,000
(Bashin's share of goodwill debited to Anil and Chaman in ratio of gain which is 13:11 respectively)			
Bashin's Capital Account	Dr.	2,61,000	
To Bashin's Loan Account			2,61,000
(Transfer of Bashin's Capital Account to his Loan Account)			
Bank	Dr.	66,000	
To Anil's Capital Account			19,500
To Chaman's Capital Account			46,500
(Cash brought in by Anil and Chaman)			

Dr. **Profit and Loss Adjustment Account** *Cr.*

Particulars	₹	*Particulars*	₹
To Provision for Bad Debts A/c	1,500	By Land and Buildings	50,000
To Outstanding Legal Expenses A/c	3,500		
To Anil's Capital A/c (4/9 profit)	20,000		
To Bashin's Capital A/c (3/9 profit)	15,000		
To Chaman's Capital A/c (2/9 profit)	10,000		
	50,000		50,000

Dr. **Capital Accounts** *Cr.*

Particulars	*Anil (₹)*	*Bashin (₹)*	*Chaman (₹)*	*Particulars*	*Anil (₹)*	*Bashin (₹)*	*Chaman (₹)*
To Bashin's Capital A/c	19,500		16,500	By Balance b/d	2,00,000	1,50,000	1,00,000
To Bashin's Loan A/c		2,61,000		By General Reserve	80,000	60,000	40,000
To Balance c/d	3,00,000		1,80,000	By P & L Adjustment A/c	20,000	15,000	10,000
				By Anil's Capital	–	19,500	–
				By Chaman's Capital	–	16,500	–
				By Bank	19,500		46,500
	3,19,500	2,61,000	1,96,500		3,19,500	2,61,000	1,96,500
				By Balance b/d	3,00,000	–	1,80,000

Balances Sheet of Anil and Chaman
as on 1st April, 2016

Liabilities		₹	*Assets*	₹	₹
Sundry Creditors		69,000	Cash in Bank		1,21,000
Outstanding Legal Expenses		3,500	Sundry Debtors	50,000	
Bashin's Loan Account		2,61,000	*Less:* Provision		
			for Bad Debts	2,500	47,500
Capital Accounts:	₹				
Anil	3,00,000		Stock		2,60,000
Chaman	1,80,000	4,80,000	Plant and Machinery		1,35,000
			Land and Buildings		2,50,000
		8,13,500			8,13,500

Working Notes:

Anil's gain in profit $= \frac{5}{8} - \frac{4}{9} = \frac{45-32}{72} = \frac{13}{72}$

Chaman's gain in profit $= \frac{3}{8} - \frac{2}{9} = \frac{27-16}{72} = \frac{11}{72}$

Ratio of Gain = 13:11

Bashin's share of goodwill = ₹$1,08,000 \text{x} \frac{3}{9}$ or ₹36,000

Anil's will be debited with ₹ $36,000 \times \frac{13}{24}$ or ₹ 19,500 and

Chaman will be debited with ₹ $36,000 \times \frac{11}{24}$ or ₹ 16,500 for goodwill.

Illustration 16:

On 31st March, 2016 the balance sheet of M/s. Ashok, Basu, and Chauhan, who were sharing profits and losses in proportion to their capitals, stood as follows:

Liabilities		₹	*Assets*	₹
Capital Accounts:			*Land and Buildings*	*2,00,000*
Ashok	*3,00,000*		*Machinery*	*2,00,000*
Basu	*2,00,000*		*Closing Stock*	*1,00,000*
Chauhan	*1,00,000*	*6,00,000*	*Sundry Debtors*	*2,00,000*
Sundry Creditors		*2,00,000*	*Cash and Bank Balances*	*1,00,000*
		8,00,000		*8,00,000*

On 31st March, 2016, Ashok desired to retire from the firm and the remaining partners decided to carry on. They agreed on the following terms and conditions:

(i) Land and buildings be appreciated by 30%

(ii) Machinery be depreciated by 20%

(iii) Closing stock to be valued at ₹ 80,000.

(iv) Provision for bad debts be made at 5%.

(v) Old credit balances of sundry creditors amounting to ₹ 10,000 be written back.

(vi) Joint Life Policy of the partners be surrendered. Cash received was ₹ 60,000.

(vii) Goodwill of the entire firm be valued at ₹ 1,80,000 and Ashok's share of the goodwill be adjusted in the accounts Basu and Chauhan who would share the future profits equally.

(viii) The total capital of the firm was to be the same as before retirement. Individual capitals of partners were to be in their profit sharing ratio.

(ix) Amount due to Ashok was to be settled on the following basis:

50% on retirement and balance 50% within one year.

Prepare Revaluation Account, Capital Accounts of the Partners, Loan Account of Ashok, Cash Book and Balance Sheet as on 1st April 2016 of M/s. Basu and Chauhan.

Solution:

Dr. **Revaluation Account** *Cr.*

Particulars		₹	*Particulars*	₹
To Machinery A/c		40,000	By Land and Building	60,000
To Closing Stock		20,000	By Sundry Creditors	10,000
To Provision for Bad Debts A/c		10,000	By Bank A/c (Joint Life Policy)	60,000
To Capital Accounts:				
Ashok	30,000			
Basu	20,000			
Chauhan	10,000	60,000		
		1,30,000		1,30,000

Dr. **Capital Accounts** *Cr.*

Particulars	*Basu* ₹	*Chauhan* ₹	*Particulars*	*Basu* ₹	*Chauhan* ₹
To Ashok Capital A/c (Goodwill)	30,000	60,000	By Balance b/fd	2,00,000	1,00,000
To Balance c/d	3,00,000	3,00,000	By Revaluation A/c	20,000	10,000
			By Bank (Additional capital)	1,10,000	2,50,000
	3,30,000	3,60,000		3,30,000	3,60,000
			By Balance b/d	3,00,000	3,00,000

Dr. **Ashok's Capital Account** Cr.

Particulars	₹	Particulars	₹
To Bank	2,10,000	By Balance b/d	3,00,000
To Ashok' Loan A/c	2,10,000	By Revaluation A/c	30,000
		By Basu's Capital A/c (Goodwill)	30,000
		By Chauhan's Capital A/c (Goodwill)	60,000
	4,20,000		4,20,000

Dr. **Ashok's Loan Account** Cr.

Particulars	₹	Particulars	₹
To Balance c/d	2,10,000	By Ashok's Capital A/c	2,10,000
		By Balance b/d	2,10,000

Dr. **Cash Book** Cr.

Particulars	₹	Particulars	₹
To Balance b/fd	1,00,000	By A's Capital A/c	2,10,000
To Revaluation A/c (J.L. Policy surrendered)	60,000	By Balance c/d	3,10,000
To Basu's Capital A/c	1,10,000		
To Chauhan's Capital A/c	2,50,000		
	5,20,000		5,20,000
To Balance b/d	3,10,000		

M/s. B and C
Balance Sheet as on 1.4.2016

Liabilities	₹	₹	*Assets*		₹
Capital Accounts:			Land and Building		2,60,000
Basu	3,00,000		Machinery		1,60,000
Chauhan	3,00,000	6,00,000	Closing Stock		80,000
A's Loan		2,10,000	Sundry Debtors	2,00,000	
Sundry Creditors		1,90,000	*Less:* Provisions for Bad Debts	10,000	1,90,000
			Cash and Bank Balances		3,10,000
		10,00,000			10,00,000

Working Notes:

(1) Calculation of ratio of gain of remaining partners.

Ratio of gain	=	New ratio – Old ratio	
Basu	=	1/2 – 1/3 = 1/6	
Chauhan	=	1/2 – 1/6 = 2/6	
Ratio of gain	=	1:2.	

(2) Goodwill borne by Basu and Chauhan:

Total goodwill of the firm	=	₹ 1,80,000	
Ashok's share	=	1/2 x ₹ 1,80,000 = ₹ 90,000	

Ashok's share to be borne by Basu and Chauhan in their ratio of gain.

Basu	=	1/3 x ₹ 90,000	= ₹ 30,000
Chauhan	=	2/3 x ₹ 90,000	= ₹ 60,000

DEATH OF A PARTNER

All the problems which arise on the retirement of a partner also arise in case of the death of a partner. However, there are a few additional points which have to be noted.

If the balance of deceased partner's capital account is not immediately paid in cash, the amount should be transferred to the deceased partner's Executors Account and not to any Loan Account.

A partner usually retires at the close of an accounting year when his capital account is credited with his share of profits for the year. But a partner's death may take place any day. Partnership deed may provide that in case of death of a partner during the accounting year, the deceased partner's capital account will be credited with his share of profits for the period for which he remained alive during the year on the basis of profits of the year preceding the year in which death takes place. Suppose, a partner C getting 1/3 share in profits died on 30 June 2016 and the profits for the year ended 31st March, 2016 have been ₹ 18,000. Then C's Capital Account will be credited with ₹ 1500 (₹ $18{,}000 \times \frac{3}{12} \times \frac{1}{3}$ = ₹ 1,500) for his share of profits for 3 months. Of course, some other basis may also be provided for, or the partnership deed may provide that final accounts will be prepared to ascertain profits for the part of the year.

Joint Life Policy

Partners often take out a joint life policy to provide funds for settling the claim of the deceased partner. Annual premium is paid by the firm and on the death of a partner, the amount of the policy is received by the firm from the insurance company.

It is possible to treat a joint life policy in anyone of the following three ways in the books of account.

1. When premium paid is treated as an expense

Under this method, the annual premium is treated as an expense and debited to the Profit and Loss Account. On the death of a partner, the amount of the policy received by the firm is credited to all the partners' capital accounts in the profit sharing ratio.

JOURNAL ENTRIES

(i) For payment of premium of the joint life policy

(a) Joint Life Insurance Premium A/c Dr.

To Bank

(Amount of premium paid on joint life policy)

	(b) Profit and Loss A/c	Dr.
	To Joint Life Insurance Premium A/c.	
	(The amount of premium charged to Profit and Loss A/c)	
(ii)	**For Receipt of the Policy Money**	
	Bank	Dr.
	To All Partners' Capital Accounts	
	(The policy money distributed among all partners in the profit sharing ratio)	

2. When premium paid is treated as an asset and surrender value is taken into account

Under this method, Joint Life Policy Account is debited with the amount of premium as and when paid. At the end of the year, the amount in excess of surrender value is treated as loss and transferred to Profit and Loss Account. The balance in Joint Life Policy Account is shown as an asset in the balance sheet. The amount received on maturity of policy in excess of surrender value will be net gain and divided among all the partners in their profit sharing ratio.

JOURNAL ENTRIES

(i)	Joint Life Policy A/c	Dr.
	To Bank	
	(The premium paid on policy)	
(ii)	Profit and Loss A/c	Dr.
	To Joint Life Policy A/c	
	(The adjustment of book value with the surrender value i.e. excess of joint life policy over the surrender value)	
(iii)	Bank	Dr.
	To Joint Life Policy A/c	
	(Amount received on maturity of policy)	
(iv)	Joint Life Policy A/c	Dr.
	To All Partners' Capital Accounts	
	(The amount received minus the surrender value on that date distributed among the partners.)	

3. When premium paid is treated as an asset and life policy reserve account is maintained.

Under this method, whenever premium is paid, the amount of the premium is debited to Joint Life Policy Account. At the end of the year, Profit and Loss account is debited and Joint Life Policy Reserve Account is credited with the amount of the premium paid for the year. Then, in order to reduce the balances of Joint Life Policy Account and Joint Life Policy Reserve Account to the figure of surrender value of the policy, Joint Life Policy Reserve Account is debited and Joint Life Policy Account is credited with the difference between balance of Joint Life Policy Account and surrender value of the policy. The entries are repeated every year. On maturity of the policy, the amount received from the insurance company is credited to Joint Life Policy Account, Joint Life Policy Reserve Account is transferred to Joint Life Policy Account and the balance in Join Life Policy Account is transferred to all the partners' capital accounts in their profit sharing ratio. The amount standing to the credit of Joint Life Policy Reserve Account may alternatively be transferred directly to partners' capital accounts in their profit sharing ratio.

JOURNAL ENTRIES

(i) For payment of premium of the Joint Life Policy

Joint Life Policy A/c Dr.

To Bank

(The amount of premium paid on Joint Life Policy)

(ii) For appropriation of amount equal to annual premium

Profit and Loss A/c Dr.

To Joint Life Policy Reserve A/c

(The amount transferred to Joint Life Policy Reserve Account)

(iii) For adjusting the difference between the premium paid and the increase in the surrender value

Joint Life Policy Reserve A/c Dr.

To Joint Life Policy A/c

(Excess of premium over surrender value adjusted)

(iv) For receipt of the policy money

(a) Bank Dr.

To Joint Life Policy A/c

(The amount received of joint life policy on maturity)

(b) Joint Life Policy Reserve A/c Dr.

To Joint Life Policy A/c

(The credit balance of joint life policy reserve account transferred to Joint Life Policy A/c)

(c) Joint Life Policy A/c Dr.

To All Partners' Capital Accounts

(Balance joint life policy transferred to capital accounts in the old profit sharing ratio of all the partners)

4. Individual policies on the life of each partner

If instead of one joint life policy, a number of individual policies are taken, on the death of a partner, the amount of the policy of the life of the deceased partner will be received in cash. The other policies will be shown at their respective surrender values while ascertaining the amount due to the executors of the deceased partner.

Repayment of the Amount due to Deceased Partner

On death of a partner, the amount due to his legal representatives will have to be paid. It may not be possible to pay the whole amount in a lump sum. As a rule, the payment is made according to the terms of partnership agreement. The various courses available are –

(a) Repayment in installments over a period of time and interest being paid on outstanding balances.

(b) The amount due may be treated as a loan to the firm. The firm may pay interest at an agreed rate or a share of profit of the firm.

(c) An annuity may be paid to the heirs of deceased partner.

Illustration 17:

A, B and C are partners in a firm sharing profits and losses in the ratio of 5:4:3 respectively. The firm had insured the partners' lives severally, A's life for ₹ 20,000, B's life for ₹ 16,000 and C's life for ₹ 14,000. The premiums were charged to the firm's profit and loss account. B died on 1.4.2016. The surrender values of these policies were 20% of the policy amount. Calculate B's share in policies.

Solution:

Claim on B's policy	₹ 16,000
Surrender value of A's and C's Life policies (20%)	
(₹ 4,000 + ₹2,800)	₹ 6,800
	₹ 22,800
B's Share =₹ $22{,}800 \times \frac{4}{12}$	₹ 7,600

Illustration 18:

A, B and C are partners sharing profits in the ratio of 2:1:1 respectively. On 30th June, 2016 their balance sheet was as follows:

Liabilities	₹	*Assets*	₹
Creditors	*40,000*	*Goodwill*	*30,000*
Bills Payable	*20,000*	*Freehold Property*	*1,00,000*
Capitals:		*Joint Life Policy*	*20,000*
A	*1,00,000*	*Stock*	*55,000*
B	*60,000*	*Debtors*	*45,000*
C	*40,000*	*Cash*	*10,000*
	2,60,000		*2,60,000*

A died on July 1, 2016. The firm had taken a joint life policy for ₹ 1,50,000, the payment for which was received on July 31, 2016. According to the partnership agreement, on retirement or death of a partner, the goodwill was to be valued at 1-1/2 times the average profit of the last four years. The profits for the last four years were ₹ 60,000, ₹ 75,000, ₹ 90,000 and ₹ 95,000 respectively. For paying the amount due to A's legal representative, B and C brought as much cash as would bring their capitals in profit-sharing ratio and the firm would have cash in hand ₹ 30,000. Calculate goodwill, prepare partners' capital accounts and the balance sheet.

Solution:

Calculation of goodwill

Average profit for four years = $\frac{60{,}000 \times 75{,}000 \times 90{,}000 \times 95{,}000}{4}$ = ₹ 80,000

Goodwill at $1\frac{1}{2}$ times=80,000×$1\frac{1}{2}$	₹1,20,000
Less: Existing goodwill	₹ 30,000
Increase in the value of goodwill	₹ 90,000

Calculation of gain in joint life policy

Sum received from insurance company	1,50,000
Less: Joint life policy amount	20,000
Net gain to be distributed amongst the partners	1,30,000

Dr. **Partners' Capital Accounts** *Cr.*

Particulars	*A* (₹)	*B* (₹)	*C* (₹)	*Particulars*	*A* (₹)	*B* (₹)	*C* (₹)
To Cash A/c	2,10,000	–	–	By Balance b/fd	1,00,000	60,000	40,000
To A's Capital A/c	–	22,500	22,500	By B's Capital	22,500	–	–
To Balance c/d	–	1,00,000	1,00,000	By C's Capital	22,500	–	–
				By Joint Life Policy A/c	65,000	32,500	32,500
				By Cash	–	30,000	50,000
	2,10,000	1,22,500	1,22,500		2,10,000	1,22,500	1,22,500

Calculation of cash brought in by B and C:

	₹	₹
Amount payable to A's legal representatives		2.10,000
Add: Desired cash in hand		30,000
Amount required		2,40,000
Less: Amount received from Insurance company	1,50,000	
Existing balance of cash in hand	10,000	1,60,000
Shortage of cash to be brought in By B and C		80,000
B's capital after adjustment of Goodwill and Life Policy		70,000
C's capital after adjustment of Goodwill and Life Policy		50,000
Shortage of cash to be brought in		80,000
Total capital of B and C after A's death		2,00,000
Share of B being 1/2th of ₹ 2,00,000	1,00,000	
Less: Already in the business	70,000	
Cash to be introduced by B	30,000	
Share of C being 1/2 of ₹ 2,00,000	1,00,000	
Less: Already in the business	50,000	
Cash to be introduced by C	50,000	

Balance Sheet of B and C

Liabilities	₹	₹	*Assets*	₹
Creditors		40,000	Goodwill	30,000
Bills Payable		20,000	Freehold Property	1,00,000
Capitals:			Stock	55,000
B	1,00,000		Debtors	45,000
C	1,00,000	2,00,000	Cash	30,000
		2,60,000		2,60,000

Illustration 19:

On 31st March, 2016 the balance sheet of Sen, Sil and Som who shared profits and losses in the ratio of 4:3:2 respectively stood as follows:

Liabilities	₹	*Assets*	₹
Sundry Creditors	*20,600*	*Furniture and Fittings*	*12,000*
Joint Life Policy Reserve	*6,000*	*Joint Life Policy*	
Capital Accounts:		*(Policy for ₹ 18,500)*	*10,000*
Sen	*10,000*	*Sundry Debtors*	*17,500*
Sil	*30,000*	*Stock*	*30,500*
Som	*10,500*	*Cash at Bank*	*7,100*
	77,100		*77,100*

On 30th June, 2016 Sen died. According to partnership deed, at the time of death, goodwill of the firm was to be valued at 2 years' purchase of average profits of the last three years and deceased partner's capital account was to be credited with the share of profits for the period he lived in the year of death on the basis of profit of immediately previous year.

Find out the amount due to Sen's executors on 30th June, 2016. Profits for the past three years have been as follows:

For the year ended 31st March, 2016	₹ 36,000
For the year ended 31st March, 2015	₹ 30,000
For the year ended 31st March, 2014	₹ 25,800

Solution:

Total profits for the past three years = ₹ 36,000 + ₹ 30,000 + ₹ 25,800

= ₹ 91,800

2 years' purchases of average profit $= ₹\ \frac{91{,}800}{3} \times 2 = ₹\ 61{,}200$

Total Goodwill = 61,200

Sen's share $= ₹\ 61{,}200 \times \frac{4}{9} = ₹\ 27{,}200$

Sen's share of profits for 3 months on the basis of profit for the year ended 31st March, 2016

$$= ₹\ 36{,}000 \times \frac{4}{9} \times \frac{1}{4} = ₹\ 4{,}000$$

Sen's share in policy $= ₹\ (18{,}500 + 6{,}000 - 10{,}000) \times \frac{4}{9} = ₹\ 6{,}444$

Total amount due to Sen's executors = ₹ 10,000 + ₹ 27,200 + ₹ 4,000 + ₹ 6,444 = ₹ 47,644.

Illustration 20:

Following is the balance sheet of A, B and C as at 1st April, 2016:

Liabilities	₹	*Assets*	₹
Sundry Creditors	*20,000*	*Goodwill*	*40,000*
Reserve fund	*32,000*	*Plant and Machinery*	*60,000*
Capital Accounts:		*Stock*	*40,000*
A	*1,00,000*	*Sundry Debtors*	*60,000*
B	*50,000*	*Cash at Bank*	*50,000*
C	*50,000*	*Cash in Hand*	*2,000*
	2,52,000		*2,52,000*

C died on 30th June, 2016. Under the terms of partnership deed, the executors of a deceased partner were entitled to –

(a) Amount standing to the credit of partner's capital account;

(b) Interest on capital balance at 15% per annum;

(c) Share or goodwill on the basis of twice the average of the past three years' profit; and

(d) Share of profit from the closing of the last financial year to the date of death on the basis of the average of three completed year profits before the death.

Profits for the years ended 31st March, 2014, 2015 and 2016 were ₹ 60,000, ₹ 70,000 and ₹ 80,000 respectively. Profits were shared in the ratio of capitals.

Pass the necessary journal entries and draw up C's Capital Account to be rendered to his executors.

Solution:

Journal Entries

Particulars		*Dr. (₹)*	*Cr. (₹)*
Reserve Fund	Dr.	8,000	
To C's Capital A/c			8,000
(Reserve fund transferred to capital account)			
Interest on Capital A/c	Dr.	1,875	
To C's Capital A/c			1,875
(Interest @ 15% credited to C's Capital Account)			
A's Capital A/c	Dr.	16,667	
B's Capital A/c	Dr.	8,333	
To C's Capital A/c			25,000
(Share of goodwill due to C, debited to the capital accounts of existing partners)			
Profit and Loss A/c	Dr.	4,375	
To C's Capital A/c			4,375
(Share of profit till 30th June, 2016 based on the average profit of the preceding three years credited to C's Capital Account)			

Dr. **C's Capital Account** *Cr.*

Particulars	₹	*Particulars*	₹
To C's Executors	89,250	By Balance b/fd	50,000
		By Reserve fund	8,000
		By Interest on Capital	1,875
		By A's Capital A/c	16,667
		By B's Capital A/c	8,333
		By Profit and Loss A/c	4,375
	89,250		89,250

Working Notes

(i) Calculation of Goodwill

Total profit of three years = ₹ 2,10,000

Average Profit = ₹ 2,10,000 ÷ 3 = ₹ 70,000

Goodwill = ₹ 70,000 × 2 = ₹ 1,40,000

Existing Goodwill = ₹ 40,000

Goodwill to be increased by ₹ 1,00,000

C's Share = ₹ 1,00,000 ÷ 4 = ₹ 25,000

(ii) Calculation of C's Share of Profit

Average Profit = ₹ 70,000

C's Share for 3 months = ₹ $70{,}000 \times \frac{1}{4} \times \frac{3}{12}$ = ₹ 4,375

DISSOLUTION OF PARTNERSHIP

Dissolution of a firm means that the business of the firm is put to an end, assets are disposed of, liabilities are paid off, and the accounts of all the partners are also settled. Dissolution of a firm differs from dissolution of a partnership. A partnership is dissolved on the expiry of the term or on the completion of the specified venture, death, retirement or insolvency of a partner. However if the remaining partners decide to continue to run the business, the partnership firm is not dissolved. If they do not continue, then the firm is also dissolved automatically. Thus, there is difference between dissolution of partnership and dissolution of firm which may be summarized as under:

– In case of dissolution of firm, the firm ceases to continue its business i.e. the business comes to an end. But in the case of dissolution of partnership, the business of the firm is continued.

– In dissolution of firm, the partnership among all the partners no longer exists while in case of dissolution of partnership, the partnership among all the partners does not come to an end.

– Dissolution of partnership does not necessarily mean dissolution of firm whereas dissolution of firm necessarily implies dissolution of partnership.

A firm is dissolved when:

– the partners of the firm decide to dissolve it,

– all the partners or all the partners except one become insolvent,

– the business of the firm is declared illegal,

– in case partnership at will, a partner gives notice of dissolution,

– The Court may order dissolution of the firm which may happen in the following circumstances:

(a) where a partner has become of unsound mind,

(b) where a partner suffers from permanent incapacity,

(c) where a partner is guilty of misconduct affecting the business,

(d) where there is persistent disregard of partnership agreement by a partner,

(e) where a partner transfers his interest or share to a third person,

(f) where a business cannot be carried on except at a loss, and

(g) where a dissolution appears to the Court to be just and equitable on any other ground.

Settlement of Accounts of Partners

The Indian Partnership Act has certain provisions for the dissolution of partnership firm. According to section 48, in settling the accounts of a firm after dissolution, the following rules shall be observed subject to agreement by the partners:

(a) Losses, including deficiencies of capital, shall be paid first out of profits, next out of capital, and, lastly, if necessary, by the partners individually in the proportions in which they were entitled to share profits;

(b) The assets of the firm, including any sums contributed by the partners to make up deficiencies of capital, shall be applied in the following manner and order:

- in paying the debts of the firm to third parties;
- in paying to each partner ratably what is due to him from the firm for advances as distinguished from capital;
- in paying to each partner ratably what is due to him on account of capital; and
- the residue, if any, shall be divided among the partners in the proportions in which they were entitled to share profits.

Thus, on dissolution the assets of the firm are sold out and the proceeds are applied in the following order:

- in paying debts due to third parties.
- in paying ratably the loans advanced by partners to the firm.
- in paying to the partners the sums due to them on account of capital, and
- if there is a surplus, it has to be distributed among the partners in the profit sharing ratio. On the other hand, if there is a loss on dissolution, it has to be made up first out of past accumulated profits, then out of capitals of the partners and lastly out of contributions from private estates of the partners in the profit sharing ratio.

Important principles

- *The private property of a partner should be used to pay his private debts first and if there is any surplus it can be used to pay firms liabilities.*
- *Similarly, firm's assets should be first used to pay firm's liabilities. A partner can use his share of the surplus only to pay his private liabilities.*
- *The liability of partners is joint and several. It means that if a partner is unable to bring in his share of loss, the other partners have to make up his share of loss also.*

Accounting Treatment on Dissolution of Partnership

On dissolution, the books of accounts of the partnership firm are closed. The various steps to be followed are as follows:

1. "Realisation Account" is opened and transfer to it all the assets except cash in hand and at bank. Sundry Debtors will be transferred at gross amount.
2. Realisation Account is created with all liabilities to outsiders and provisions against assets like Provision for Bad Debts. However, accounts denoting accumulated losses or profits will not be transferred to Realisation Account.
3. Now, Realisation Account will be credited with the actual amount realised by sale of assets. If a partner takes over an asset, the capital account of that partner is debited and Realisation Account is credited with the value agreed upon.
4. Actual amount paid to the creditors of the firm is debited to Realisation Account. If a partner takes over a liability, his capital account is credited and Realisation Account is debited with the amount agreed upon.
5. Expenses during the course of dissolution are debited to Realisation Account and credited to cash.
6. Profit or loss revealed by Realisation Account is transferred to all the partners' capital accounts in their profit sharing ratio. Realisation Account is thus closed.
7. Loans advanced by partners to the firm are repaid.

8. Any reserve or accumulated profit or loss lying in the books of accounts is transferred to capital accounts in the profit sharing ratio.
9. Partners whose capital accounts may be showing a debit balance bring cash to clear their accounts.
10. Payment is made to the partners whose capital accounts are showing credit balances. This will close the books of accounts.

DIFFERENCE BETWEEN REVALUATION ACCOUNT AND REALISATION ACCOUNT

	Revaluation Account		*Realisation Account*
(i)	The effect of the revaluation of assets and liabilities is recorded in revaluation account.	(i)	It records the sale of various assets and payment of liabilities.
(ii)	Revaluation account is prepared at the time of reconstitution of the firm.	(ii)	It is prepared only at the time of dissolution of the firm.
(iii)	Revaluation account is prepared to find out the profit (loss) on the revaluation of assets and liabilities.	(iii)	Realisation account is prepared to find out the profit (loss) on the realization of assets and settlement of liabilities.
(iv)	It contains only those assets and liabilities which are revalued.	(iv)	It contains generally all assets and liabilities.
(v)	The balance of this account is transferred to the old partners' capital accounts.	(v)	The balance of this account is transferred to the capital accounts of all partners.
(vi)	Accounting entries are made on the basis of the difference between book value and revalued figures.	(vi)	Accounting entries are made at the book values of assets and liabilities.
(vii)	On revaluation, the accounts of assets and liabilities are not closed.	(vii)	The accounts of assets and liabilities are closed on preparation of realization account.

Return of Premium on Dissolution

If a partner on his admission pays to the other partner an amount for goodwill (also known as premium) and it is agreed that the partnership would be for a fixed term, then, if the firm is dissolved before the expiry of such a term, the partner will be entitled to a refund of a ratable amount of the premium so paid. Suppose, A and B admit C as a new partner on the condition that C pays ₹ 10,000 for goodwill and it is agreed that the partnership would be for 10 years. But if the firm is dissolved after 4 years, C will be entitled to a refund of ₹ 6,000 depending upon the circumstances.

However, such a refund cannot be claimed under the following conditions:

(i) When the firm is dissolved due to the death of a partner.

(ii) When the dissolution takes place mainly due to the misconduct of the partner making the claim, or

(iii) Where the dissolution is in pursuance of an agreement that no such refund will be made.

Insolvency of a Partner

In dissolution, if the capital account of a partner shows a debit balance, he will have to pay the amount to the firm. But if he is insolvent, he will not be able to do so; he will not be able to pay the full amount of such a debit balance. The sum which becomes irrecoverable from a partner due to his insolvency is a loss to be borne by other partners. Before the decision in Garner v. Murray case was made, such loss used to be treated as an ordinary loss and transferred to the capital accounts of the solvent partners in their relative profit sharing ratio. But decision in *Garner* v. *Murray* changed the position.

Decision in Garner Vs. Murray

According to the decision in *Garner* v. *Murray*, in case of insolvency of a partner:

(a) first, the solvent partners should bring in cash equal to their respective shares of the loss on realisation, and

(b) then, the loss due to the insolvency of a partner should be divided among the other partners in the ***ratio of capitals*** then standing.

The effect of this decision practically is that the deficiency in the capital account of the insolvent partner has to be borne by the solvent partners in the ratio of capitals standing just prior to dissolution.

If the capitals are fixed, then the loss due to the insolvency of a partner will be borne by the solvent partners in the ratio of their capitals.

If the capitals are fluctuating, all necessary adjustments in respect of reserves or profit and loss account are first made (but the loss on realisation is not adjusted) in the capital accounts of all the partners, and then the ratio of their capitals is calculated to transfer the deficiency of the insolvent partner.

> ***Important Note:***
>
> *If on the date of dissolution, a partner had no credit balance in his capital account, he will not bear any loss on account of insolvency of another partner. This is irrespective of his private wealth.*

ACCOUNTING IN CASE OF INSOLVENCY - STEPS SUMMARIZED

– Prepare Realisation Account in the usual manner.

– Transfer profit of loss on realisation to all the partners in profit sharing ratio.

– Prepare insolvent partner's capital account. If anything is received from his estate, it should be credited to his account.

– The debit balance of insolvent partner should be transferred to all other solvent partners in the ratio of capitals before dissolution (or in the ration of fixed capitals if capitals are fixed).

– Then, settle claims of solvent partners.

Insolvency of All Partners

If all the partners become insolvent, creditors will not be able to get their amounts in full. All the cash available together with whatever can be received from the private estates of the partners will be paid to the creditors after the expenses of realisation have been met. In case of insolvency of all the partners, creditors should not be transferred to Realisation Account; only assets should be transferred to this account. Amount realised from assets should be credited to Realisation Account. Expenses should be debited to Realisation Account. Now the balance in Realisation Account should be transferred to the Capital Accounts in profit sharing ratio. Now Cash Account should be prepared. After recording the amounts which are received from the estates of the partners, the entire cash should be distributed among the creditors ratably. The balances in the accounts of creditors and in the capital accounts should be transferred to Deficiency Account. Thus, all the accounts will be closed.

Illustration 21:

On 31st March, 2016 the following was the balance sheet of A, B and C when the firm was dissolved:

Liabilities	₹	*Assets*	₹	₹
Capital Accounts:		*Goodwill*		*10,000*
A	*30,000*	*Plant and Machinery*		*20,000*
B	*30,000*	*Furniture*		*8,000*
C	*30,000*	*Investments*		*10,000*
General Reserve	*9,000*	*Stock*		*51,060*
B's Loan	*5,000*	*Debtors*	*23,600*	
Mrs. A's Loan	*5,000*	*Less: Provision for Bad*		
Current Accounts		*Debts*	*1,020*	*22,580*
A	*2,860*			
C	*1,240*	*Bill Receivable*		*5,000*
Bill Payable	*10,000*	*Cash at Bank*		*2,760*
Sundry Creditors	*6,530*	*Unexpired Insurance*		*125*
		B's Current Account		*105*
	1,29,630			*1,29,630*

Investments were taken over by A for ₹ 13,000 whereas bills receivable were taken over by B for ₹ 4,800, fixed assets fetched ₹ 17,000 whereas stock realised ₹ 60,000. All the debtors paid the amounts due from them. Total rebate of ₹ 110 was received on retiring all bills payable immediately. Expenses of realisation came to ₹ 1,441. Pass Journal entries to close the books of the firm and show Realisation Account, Bank Account, and the Capital Accounts of all the partners.

Solution:

Journal Entries

Particulars		*Dr. (₹)*	*Cr. (₹)*
Realisation Account	Dr.	1,27,785	
To Goodwill			10,000
To Plant and Machinery			20,000
To Furniture			8,000
To Investments			10,000
To Stock			51,060
To Debtors			23,600
To Bills Receivable			5,000
To Unexpired Insurance			125
(Transfer of assets to Realisation Account)			
Provision for Bad Debts	Dr.	1,020	
Mrs. A's Loan	Dr.	5,000	
Bills Payable	Dr.	10,000	
Sundry Creditors	Dr.	6,530	
To Realisation Account			22,550
(Transfer of liabilities to outsiders to Realisation Account)			
Note: Mrs. A is also an outsider			
Bank	Dr.	1,00,600	
To Realisation Account			1,00,600
(Sale proceeds of fixed assets and stock and amount received from debtors)			

Particulars		₹	₹
A's Current Account	Dr.	13,000	
B's Current Account	Dr.	4,800	
To Realisation Account			17,800
(For investments taken over by A for ₹ 13,000 and bills receivable taken over by B for ₹4,800)			
Realisation Account	Dr.	21,420	
To Bank			21,420
(Payment made to pay off liabilities to outsiders – ₹ 5,000 to Mrs. A. ₹ 9,890 for bills payable and ₹ 6,530 to creditors)			
Realisation Account	Dr.	1,441	
To Bank			1,441
(Payment of expenses of realisation amounting ₹ 1,441)			
A's Current Account	Dr.	3,232	
B's Current Account	Dr.	3,232	
C's Current Account	Dr.	3,232	
To Realisation Account			9,696
(Transfer of loss on realisation)			
B's Loan Account	Dr.	5,000	
To Bank			5,000
(Payment of B's loan)			
General Reserve	Dr.	9,000	
To A's Current Account			3,000
To B's Current Account			3,000
To C's Current Account			3,000
(Transfer of General Reserve)			
A's Capital Account	Dr.	10,372	
B's Capital Account	Dr.	5,137	
To A's Current Account			10,372
To B's Current Account			5,137
(Transfer of debit balances of current accounts of A and B to their capital accounts)			
C's Current Account	Dr.	1,008	
To C's Capital Account			1,008
(Transfer of credit balance in C's current account to C's capital account)			
A's Capital Account	Dr.	19,628	
B's Capital Account	Dr.	24,863	
C's Capital Account	Dr.	31,008	
To Bank			75,499
(Payment to partners)			

Ledger Accounts

Dr. **Realisation Account** *Cr.*

Particulars	₹	*Particulars*	₹
To Sundry Assets:		By Provision for Bad Debts	1,020
Goodwill	10,000	By Mrs. A's Loan	5,000
Plant and Machinery	20,000	By Bills Payable	10,000
Furniture	8,000	By Sundry Creditors	6,530
Investments	10,000	By Bank	1,00,600
Stock	51,060	By A's Current Account	
Debtors	23,600	(Investments)	13,000
Bills Receivable	5,000	By B's Current Account	
Unexpired Insurance	125	(B/R)	4,800
To Bank (Liabilities)	21,420	By A's Current Account	
To Bank (Expenses)	1,441	(1/3rd loss)	3,232
		By B's Current Account	
		(1/3rd loss)	3,232
		By C's Current Account	
		(1/3rd loss)	3,232
	1,50,646		1,50,646

Dr. **Bank** *Cr.*

Particulars	₹	*Particular*	₹
To Balance b/fd	2,760	By Realisation (liabilities)	21,420
To Realisation A/c		By Realisation (expenses)	1,441
(Sale proceeds of assets)	1,00,600	By B's Loan Account	5,000
		By A's Capital Account	19,628
		By B's Capital Account	24,863
		By C's Capital Account	31,008
	1,03,360		1,03,360

Dr. **Partners' Current Accounts** *Cr.*

Particulars	*A (₹)*	*B (₹)*	*C (₹)*	*Particulars*	*A (₹)*	*B (₹)*	*C (₹)*
To Balance b/fd	–	105	–	By Balance b/fd	12,860	–	1,240
To Realisation	13,000	4,800	–	By General Reserve	3,000	3,000	3,000
To Realisation (loss)	3,232	3,232	3,232	By A's Capital	10,372	–	–
To C's Capital	–	–	1,008	By B's Capital	–	5,137	–
	16,232	8,137	4,240		16,232	8,137	4,240

Dr. **Partners' Capital Accounts** *Cr.*

Particulars	*A (₹)*	*B (₹)*	*C (₹)*	*Particulars*	*A (₹)*	*B (₹)*	*C (₹)*
To A's Current A/c	10,372	–	–	By Balance b/fd	30,000	30,000	30,000
To B's Current A/c	–	– 5,137	–	By C's Current A/c	–	–	1,008
To bank	19,628	24,863	31,008				
	30,000	30,000	31,008		30,000	30,000	31,008

Illustration 22:

A, B and C commenced business on 1st April, 2016. They agreed to share the profits and losses in the ratio of 2: 2: 1. Their capitals were ₹ 30,000, ₹ 22,500 and ₹ 15,000 respectively. The partnership deed provided for interest on capital at 6% per annum. During 2016-17 the firm earned a profit of ₹ 20,050 (before providing for interest on capital). During the year the partners' drawings were A – ₹7,000; B – ₹ 6,250; and C – 4,000.

The relations between partners were not good. They decided to dissolve the firm on 31st March, 2017. The assets were sold which realised ₹ 75,000. There were creditors to the extent of ₹ 12,000 which were paid off at a discount of 5%. Expenses of realisation amounted to ₹ 1,200.

Prepare the necessary accounts to close the books of the firm.

Solution:

Profit and Loss Account

Dr. *Cr.*

Date	*Particulars*	₹	*Date*	*Particulars*	₹
2017			2017		
Mar. 31	To Capital Accounts (interest)		Mar. 31	By Net Profit	20,050
	₹				
	A 1,800				
	B 1,350				
	C 900	4,050			
	To Profit transferred to:				
	₹				
	A 6,400				
	B 6,400				
	C 3,200	16,000			
		20,050			20,050

Dr. **A's Capital Account** *Cr.*

Date	*Particulars*	₹	*Date*	*Particulars*	₹
2017			2016		
Mar.31	To Drawings	7,000	Apr.1	By Bank	30,000
	To Balance c/d	31,200	2017		
			Mar.31	By Profit & Loss A/c (interest)	1,800
				By Profit & Loss A/c (share of profit)	6,400
		38,200			38,200
2017			2017		
Mar. 31	To Realisation (loss)	3,160	Mar. 31	By Balance b/d	31,200
	To Bank	28,040			
		31,200			31,200

Dr. **B's Capital Account** *Cr.*

Date	*Particulars*	₹	*Date*	*Particulars*	₹
2017			2016		
Mar. 31	To Drawings	6,250	Apr. 1	By Bank	22,500
	To Balance c/d	24,000	2017		
			Mar. 31	By Profit & Loss A/c (interest)	1,350
				By Profit & Loss A/c (share of profit)	6,400
		30,250			30,250
2017			2017		
Mar. 31	To Realisation (loss)	3,160	Mar. 31	By Balance b/d	24,000
	To Bank	20,840			
		24,000			24,000

Dr. **C's Capital Account** *Cr.*

Date	*Particulars*	₹	*Date*	*Particulars*	₹
2017			2016		
Mar. 31	To Drawings	4,000	Apr. 1	By Cash	15,000
	To Balance c/d	15,100	2017		
			Mar. 31	By Profit & Loss A/c (interest)	900
				By Profit & Loss A/c (share of profit)	3,200
		19,100			19,100
2017			2017		
Mar. 31	To Realisation (loss)	1,580	Mar. 31	By Balance b/d	15,100
	To Bank	13,520			
		15,100			15,100

Balance Sheet as at 31st March, 2017

Liabilities		₹	*Assets*	₹
Sundry Creditors		12,000	Sundry Assets	82,300
Capital Accounts:				
A	31,200			
B	24,000			
C	15,100	70,300		
		82,300		82,300

Dr. **Realisation Account** *Cr.*

Date	*Particulars*	₹	*Date*	*Particulars*	₹
2017			2017		
Mar. 31	To Sundry Assets	82,300	Mar.31	By Sundry Creditors	12,000
	To Cash (expenses)	1,200		By Cash	
	To Cash (creditors			(assets realised)	75,000
	₹ 12,000			By Loss transferred to:	
	less 5%)	11,400		A – 3,160	
				B – 3,160	
				C – 1,580	7,900
		94,900			94,900

Cash Account

Date	*Particulars*	₹	*Date*	*Particulars*	₹
2017			2017		
Mar. 31	To Realisation A/c		Mar. 31	By Realisation	
	(assets realised)	75,000		(expenses)	1,200
				By Realisation A/c	
				(creditors)	11,400
				By Capital Accounts:	
				₹	
				A – 28,040	
				B – 20,840	
				C – 13,520	62,400
		75,000			75,000

Illustration 23:

On 31st March, 2016 the following was the balance sheet of A, B and C who shared profits and losses in the ratio of 2:1:1 respectively.

Liabilities	₹	*Assets*	₹
Creditors	*16,000*	*Cash in hand*	*200*
General Reserve	*5,000*	*Stock*	*18,800*
Capital Accounts:		*Debtors*	*11,300*
A	*30,000*	*Furniture*	*12,500*
B	*20,000*	*Plant & Machinery*	*20,000*
C	*1,000*	*Goodwill*	*9,200*
	72,000		*72,000*

The firm was dissolved on this date due to C's insolvency. Assets realised ₹32,000. Expenses of dissolution came to ₹ 200. C's estate paid 50% of what was due to C. Close the books of the firm assuming that the loss due to C's insolvency has been divided:

(i) in the ratio of fixed capitals.

(ii) in the ratio of fluctuating capitals.

Solution:

Case (i) Loss due to deficiency is divided in the ratio of fixed capital accounts

Dr. Realisation Account Cr.

Particulars	₹	Particulars	₹
To Stock	18,800	By Creditors	16,000
To Debtors	11,300	By Cash (Assets)	32,000
To Furniture	12,500	By A's Capital Account	20,000
To Plant & Machinery	20,000	By B's Capital Account	10,000
To Goodwill	9,200	By C's Capital Account	10,000
To Cash (Creditors)	16,000		
To Cash (Expenses)	200		
	88,000		88,000

Dr. **Capital Account** Cr.

Particulars	A (₹)	B (₹)	C (₹)	Particulars	A (₹)	B (₹)	C (₹)
To Realisation	20,000	10,000	10,000	By Balance b/d	30,000	20,000	1,000
To C's Capital	–	2,325	1,550	By General Reserve	2,500	1,250	1,250
To Cash A/c	30,175	19,700	–	By Cash A/c	20,000	10,000	3,875
				By A's Cap	–	–	2,325
				By B's Cap	–	–	1,550
	52,500	31,250	10,000		52,500	31,250	10,000

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

Particulars	₹	*Particulars*	₹
To Balance b/fd	200	By Realisation A/c (creditors)	16,000
To Realisation A/c (assets)	32,000	By Realisation A/c (expenses)	200
To A's Capital Account	20,000	By A's Capital Account	30,175
To B's Capital Account	10,000	By B's Capital Account	19,700
To C's Capital Account	3,875		
	66,075		66,075

Note: Since, current accounts have not been specified in the question the adjustments have been made in capital accounts.

Case (ii) Loss due to deficiency is divided in the ratio of fluctuating capital accounts

Realisation Account will be the same as in the case (i)

Capital Accounts

Particulars	*A (₹)*	*B (₹)*	*C (₹)*	*Particulars*	*A (₹)*	*B (₹)*	*C (₹)*
To Realisation	20,000	10,000	10,000	By Balance b/d	30,000	20,000	14,000
To C's Capital	2,343	1,532	–	By Gen. Res.	2,500	1,250	1,250
To Cash A/c	30,157	19,718	–	By Cash A/c	20,000	10,000	3,875
				By A's Capital (26/43ths share)	–	–	2,343
				By B's Capital A/c (17/43ths share)	–	1,532	–
	52,500	31,250	10,000		52,500	31,250	10,000

Balances in A's Capital Account and B's Capital Account after adjustment for General Reserve are ₹ 32,500 and ₹ 21,250 respectively. Hence, A and B will bear the loss of ₹ 3,875 due to C's insolvency in the ratio of 32,500 : 21,250 or 26 : 17 respectively.

A's share = ₹ 3,875 $\times \frac{26}{43}$ = ₹ 2,343

B's share = ₹ 3,875 $\times \frac{17}{43}$ = ₹ 1,532

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

Particulars	₹	*Particulars*	₹
To Balance b/fd	200	By Realisation A/c (Creditors)	16,000
To Realisation A/c (Assets)	32,000	By Realisation A/c (Expenses)	200
To A's Capital Account	20,000	By A's Capital Account	30,157
To B's Capital Account	10,000	By B's Capital Account	19,718
To C's Capital Account	3,875		
	66,075		66,075

Illustration 24:

A, B, C and D are partners in a firm sharing profits and losses in the ratio of 4 : 1 : 2 : 3. The following is the balance sheet as at March 31st, 2016.

Liabilities	₹	₹	*Assets*	₹	₹
Sundry creditors		*30,000*	*Cash in hand*		*14,000*
Capital accounts:			*Sundry debtors*	*35,000*	
A	*70,000*		*Less: Provision for bad debt*	*5,000*	*30,000*
D	*30,000*	*1,00,000*	*Other assets*		*51,000*
			Capital accounts:		
			B	*20,000*	
			C	*15,000*	*35,000*
		1,30,000			*1,30,000*

On March 31st, 2016, the firm is dissolved. The partnership agreement provides that the deficiency of an insolvent partner will be borne by the solvent partners in the ratio of capitals as they stand just before dissolution.

The following arrangements are agreed upon:

(i) *A is to take over 60% of book debts at 70% and D is to take over the balance at 75%. Further, they are to be allowed ₹ 2,100 and 1,100 respectively to cover future losses.*

(ii) *D is to realise other assets and to pay off the creditors. He is to receive 5% gross commission on the amounts finally payable to other partners but to bear expenses of realisation. He reports the results of realisation as follows:*

Other assets realize at a loss of 2% on net collection and pays of the creditors at a discount of 30%. Realisation expenses amount to ₹ 3,000 but the same is paid by the firm. B is declared insolvent and a dividend of 20% in a rupee is realised from his estate.Prepare Cash Account, Realisation Account and Capital Accounts.

Solution:

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

Particulars	₹	*Particulars*	₹
To Balance b/fd	14,000	By Realisation A/c	
To Realisation A/c	50,000	(payment to creditors)	21,000
To B's Capital A/c		By D's Capital A/c (expenses)	3,000
(20% dividend)	4,000	By A's Capital A/c	44,000
To C's Capital A/c	15,000	By D's Capital A/c	15,000
	83,000		83,000

Dr. **Realisation Account** *Cr.*

Particulars	₹	*Particulars*	₹
To Debtors	35,000	By Provision for bad debts	5,000
To Other assets	51,000	By Sundry creditors	30,000
To Cash A/c		By Cash A/c (realisation	
(30,000 – 9,000)		of other assets)	50,000
(payment to creditors)	21,000	By A's Capital A/c	
		(debtors taken over)	12,600
		By D's Capital A/c	
		(debtors taken over)	9,400
	1,07,000		1,07,000

Dr. **A's Capital Account** *Cr.*

Particulars	₹	*Particulars*	₹
To Realisation A/c (debtors taken over)	12,600	By Balance b/fd	70,000
To B's Capital A/c (deficiency)	11,200		
To D's Capital A/c (commission)	2,200		
To Cash A/c (final payment)	44,000		
	70,000		70,000

Dr. **B's Capital Account** *Cr.*

Particulars	₹	*Particulars*	₹
To Balance b/fd	20,000	By Cash A/c	4,000
		By A's Capital A/c (7/10ths deficiency)	11,200
		By D's Capital A/c (3/10ths deficiency)	4,800
	20,000		20,000

Dr. **C's Capital Account** *Cr.*

Particulars	₹	*Particulars*	₹
To Balance b/fd	15,000	By Cash A/c	15,000
	15,000		15,000

Dr **D's Capital Account** *Cr.*

Particulars	₹	*Particulars*	₹
To Realisation A/c (debtors taken over)	9,400	By Balance b/fd	30,000
To Cash A/c (expenses)	3,000	By A's Capital A/c (commission)	2,200
To B's Capital A/c (deficiency)	4,800		
To Cash A/c (final payment)	15,000		
	32,200		32,200

Working Notes:

Sundry Debtors taken over by A:

₹ 35,000 x 60% x 70%	=	₹ 14,700
Less: Allowance for further loss	=	₹ 2,100

₹ 12,600

Sundry Debtors taken over by D:

₹ 35,000 x 40% x 75%	=	₹ 10,500
Less : Allowance for further loss	=	₹ 1,100
		₹ 9,400

D's Commission

Gross amount payable	₹ 46,200
Commission $\frac{5}{105} \times 46{,}200$	₹ 2,200

Illustration 25:

Below is the Balance Sheet of C, D and E as on 31st March, 2017

Liabilities	₹		*Assets*	₹
Sundry Creditors	*2,00,000*		*Cash*	*31,200*
Loan	*1,00,000*	*3,00,000*	*Stock*	*1,56,300*
Capital Accounts:			*Debtors*	*47,200*
C	*80,000*		*Furniture*	*95,300*
D	*60,000*		*Profit & Loss Account*	*1,20,000*
E	*10,000*	*1,50,000*		
		4,50,000		*4,50,000*

The firm was dissolved due to insolvency of all the partners. Stock was sold for ₹ 1,09,000 while furniture fetched ₹ 40,000. ₹ 41,000 were received from Debtors. Expenses were ₹ 2,200. Nothing could be recovered from D and E but C's private estate showed a surplus of ₹ 6,000. Close the books of the firm.

Solution:

Dr. **Realisation Account** *Cr.*

Particulars	₹	*Particulars*	₹
To Stock	1,56,300	By Cash A/c (assets)	1,90,000
To Debtors	47,200	By C's Capital A/c	37,000
To Furniture	95,300	By D's Capital A/c	37,000
To Cash A/c (expenses)	2,200	By E's Capital A/c	37,000
	3,01,000		3,01,000

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

Particulars	C (₹)	D (₹)	E (₹)	*Particulars*	C (₹)	D (₹)	E (₹)
To Profit and Loss A/c - Transfer	40,000	40,000	40,000	By Balance b/fd	80,000	60,000	10,000
To Realisation (Loss)	37,000	37,000	37,000	By Cash A/c	6,000	–	–
To Deficiency A/c	9,000	–	–	By Deficiency	–	17,000	67,000
	86,000	77,000	77,000		86,000	77,000	77,000

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

Particulars	₹	*Particulars*	₹
To Balance b/d	31,200	By Realisation A/c (expenses)	2,200
To Realisation A/c (assets)	1,90,000	By Loan A/c	75,000
To C's Capital Account	6,000	By Sundry Creditors	1,50,000
	2,27,200		2,27,200

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

Particulars	₹	*Particulars*	₹
To Cash A/c	75,000	By Balance b/fd	1,00,000
To Deficiency A/c	25,000		
	1,00,000		1,00,000

Dr. **Sundry Creditors** *Cr.*

Particulars	₹	*Particulars*	₹
To Cash A/c	1,50,000	By Balance b/fd	2,00,000
To Deficiency A/c	50,000		
	2,00,000		2,00,000

Dr. **Deficiency Account** *Cr.*

Particulars	₹	*Particulars*	₹
To D's Capital Account	17,000	By Loan Account	25,000
To E's Capital Account	67,000	By Sundry Creditors	50,000
		By C's Capital	9,000
	84,000		84,000

What is Limited Liability Partnership 'LLP'

Limited Liability Partnership entities, the world wide recognized form of business organization has been introduced in India by way of Limited Liability Partnership Act, 2008. A Limited Liability Partnership, popularly known as LLP combines the advantages of both the Company and Partnership into a single form of organization. In an LLP one partner is not responsible or liable for another partner's misconduct or negligence; this is an important difference from that of a unlimited partnership. In an LLP, all partners have a form of limited liability for each individual's protection within the partnership, similar to that of the shareholders of a corporation. However, unlike corporate shareholders, the partners have the right to manage the business directly. An LLP also limits the personal liability of a partner for the errors, omissions, incompetence, or negligence of the LLP's employees or other agents.

Limited Liability Partnership is managed as per the LLP Agreement, however in the absence of such agreement the LLP would be governed by the framework provided in Schedule 1 of Limited Liability Partnership Act, 2008 which describes the matters relating to mutual rights and duties of partners of the LLP and of the limited liability partnership and its partners.

LLP has a separate legal entity, liable to the full extent of its assets; the liability of the partners would be limited to their agreed contribution in the LLP. Further, no partner would be liable on account of the independent or un-authorized actions of other partners, thus allowing individual partners to be shielded from joint liability created by another partner's wrongful business decisions or misconduct.

Limited Liability Partnership Act, 2008 came into effect by way of notification dated 31st March 2009.

Difference Between Limited Liability Partnership And Partnership Firm

SR. NO.	BASIS	LIMITED LIABILITY PARTNERSHIP	PARTNERSHIP FIRM
1.	Governing Law	The Limited Liability Partnership Act, 2008 and various Rules made thereunder	The Indian Partnership Act, 1932 and various Rules made thereunder
2	Registration	Compulsory	Optional
3	Creation	Created by law	Created by contract
4	Separate Legal Entity	It is separate legal entity, separate from its partners\ designated partners.	It is not separate legal entity from partners. Partners are collectively referred as firm.
5	Perpetual succession	It has perpetual succession.	It does not have perpetual succession.
6	Common Seal	It denotes the signature of the Company and LLP may have its own common seal, if it besides to have one.	Not required
7	Legal Proceeding	LLP can also sue and be sued	Only registered partnership can sue.
8	Liability	Liability of partners is limited up to their capital contribution however in case a partners acts with an intension to conduct fraud, they are personally liable.	Liability of partners is unlimited
9	Transferability of interest	Rights/interest of partners are transferable as per the provisions of LLP agreement.	Transferability of Interest subject to the mutual consent of all the members.
10	Maximum number of Member	No cap of maximum number of its partners	Maximum 10 for banking business and 20 for other business.

LESSON ROUND UP

- Partnership is the relationship between persons who have agreed to share the profits of a business carried on by all or any of them acting for all.
- Following are the features of partnership:
  - There must be an agreement entered into by all the persons concerned.
  - There must be a 'business' and for this purpose business would include any trade, profession or occupation.
  - The business must be carried on for the purpose of earning profits which would be divided among the partners.
  - The business must be carried on by some or all of the partners for the benefit of all of them.
- In partnership accounts, capital accounts of the partners may be fixed or fluctuating depending upon the method of recording.
- Profit and loss appropriation account is prepared to make adjustments regarding salary to partners, interest on capital and drawing, commission, etc. and then the profit is distributed among the partners in the agreed ratio.
- When there is a change in profit sharing ratio, it results in gain to one partner and loss to the others.
- On admission of a new partner, one is required to: calculate new profit sharing ratio, find out sacrificing ratio, adjust the re-value of assets and liabilities, treat the goodwill, and make adjustments for reserves, past profit or loss and capital according to new profit sharing ratio.
- The difference between the old ratio and the new ratio is known as sacrificing ratio.
- Revaluation account is prepared to find out the effects of revaluation of assets and liabilities on admission and retirement/death of a partner and the effect of net increase or decrease in assets and liabilities is transferred to old partners in old profit sharing ratio.
- On the admission of a new partner, capitals of all the partners may be required to be in proportion to their respective shares in profit and the capital brought in by the new partner may be taken as the basis.
- On retirement of a partner, adjustments may be made for reserves and undistributed profits, revaluation of assets and liabilities, profit sharing ratio, goodwill, share of the partner in the profit or loss up to the date of retirement, share of joint life policy, etc.
- The net amount payable to the retiring partner after making all adjustments will be settled by paying cash or by transferring it to a separate loan account.
- Whenever a partner dies, the deceased partner's share is calculated and the payment is made to the legal representatives of the deceased partner.
- Dissolution of partnership is different from dissolution of firm. In case of dissolution of firm, the firm ceases to continue its business but in the case of dissolution of partnership, the business of the firm is continued.
- On dissolution, the books of accounts of the firm are closed. For this, a realisation account is prepared. Capital accounts of the partners are also prepared, the partners with debit balances in their capital accounts are required to bring in the required cash while partners with credit balances in their capital accounts are paid off.

– When a partner cannot bring cash because of insolvency, the other partners have to share such a deficiency according to the rule laid down in Garner vs. Murray.

GLOSSARY

Partners	Persons who have entered into partnership with one another.
Partnership deed	The written contract of partnership.
Goodwill	Present value of a firm's anticipated super normal earnings.
Sacrificing ratio	The difference between old profit sharing ratio and the new profit sharing ratio of the old partners.
Surrender Value	The sum of money that an insurance company will pay to the policy holder in the event of voluntary termination of the policy before its maturity if the insured event occurs.

SELF-TEST QUESTIONS

Theory Questions:

1. What is meant by partnership?
2. What is a partnership deed?
3. Distinguish between fluctuating and fixed capital accounts.
4. Why is interest allowed on capital?
5. Why is interest charged on drawings? How is it calculated?
6. What is goodwill? In what ways can it be treated on admission of a partner?
7. Why are adjustments in the values of assets and liabilities made on the admission of a partner?
8. What are the accounting adjustments necessary at the time of retirement of a partner?
9. What is the significance of purchase of shares of a retiring partner by the remaining partners?
10. What is dissolution of a firm? How does if differ from dissolution of a partnership?
11. When is a firm dissolved?
12. When may the Court order dissolution of a firm?
13. On dissolution of a firm, in what order are payments made to creditors and partners?
14. What is *Garner v. Murray* rule? What is its effect in case of insolvency of a partner? Will it make any difference if capital accounts of the partners are fixed or fluctuating?
15. How does insolvency of all the partners of a firm affect the creditors of the firm?
16. Explain LLP

Practical Questions:

1. 1st March, 2016 the following was the balance sheet of A and B who were carrying on business in partnership sharing profits and losses in the ratio of 3:2 respectively:

Liabilities	₹	₹	*Assets*	₹	₹
Capital Accounts			Goodwill		5,000
A	18,000		Machinery		20,000
B	14,000	32,000	Furniture		10,000
			Debtors	10,000	
General Reserve		9,000	*Less:* Provision for		
Sundry Trade Creditors		19,700	Bad Debts	(500)	9,500
Bank Overdraft		6,100	Stock		22,300
		66,800			66,800

C was admitted to the firm on this date on the following terms:

(i) C would get 1/5th share of future profits.

(ii) C would bring ₹ 3,000 by way of his share of goodwill and ₹ 15,000 as capital.

(iii) Provision for bad debts would be reduced to ₹ 350.

(iv) Capitals of the partners would be in their profit sharing ratio; A and B bringing in cash or withdrawing cash as need be.

Pass journal entries, show the important ledger accounts and prepare balance sheet as it would appear immediately after C' admission.

2. Following is the balance sheet of A and B (sharing profit and losses in the ratio of 3:2 respectively on 31st March, 2016:

Liabilities	₹	*Assets*	₹
Outstanding Expenses	11,000	Goodwill	2,00,000
Creditors	1,30,000	Plant and Machinery	1,85,000
8% Loan	2,00,000	Furniture and Fittings	67,000
Capital Accounts:		Stock	2,46,000
A	3,00,000	Debtors	9,3,500
B	2,00,000	Cash at Bank	49,500
	8,41,000		8,41,000

A retires on that date. Goodwill is valued at ₹ 2,50,000. It is also agreed that plant and machinery be depreciated by 10% and provision for bad debts amounting to ₹ 1,500 be made. A new partner named C is admitted who buys one half of A's share, B buying the remaining half share. Find out the amount brought in by C and prepare the initial balance sheet of B and C.

3. Balance Sheet C, D and E as on 31st March, 2016

Liabilities	₹	*Assets*	₹
Capital Accounts		Fixed Assets :	
C	50,000	Goodwill	25,000
D	30,000	Plant and Machinery	30,000
E	20,000	Furniture	10,000
Current Accounts		Current Assets:	
D	1,500	Investments	15,000
E	1,300	Stock	40,000
Current Liabilities		Debtors	8,000
Trade Creditors	16,250	Cash In Hand	500
Bills Payable	10,000	Current Account	900
Outstanding Expenses	350		1,29,400
	1,29,400		

C died on 31st December, 2016 by which date he had withdrawn ₹ 8,500. Partnership deed provided that in case of death of a partner, in addition to the amount standing to the credit of capital and current accounts of such a partner, the executors will also been titled to a share of the profits from the closing of the last accounting year to the date of death on the basis of the last year's profits. It also provided that goodwill of the firm in case of death of a partner should be revalued at 2 years' purchase of the average profits of the last three years. Profits for 2013-14, 2014-15, and 2015-16 were ₹ 37,500, ₹ 45,800 and ₹ 37,700 respectively.

Investments were sold for ₹ 24,000 net at the stock exchange to pay immediately to C's executors for one-third of the total amount due to them.

Find out the balance left in C's Executors Account? Calculations may be made to the nearest rupee.

(Hints**:** Profit on sale of investment will be shared by the executors also since it is due to appreciation in the value of assets within the life time of C.)

4. A, B and C were carrying on business in partnership sharing profit and losses in the ratio 3:2:1 respectively. On 31st March, 2016 balance sheet of the firm stood as follows:

Liabilities		₹	*Assets*	₹
Bills Payable		1,50,000	Cash at Bank	89,000
Sundry Creditors		1,83,400	Creditors	80,000
Capital Accounts	₹		Stock	2,34,400
A	1,50,000		Furniture	50,000
B	1,00,000		Buildings	2,30,000
C	1,00,000	3,50,000		
		6,83,400		6,83,400

B retired on the above mentioned date on the following terms:

(i) Buildings be appreciated by ₹ 70,000.

(ii) Provision for bad debts be made @ 5% on debtors.

(iii) Goodwill of the firm be valued @ ₹ 90,000 and adjustment in this respect be made without raising Goodwill Account.

(iv) ₹ 70,000 be paid to B immediately and the balance due to him be treated as a loan carrying interest @ 6% per annum.

Pass journal entries to record the above mentioned transactions and show the balance sheet of the firm as it would appear immediately after B's retirement.

5. A, B and C were equal partners. On 31st March, 2016 their balance sheet stood as follows:

Liabilities	₹	*Assets*	₹
Sundry Creditors	1,80,000	Cash in hand	10,000
General Reserve	60,000	Debtors	1,25,000
A's Capital Account	1,80,000	Stock	1,85,000
B's Capital Account	80,000	Furniture	1,04,000
		C's Capital Account – overdrawn	76,000
	5,00,000		5,00,000

On this date, the firm was dissolved due to C's insolvency. Only ₹ 1,17,000 could be realised from debtors while stock and furniture fetched ₹ 1,16,800 and ₹ 80,000 respectively. Expenses came to ₹ 1,800. C's estate could pay only 50% of what was due from C. Show Realisation Account and the accounts of the partners. Assume the capitals are fluctuating. Apply *Garner* v. *Murray* rule.

MULTIPLE CHOICE QUESTIONS

1. Equity Shareholders are:

   (A) Customers of the company (B) Owners (C) Creditors (D) None of these

2. On an equity share of Rs. 10, the minimum amount of share application under the law should be:

   (A) Rs.0.50 (B) Re. I (C) Rs.2 (D) Rs.2.50 15.

3. When shares are forfeited, called up amount on shares is debited to:

   (A) Forfeiture Account (B) Capital Reserve Account (C) General Reserve A/c (D) CapitalA/c

4. Redeemable preference shares can be redeemed:

   (A) Only if they are fully paid (B) Even if they are partly paid (C) If they are paid not less than 50% of the nominal value of shares (D) Only if they are issued at a premium

5. Bonus shares are issued by the companies because : (A) Surplus cash is available (B) There is heavy competition from similar companies (C) There is heavy accumulated general reserve (D) They have high gross profit ratio

6. Book building is a method of: (A) Issuing shares (B) Buy back of share (C) Issuing debenture (D) Redemption of debenture

7. P to whom 100 shares of ` 10 each were allotted at par paid the application money of ` 2 and allotment money of ` 4 per share. He did not pay the call money of ` 4 per share. His shares were forfeited. The amount to be credited to Share forfeiture account is

   (A) Rs. 400 (B) Rs. 1000 (C) Rs. 600 (D) None of the above

8. Redeemable Preference shares can be redeemed out of ___________

   a) The sale proceeds of Investments

   b) The proceeds of a fresh issue of shares

   c) Share premium

   d) The proceeds of issue of debentures

9. When Redeemable Preference shares are due for redemption, the entry passed is

   a) Debit redeemable Preference Share capital a/c; Credit cash a/c

   b) Debit Redeemable Preference share capital a/c; credit Preference share holders a/c

   c) Debit preference share holders a/c; credit cash a/c

   d) Debit preference share holders a/c; credit capital reduction a/c

10. Which of the following cannot be utilized for the redemption of preference shares of a company

    a) Proceeds of fresh issue of shares

    b) General Reserve

    c) Profit and Loss Account

    d) Securities premium on fresh issue of shares

Lesson 9
Joint Venture and Consignment Account

LESSON OUTLINE

- Brief on Consignment Account
- Brief on Joint Venture
- Difference between Consignment and Joint Venture Account
- Objective Question

LEARNING OBJECTIVES

Dynamics of modern business has 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.

In the light of these changes the Consignment Account and Joint Venture hold a great amount of importance.

In this lesson we shall study various underlying concepts within these broad area.

CONSIGNMENT ACCOUNTING

Meaning of Consignment: In accounting, the term "consignment" relates to dealing with a situation where one person or firm sends goods to another person or firm on the basis that the goods will be sold on behalf of and at the risk of the former.

Features of consignment :

(a) The party which sends the goods is called consignor.

(b) The party to whom goods are sends is called consignee.

(c) The ownership of the goods remains with the consignor.

(d) The consignor sends to consignee a Performa invoice, statement that looks like an invoice but is really not one. The object of Performa invoice is only to convey information to the consignee regarding particulars of the goods sent.

(e) The consignee recovers from the consignor all expenses incurred by him on the consignment and charge commission on sales made by him also.

ACCOUNTING ENTRIES IN THE BOOKS OF CONSIGNOR:

(1) On dispatch of goods:-

Consignment account

To Goods sent on consignment account (With the cost of goods)

(2) On payment of expenses on dispatch:-

Consignment account

To Bank account (With the amount spent as expenses)

(3) On receiving advance:

Cash or bills receivable account

To Consignee's personal account (With the amount cash or bill)

(4) On the consignee reporting sale (as per A/S):-

Consignee's personal account

To Consignment account (With gross proceeds of sales)

(5) For expenses incurred by the consignee (as per A/S):-

Consignment account (With the amount of expenses)

To Consignee's personal account

(6) For commission payable to the consignee:-

Consignment account (With the amount of expenses)

To Consignee's personal account

Assuming that all the goods sent have been sold, the consignment account will show at this stage the actual profit or loss made on it. The same is transferred to profit and loss account.
The entry in case of profit is :

Consignment account

To profit and loss account

In case of loss the entry is :

Profit and loss account

To Consignment account

Note: The goods sent on consignment account may be closed by a transfer to trading account.

When Consignment is Partly Sold:
When all the goods sent on consignment have not been sold., the value of unsold goods in the hands of the consignee must be ascertained and the profit or loss should be found out by taking this stock into account. The entry is:

Stock on consignment account

To Consignment account

Stock on consignment account is an asset and will be shown in the balance sheet of the consignor. Valuation of stock is discussed on valuation of stock page.

ACCOUNTING ENTRIES IN THE BOOKS OF CONSIGNEE:

(1) When consignment goods are received:-

No entry is made in the books of account. The consignee is not the owner of the goods and therefore he makes no entry when he receives the goods.

(2) For expenses incurred by the consignee:-

Consignor's personal account

To Cash account

(3) When advance is given:-

Consignor's personal account

To Cash or bills payable account

(4) When goods are sold:-

Cash or bank account

To Consignor's personal account

(5) For commission due:-

Consignor's personal account

To commission account

The consignor's account will be closed by debiting it with cash or final bill or draft in settlement.

SELF EXAMINATION MULTIPLE CHOICE QUESTIONS

Choose the most appropriate answer from the given options:

1. K of Kolkata sends out 500 boxes of hair oil costing Rs. 300 each. Each box consist of 12 packets. 300 boxes were sold by consignee at a profit of Rs. 30 per packet. Amount of sale value will be:

   (a) Rs. 108000

   (b) Rs. 90000

   (c) Rs. 99000

   (d) Rs. 106500

2. Goods costing Rs. 300000 sent out to consignee at cost+ 25%of invoice price. Invoice value of goods will be:

   (a) Rs. 375000

   (b) Rs. 400000

   (c) Rs. 425000

   (d) None

3. Goods costing Rs. 180000 sent out to consignee at cost+ 25%on cost price. Invoice value of goods will be:

(a) Rs. 216000

(b) Rs. 225000

(c) Rs. 210000

(d) None

4. Goods of the invoice value Rs. 240000 sent out to consignee at 50% profit on cost price. The loading amount will be:

(a) Rs. 80000

(b) Rs. 120000

(c) Rs. 60000

(d) None

5. Chandu of Jaipur sent out certain goods to Makkhu of Delhi. 1/10th of the goods were lost in transit. Invoice value of goods lost was Rs. 15000. If profit on cost is 25% then cost price of goods sent out on consignment will be:

(a) Rs. 112500

(b) Rs.120000

(c) Rs. 180000

(d) Rs.100000

6. Ganguli of Kolkata sends out goods costing Rs. 80000to Jaggu of Delhi. 4/5th of the goods were sold by consignee for Rs.70000. Commission 2% on sales plus 20% of gross sales less all commission exceeds cost price. The amount of commission will be:

(a) Rs. 2833

(b) Rs. 2900

(c) Rs. 3000

(d) Rs. 2800

7. Shiva of Jaipur sends out 1000 bags to Sanat of Delhi costing Rs. 800 each. Consignor's expenses Rs. 8000. Sanat's expenses non-selling Rs.4000, selling Rs.8000. 100 bags were lost in transit. Value of goods lost in transit will be:

(a) Rs. 80800

(b) Rs. 81200

(c) Rs. 80000

(d) Rs. 92000

8. K of Kanpur sends out 1000 bags to Y of Noida costing Rs. 2000 each.550 bags were sold at 20% above cost price. Sales value will be:

(a) Rs. 1320000

(b) Rs. 2100000

(c) Rs. 1100000

(d) Rs. 1080000

9. Which of the following statement is not true:

(a) If de-credere commission is allowed, bad debt will not be recorded in the books of consignor

(b) If de-credere commission is allowed, bad debt will be debited in consignment account

(c) De-credere commission is allowed by consignor to consignee

(d) De-credere commission is generally relevant for credit sales

10. X of Chandigarh sends out 400 bags to Y of Delhi at invoice price of Rs. 250 each. Consignor's expenses Rs. 2000.Y's expenses non-selling Rs.2000, selling Rs.1000. 300 bags were sold by Y. If profit on cost is 25%. Then the value of consignment inventories will be:

(a) Rs. 20400

(b) Rs. 20200

(c) Rs. 20000

(d) Rs.21000

11. Commission will be shared by:

(a) Consignor and Consignee

(b) Only Consignee

(c) Only Consignor

(d) Third party

12. The owner of the consignment inventories is:

(a) Consignor

(b) Consignee

(c) Trade costumers

(d) None of the above

13. The consignment account is a

(a) Personal account

(b) Real account

(c) Nominal account

(d) Artificial Personal account

Answers

1.(c)	2. (b)	3. (b)	4. (a)	5. (b)
6. (a)	7. (a)	8. (a)	9. (b)	10. (d)
11. (b)	12. (a)	13. (c)		

JOINT VENTURE ACCOUNTS

A joint venture is a short duration "business" entered into by two or more persons jointly. Joint venture may be described as a temporary partnership between two or more persons without the use of the firm name, for a limited purpose. In other words, in joint venture, two or more persons agree to undertake a particular venture and to share the profit and loss thereof in an agreed ratio. Venture may be for the construction of building, underwriting of a particular issue of shares or debentures, supply of certain quantity of goods, etc.

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.

FEATURES OF JOINT VENTURE

(a) It is short duration special purpose partnership and also may be described as a temporary partnership.

(b) Parties in venture are called co-venturers.

(c) Co-venturers may contribute funds for running the venture.

(d) Co-venturers share profit or loss of the venture at the agreed ratio, if agreement is silent on this point then in equal ratio.

(e) Generally profit or loss of the venture is computed on completion of the venture.

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:

1. Nature

Joint venture: It is a temporary partnership business without a firm name.

Consignment: It is an extension of business by principal through agent.

2. Parties

Joint venture: The parties involving in joint venture are known as co-ventures.

Consignment: Consignor and consignee are involving parties in the consignment.

3. Relation

Joint venture: The relation between co-ventures is just like the partners in partnership firm.

Consignment: The relation between the consignor and consignee is 'principal and agent'.

4. Sharing Profit

Joint venture: The profits and losses of joint venture are shared among the co-ventures in their agreed proportion.

Consignment: The profits and losses are not shared between the consignor and consignee. Consignee gets only the commission.

5. Rights

Joint venture: The co-ventures in a joint venture have equal rights.

Consignment: In consignment, the consignor enjoys principal's right whereas consignee enjoys the right of agent.

6. Exchange of Information

Joint venture: The co-ventures exchange the required information among them regularly.

Consignment: The consignee prepares an account sale which contains a details of business activities carried on and is being sent to the consignor.

7. Ownership

Joint Venture: All the co-ventures are the owners of the joint venture.

Consignment: The consignor is the owner of the business.

8. Method of Maintaining Accounts

Joint venture: There are different methods of maintaining accounts in joint venture. As per agreement the co-ventures maintain their account.

Consignment: In consignment, there is only one method of maintaining account.

9. Basis of Account

Joint venture: Cash basis of accounting is applicable in joint venture.

Consignment: Actual basis is adopted in consignment.

10. Continuity

Joint venture: As soon as the particular venture is completed, the joint venture is terminated.

Consignment: The continuity of business exists according to the willingness of both consignor and consignee.

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 i made incharge of recording of all transactions. Generally this method is not adopted.

SELF EXAMINATION MULTIPLE CHOICE QUESTIONS

Choose the most appropriate answer from the given options:

1. Which of the following statement is true ?

   (a) Only one venture bears the risk

   (b) Only one venture can purchase the goods

   (c) Only one venture can sell the goods

   (d) In joint venture most of the provisions of Partnership Act applies

2. A and B into a joint venture to underwrite shares of Purvi Ltd. Purvi Ltd make an equity issue of 400000 equity shares. 80% of shares underwritten by the venturers. 320000 shares are subscribed by the public. How many shares are to be subscribed by the ventures?

   (a) 80000

   (b) 64000

   (c) 72000

   (d) Nil

3. A and B purchased a piece of land for Rs. 200000 and sold it for Rs. 600000. Originally A has contributed Rs. 120000 and B Rs. 80000. What will be the profit share of A?

   (a) Rs. 240000

   (b) Rs. 200000

   (c) Rs. 160000

   (d) Rs. Nil

4. If an inventories is taken over by the venture, it will be treated as

   (a) Income of the joint venture, hence credited to joint venture account

   (b) Expense of the joint venture, hence debited to joint venture account

(c) To be ignored as joint venture transaction

(d) It will be treated in the personal book of the venture and not in the books of joint venture.

5. Which of the following statement is true?

   (a) The joint venture can be formed by a single person only.

   (b) A legal deed should be drafted before forming joint venture.

   (c) The profit to be shared between the venturers in agreed ratio.

   (d) Joint venture follows going concern concept.

6. Goods costing Rs.50000 (market value Rs. 60000) destroyed by an accident, insurance claim nil

   (a) Rs.50000 will be credited to joint venture account.

   (b) No entry will be made in the books of joint venture.

   (c) Rs.50000 will be debited to joint venture account as loss.

   (d) Rs.60000 will be credited to joint venture account.

7. A purchased goods costing Rs.450000. B sold the goods for Rs.650000. Profit sharing ratio between A and B equal. If same set of books is maintained, what will be the final remittance?

   (a) B will remit Rs.225000 to A

   (b) B will remit Rs.550000 to A

   (c) A will remit Rs.350000 to B

   (d) B will remit Rs.325000 to A

8. A purchased goods costing Rs.200000. B sold three-fourth of the goods for Rs.250000.Balance goods were taken over by B at cost less 20%. If same set of books is maintained, profit on the venture will be

   (a) Rs. 58000

   (b) Rs.13000

   (c) Rs. 50000

   (d) Rs.42000

9. Which of the following statement is not true?

   (a) Joint venture is terminable in nature

   (b) Joint venture is a going concern

   (c) Generally joint venture does not follow accrual basis of accounting

   (d) The co-venturers shares the profit in agreed ratio

10. If unsold goods costing Rs. 20000 is taken over by a co-venturer at cost less 25%, the joint venture account will be credited by

   (a) Rs. 20000

   (b) Rs. 15000

(c) Rs. 5000

(d) Nil

11. Which of the following statement is true?

    (a) Memorandum joint venture account is prepared to find out amount due from co-venturer.

    (b) Memorandum joint venture account is prepared when separate set of books is maintained.

    (c) In memorandum joint venture account only one venturer's transactions are recorded.

    (d) Memorandum joint venture account is prepared to find out profit on venture.

Answers

1.(d)	2. (b)	3. (b)	4. (a)	5. (c)
6. (b)	7. (b)	8. (a)	9. (b)	10. (b)
11. (d)				

Lesson 10
Introduction to Company Accounts

LESSON OUTLINE

- Basic Concepts of Company Accounts
- Issue of Shares
  - For Cash
  - Under Subscription of Shares
  - Over Subscription of Shares
  - Calls in Advance and Interest on Calls in Advance
  - Calls in Arrears and Interest on Calls in Arrears
  - Issue of shares for consideration other than cash
- Review Questions
- Forfeiture of Shares
- Re-issue of Forfeited Shares
- Forfeiture and Re-issue of Shares allotted on Pro-Rata basis in case of over subscription
- Issue of Debentures
  - For cash
  - For consideration other than Cash
  - As Collateral Security
- Redemption of Preference Shares
  - Out of the profits of the company
  - Out of the proceeds of the fresh issue
  - Out of the profits of the company and proceeds of the fresh issue
- Lesson Round Up
- Glossary
- Self-Test Questions

LEARNING OBJECTIVES

The company form of business organization is formed to overcome the limitations of partnership form of business organization. A company is an association or collection of individual real persons and/or other companies, who provide some form of capital with a common purpose or focus and an aim of gaining profits. Thus, a company can be defined as an "artificial person" created by law, with a distinct legal entity, perpetual succession and a common seal. It is not affected by the death, insanity or insolvency of an individual member.

Company accounting is different from sole proprietorship and partnership accounting. Company being a legal entity, has to maintain proper books of accounts to give a true and fair view of the state of affairs of the company. The books are kept on accrual basis and according to double entry system of accounting. The company has to prepare its balance sheet and stamtement of profit & loss anc CFS from the books of account maintained by it.

In this lesson, we will study some basic concepts of company accounts like shares, share capital, entries for issue of share, debentures, forfeiture and re- issue of shares and redemption of preference shares.

We are not going to see a signficant upside until we get a clearer sense of how companies make their money and how it is accounted for.

Charles Pradilla

BASIC CONCEPTS OF COMPANY ACCOUNTS

The company form of business organization is a voluntary association of persons to carry on a business. Normally, it is given a legal status and is subject to certain legal regulations. It is an association of persons who generally contribute money for some common purpose. The money so contributed is the capital of the company. The persons who contribute capital are its members. The proportion of capital to which each member is entitled is called his share, therefore members of a joint stock company are known as shareholders and the capital of the company is known as share capital. The total share capital is divided into a number of units known as 'shares'. The companies are governed by the Indian Companies Act, 2013.

Meaning of Shares

Share as defined in Section 2(84) of the Companies Act, 2013 means a share in the share capital of a company and it also includes stock. A share is one unit into which the total share capital is divided. It is a fractional part of the share capital and forms the basis of ownership in the company. For example, when a company has a share capital of ₹ 5,00,000 divided into 50,000 shares of ₹ 10 each and a person who has taken 50 shares of that company is said to have a share in the share capital of the company to the tune of ₹ 500. In other words, shares are divisions of the share capital of a company.

KINDS OF SHARE CAPITAL

The share capital of a company limited by shares shall be of two kinds under the Companies Act 2013, namely :–

(a) *Equity share capital*: Equity share capital with reference to any company limited by shares means all share capital which is not preference share capital. Equity share capital can be

   (i) with voting rights; or

   (ii) with differential rights as to dividend or voting or any other right.

(b) *Preference share capital*: Preference share capital with reference to any company limited by shares means that part of the issued share capital of the company which carries or would carry a preferential right with respect to –

   - payment of dividend, either as a fixed amount or an amount calculated at a fixed rate; and

   - repayment, in the case of a winding up or repayment of capital, of the amount of the share capital paid-up or deemed to have been paid-up, whether or not, there is a preferential right to the payment of any fixed premium or premium on any fixed scale, specified in the memorandum or articles of the company.

   Deemed preference share capital: The capital shall be deemed to be preference capital, notwithstanding that it is entitled to either or both of the following rights, namely:–

   - that in respect of dividends, in addition to the preferential rights to the payment of dividend, it has a right to participate, whether fully or to a limited extent, with capital not entitled to the preferential right aforesaid;

- that in respect of capital, in addition to the preferential right to the repayment, on a winding up, it has a right to participate, whether fully or to a limited extent, with capital not entitled to that preferential right in any surplus which may remain after the entire capital has been repaid.

Types of Share Capital in Balance Sheet

(a) Nominal or Authorized Capital: It refers to that amount which is stated in the Memorandum of Association as the share capital of the company. The company is registered with this amount of capital. This is the maximum limit of capital which the company is authorized to issue and beyond which the company cannot issue shares unless the capital clause in the Memorandum is altered and the authorized capital is increased.

(b) Issued Capital: It refers to that part of the authorized capital of the company which has actually been offered to the public for subscription in cash and the shares allotted to vendors/promoters for consideration other than cash. It sets the limit of the capital available for subscription. The prescribed form of the Balance Sheet requires that under the head "Issued Capital", should be stated (i) the different classes of share capital as also the sub-classes of the preference shares, (ii) the date and terms of redemption or conversion (if any) of any redeemable preference capital, and (iii) any option on un-issued share capital.

(c) Subscribed Capital: It refers to that part of the issued capital which has actually been subscribed by the public and subsequently allotted to them by the directors of the company which are fully paid or partially paid.

(d) Called up Capital: It is that portion of the subscribed capital which the shareholders are called upon to pay on the shares allotted to them. A company does not necessarily require the full amount at once on the shares subscribed and hence calls up only such portion as it needs. The balance then remaining is known as uncalled capital.

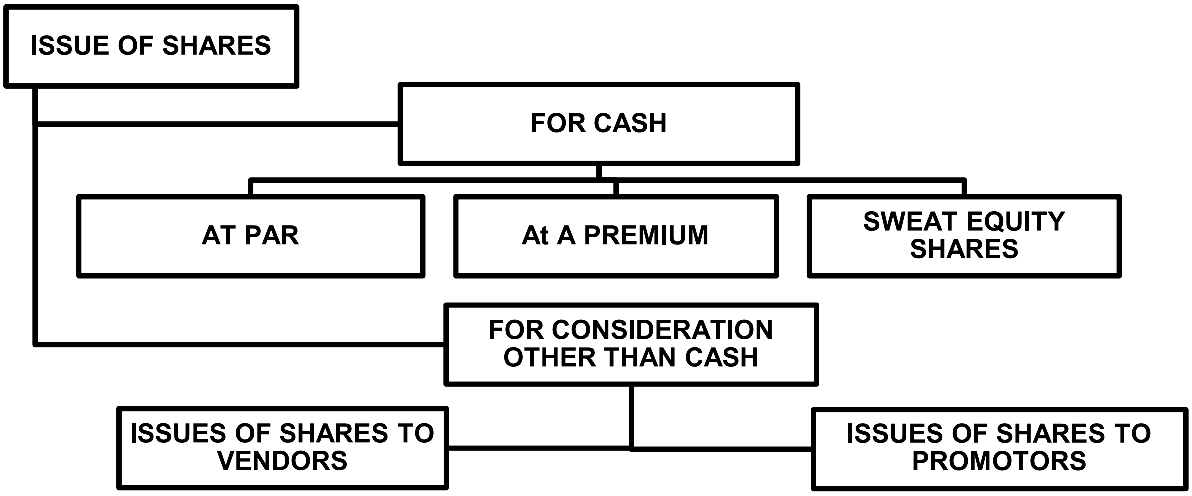
(e) Paid-up Capital: It refers to that part of the called up capital which has actually been paid by the shareholders. This is the actual capital of the company which is included in the total of the Balance Sheet. Paid-up capital is equal to the called up capital if all the shareholders have paid the amount called up by the company.

ISSUE OF SHARES

When a public company desires to raise capital by issuing its shares to the public, it has to invite the public to subscribe for its shares. The invitation is made through a document called the prospectus. The person who intends to subscribe to those shares should make an application for the desired number of shares to the company. Then, the company will allot shares to the applicant.

Allotment means the appropriation of a certain number of shares to an applicant in response to his application. The company cannot allot more than the number of shares offered to the public for subscription through the prospectus. Moreover, the company cannot make allotment unless the amount stated in the prospectus as the minimum subscription has been subscribed and the sum payable on application for the stated amount has been received by the company.

If the number of shares applied for is less than the number of shares offered, the allotment can be only for the shares applied for provided minimum subscription is raised. The minimum subscription is 90% of the issued amount.



ISSUE OF SHARES FOR CASH

Issue of Shares at par

Shares are said to be issued at par when the issue price is equal to the face value or nominal value of the shares i.e. issue price is ₹ 10 and face value is also ₹ 10. When the shares are issued, the company may ask the payment of the shares either in one lump sum or in installments.

(a) When shares are issued at par and are payable in full in a lump sum:

1) On receipt of application money -

Bank	Dr.	*(With the amount received on application)*
To Share Application and Allotment A/c		

(2) On allotment of shares -

Note:

(i) When the capital of the company consists of shares of different classes, a separate share application account will be opened for each class of shares, i.e. equity share application account/preference share application account etc.

(ii) Unless shares are allotted by the company, the receipt of application is simply an offer and cannot be credited to Share Capital Account.

(iii) If the company fails to raise the minimum subscription, then no shares can be allotted and the application money has to be returned to the applicants. For this, the entry will be as follows:

Share Application and Allotment A/c To Bank	Dr.	(*With the application money received now refunded)*

(iv) In actual practice, the cash transactions are not journalised but the same have to be entered in the cash book. The entry in the Cash Book will be as follows:

Cash Book (Bank Columns)

Dr.			*Cr.*
Particulars	*₹*	*Particulars*	*₹*
To Share Application and Allotment A/c (Received of Application money on..... shares @ ₹..................per share)	XXX	By Share Application and Allotment A/c (Refund of application money on......... shares @ ₹........ per share)	XXX

Example: A Ltd. issued 10 lakh equity shares of ₹ 10 each payable in full on application. The company received application for 10 lakh shares. Applications were accepted in full.

Journal Entries

Particulars	*Dr.*	*Cr.*
Bank Dr.	1,00,00,000	
To Equity Share Application and Allotment A/c		1,00,00,000
(Application money on 10 lakh equity shares @ ₹10 per share)		
Equity Share Application and Allotment A/c Dr.	1,00,00,000	
To Equity Share Capital A/c		1,00,00,000
(Allotment of 10 lakh equity shares of ₹ 10 each)		

(b) When shares are issued at par and the amount is payable in installments:

When shares are not payable in a lump sum, the amount can be called in a number of installments. After allotment, whenever the need arises, the directors may demand further money from the shareholders towards payment of the value of shares taken up by them. Such demands are termed as calls. The different calls are distinguished from each other by their serial numbers, i.e. first call, second call, third call and so on. The last installment is also termed the final call along with the number of the last call.

- First installment is called ‘application money’
- Second installment is called ‘allotment money’
- Third installment is called ‘first call money’ and
- The last installment is called ‘second final call money’.

JOURNAL ENTRIES

(i) On receipt of application money

Bank	Dr.	(*with the amount received on application)*
To Share Application Account		
(Being the application money received in respect of...... shares @ ₹.........per share)		

(ii) On allotment of shares

Share Application Account	Dr.	(*with the amount of application money on allotted shares)*
To Share Capital Account		
(Being the application money on allotted shares now transferred to share capital account)		

(iii) On refund of application money on rejected applications

Share Application Account	Dr.	(*with the amount actually repaid)*
To Bank		
(Being application money on ____ shares refunded)		

(iv) On making the allotment money (second installment) due

Share Allotment Account	Dr.	(*with the amount due on allotment)*
To Share Capital Account		
(Being the allotment money due in respect of allotment of........ shares @ ₹....... each)		

(v) On receipt of allotment money is received the following journal entry is made

Bank	Dr.	(*with the actual amount received as allotment money)*
To Share Allotment Account		
(Being the amount received on.......shares @ ₹........ each)		

(vi) On making the first call

Share First Call Account	Dr.	(*with the amount due on first call)*
To Share Capital Account		
(Being the amount due on first call @ ₹..... per share on......shares)		

(vii) On receipt of first call money

Bank	Dr.	(*with the amount received on first call)*
To Share First Call Account		
(Being the amount received in respect of first call @ ₹..... per share on......shares)		

(viii) When second call is made

Share Second Call Account	Dr.	(*with the amount due on second call)*
To Share Capital Account		

(Being the amount due on second call
@ ₹.... per share on.... shares)

(ix) On receipt of second call money:

Bank	Dr.	(*With the amount actually received on second call)*
To Share Second Call Account		
(Being the amount received in respect of second call @ ₹.......... per share on............. shares)		

(x) When the third & final call is made:

Share Third & Final Call Account	Dr.	(*with the amount due on final call)*
To Share Capital Account		
(Being the amount due on final call @ ₹............... per share on........shares)		

(xi) On receipt of Third & final call money:

Bank	Dr.	(*with the amount actually* received on final call)
To Share Third & Final Call Account		
(Being the amount received in respect of final call @ ₹............... per share on................. shares)		

Issue of Shares at Premium

The shares of many successful companies which offer attractive rates of dividend on their existing capitals fetch a higher price than their face value in the market. When shares are issued at a price higher than the face value, they are said to be issued at a premium. Thus, the excess of issue price over the face value is the amount of premium. For example, if a share of Rs. 10 is issued at Rs. 12, Rs. (12 – 10) = Rs. 2 is the premium.

The premium on issue of shares must not be treated as revenue profits. On the contrary, it must be regarded as capital receipt. The Companies Act requires that when a company issues shares at a premium whether for cash or otherwise, a sum equal to the aggregate amount of the premium collected on shares must be credited to a separate account called "Securities Premium Account". There are no restrictions in the Companies Act on the issue of shares at a premium, but there are restrictions on its disposal. Under Section 52(2) of the Companies Act 2013, the Securities Premium Account may be applied by the company–

(a) towards the issue of unissued shares of the company to the members of the company as fully paid bonus shares;

(b) in writing off the preliminary expenses of the company;

(c) in writing off the expenses of, or the commission paid or discount allowed on, any issue of shares or debentures of the company;

(d) in providing for the premium payable on the redemption of preference shares or of any debentures of the company; or

(e) for the purchase of its own shares or other securities under section 68.

It is to be noted here that utilization of the amount of Securities Premium Account except in any of the modes specified above, will attract the provisions relating to the reduction of share capital of a company under the section 66 of the Companies Act 2013.

The Securities Premium Account must be shown as "Securities premium reserves" separately in the liabilities side of the balance sheet under the head "Reserves & Surplus".

The premium is usually payable with the installment due on allotment. However, some companies may charge premium with share application money or partly with share application money and partly at the time of allotment of shares. It may be included in call money also.

JOURNAL ENTRY

When allotment money becomes due:

Share Allotment A/c	Dr.	*(with the money due on allotment including premium)*
To Securities Premium A/c		*(with the premium amount)*
To Share Capital A/c		*(with the share allotment amount)*
(Being allotment money due on shares issued at premium)		

Issue of Shares at A Discount

When shares are issued at a price lower than the face value, they are said to be issued at discount. Thus, the excess of the face value over the issue price is the amount of discount. For example, if a share of ₹ 10 is issued at ₹ 9 then ₹ (10 – 9) = Re. 1 is the discount.

As per companies Act 2013, a company shall not issue shares at a discount except as provided in section 54 for issue of sweat equity shares. Any share issued by a company at a discounted price shall be void.

Where a company contravenes the provisions of this section, the company shall be punishable with fine which shall not be less than one lakh rupees but which may extend to five lakh rupees and every officer who is in default shall be punishable with imprisonment for a term which may extend to six months or with fine which shall not be less than one lakh rupees but which may extend to five lakh rupees, or with both.

REVIEW QUESTIONS

1. When shares are issued at a price higher than the face value, they are said to be issued at _____.

2. ____ means the appropriation of a certain number of shares to an applicant in response to his application.

3. When shares are issued at a price lower than the face value, they are said to be issued at ________.

Illustration 1:

P Ltd. was registered with an authorised capital of ₹ 10,00,000 divided into 1,00,000 equity shares of ₹ 10 each out of which 50,000 equity shares were offered to the public for subscription. The shares were payable as under:

₹ 3 per share on application

₹ 2 per share on allotment

₹ 2 per share on 1st call

₹ 3 per share on 2nd and final call

The shares were fully subscribed for and the money was duly received.

Show the journal and cash book entries.

Solution:

In the books of P Ltd.

Journal Entries

Date	*Particulars*		*Debit (₹)*	*Credit (₹)*
	Equity Share Application A/c	Dr.	1,50,000	
	Equity Share Allotment A/c	Dr.	1,00,000	
	To Equity Share Capital A/c			2,50,000
	(Capitalization of application money @ ₹ 3 per share and allotment money due on 50,000 equity shares transferred as per Boards resolution dated.....)			
Date	*Particulars*		₹	₹
	Equity Share First Call A/c	Dr.	1,00,000	
	To Equity Share Capital A/c			1,00,000
	(First call money on 50,000 equity shares @ ₹2 per share due as per Board's resolution dated.....)			
	Equity Share Second & Final Call A/c	Dr.	1,50,000	
	To Equity Share Capital A/c			1,50,000
	(Second and final call money due on 50,000 Equity Shares @ 3 per share as per Board's resolution dated.....)			

Cash Book (Bank Columns)

Dr. Cr.

Particulars	₹	Particulars	₹
To Equity Share Application A/c	1,50,000	By Balance c/fd	5,00,000
To Equity Share Allotment A/c	1,00,000		
To Equity Share First Call A/c	1,00,000		
To Equity Share Second & Final Call A/c	1,50,000		
	5,00,000		5,00,000

Illustration 2:

Wonder Ltd. issued 10,000, 12% Preference Shares of ₹ 100 each at a premium of ₹ 10 per share payable as follows:

On Application	*₹ 30*
On Allotment	*₹ 30 (including premium)*
On First Call	*₹ 25*
On Final Call	*₹ 25*

Applications were received for 12,000 shares and the directors allotted 10,000 shares and rejected applications for 2,000 shares and the money received thereon was refunded.

The allotment money was duly received while the first call money was received on 9,000 shares and the final call money on 8,000 shares.

Show the cash book and journal entries.

Solution:

In the books of Wonder Ltd.

Journal Entries

Date	*Particulars*	*Debit (₹)*	*Credit (₹)*
	12% Preference Share Application and Allotment A/c Dr.	6,00,000	
	To 9% Preference Share Capital A/c		5,00,000
	To Securities Premium A/c		1,00,000
	(Capitalisation of application money @ ₹ 30 per share and allotment money due @ ₹ 30 per share shares including ₹ 10 as premium on 10,000, 12% preference as per Board's resolution dated.....)		
Date	*Particulars*	₹	₹
	12% Preference Share First Call A/c Dr.	2,50,000	
	To 12% Preference Share Capital A/c		2,50,000

	(First call money due @ ₹ 25 per share on 10,000, 12% Preference Shares as per Board's resolution dated.......)		
	Calls-in-Arrear A/c Dr.	25,000	
	To 12% Preference Share First Call A/c		25,000
	(First call money due on 1,000, 12% Pref. Shares @ ₹ 25 per share transferred to Call-in-Arrear A/c)		
	12% Preference Share Final Call A/c Dr.	2,50,000	
	To 12% Preference Share Capital A/c		2,50,000
	(Final call money due @ ₹ 25 per share on 10,000, 12% Pref. shares as per Board's resolution dated...)		
	Calls-in-Arrear A/c Dr.	50,000	
	To 12% Preference Share Final Call A/c		50,000
	(Final call money due on 2,000, 12% Pref. Shares @ ₹ 25 per share transferred to Calls-in-Arrear A/c)		

Cash Book (Bank Columns)

Dr. Cr.

Particulars	₹	Particulars	₹
To 12% Preference Share Application and Allotment A/c (Application money on 12,000, 12% Pref. Shares @ ₹ 30 per share)	3,60,000	By 12% Preference Share Application and Allotment A/c (Refund of Application money on 2000, 12% Pref. Shares @ ₹ 30 per share)	60,000
To 12% Preference Share Application and Allotment A/c (Allotment money @ ₹ 30 per share on 10,000, 12% preference shares)	3,00,000	By Balance c/d	10,25,000
To 12% Preference Share First Call A/c (First call money @ ₹ 25 per share on 9,000, 12% Pref. Shares)	2,25,000		
To 12% Preference Share Final Call A/c (Final call money @ ₹ 25 per share on 8,000, 12% Pref. shares)	2,00,000		
	10,85,000		10,85,000

UNDER-SUBSCRIPTION OF SHARES

In actual practice, it rarely happens that the number of shares applied for is exactly equal to the number of shares offered to public for subscription. If the number of shares applied for is less than the number of shares issued the shares are said to be undersubscribed. When an issue is under-subscribed, entries are made on the basis of number of shares applied for, provided the minimum subscription is raised.

OVER-SUBSCRIPTION OF SHARES

When the number of shares applied for exceeds the number of shares issued, the shares are said to be over-subscribed. In such a situation, the directors allot shares on some reasonable basis because the company can allot only that number of shares which has been actually offered for subscription. Moreover, as per the guidelines issued by SEBI, the company cannot reject out-rightly any application for shares unless it has incomplete information or absence of signature(s) or insufficient application money and so on. In short, the following procedure is adopted:

(i) Total rejection of some applications;

(ii) Acceptance of some applications in full; and

(iii) Allotment to the remaining applicants on pro-rata basis.

The shares should be issued in tradable lot. In case of pro-rata allotment, no applicant for shares is refused and no applicant is allotted the shares in full. Each applicant receives the shares in some proportion. In such cases, the excess amount of application money (i.e. overpaid amount) is not refunded but retained and treated as a payment towards allotment money. The following journal entry is made to transfer excess application money to allotment account.

Share Application A/c	Dr.	*(with the excess application*
To Share Allotment A/c		*money)*
(Being the surplus application money transferred		
to share allotment account)		

Surplus money exceeding that due on allotment should be refunded to the allottees. However, the company may transfer this to Calls-in-Advance Account if:

(i) Acceptance of calls in advance is permitted by the company's Articles.

(ii) The consent of the applicant has been taken either by a separate letter or by inserting a clause in the company's prospectus.

The company can retain the calls in advance at the most so much amount as is sufficient to make the allotted shares fully paid up ultimately.

The journal entry will be as follows:

Share Application A/c	Dr.	(with the excess application
To Calls-in-Advance A/c		money left over the amount
(Being the surplus application money transferred		due on application and
to Calls-in-Advance Account)		allotment)

CALLS-IN-ADVANCE AND INTEREST ON CALLS-IN-ADVANCE

If authorised by the articles, a company may receive from a shareholder the amount remaining unpaid on shares, even though the amount has not been called up. This is known as calls-in-advance. It is a debt of a company until the calls are made and the amount already paid is adjusted. Calls-in-advance may also arise when the number of shares allotted to a person is much smaller than the number applied for and the terms of issue permit the company to retain the amount received in excess of application and allotment money. Of course, the company can retain only so much as is required to make the allotted shares fully paid ultimately. The calls-in-advance account is ultimately closed by transfer to the relevant call accounts. It is noted that the money received on calls-in-advance does not become part of share capital. It is shown under a separate heading, namely 'calls-in-advance' on the liabilities side. No dividend is paid on calls-in-advance.

Accounting Treatment

(i) On receipt of call money in advance:

Bank A/c	Dr.	(with the amount of call
To Call-in-Advance A/c		money received in advance)
(Being the calls received in advance)		

(ii) As and when calls are made:

Calls-in-Advance A/c	Dr.	(with the amount adjusted on
To Relevant Call A/c		relevant call becoming due)

The amount received as calls-in-advance is a debt of the company, the company is liable to pay interest on the amount of Calls-in-Advance from the date of receipt of the amount till the date when the call is due for payment. Generally the Articles of the company specify the rate at which interest is payable. If the articles do not contain such rate, Table F will be applicable & company liable to pay interest @ 12% p.a.

It is to be noted that the interest payable on Calls-in- Advance is a charge against the profits of the company. As such, Interest on Calls-in-Advance must be paid even when no profit is earned by the company.

Accounting Treatment

(i) If Interest on Calls-in-Advance is paid in cash -

Interest on Calls-in-Advance A/c	Dr.	(with the amount of
To Bank A/c		interest paid)
(Interest on Calls-in-Advance paid @ .....% p.a. on ₹........... for............ months)		

(ii) If interest on Calls-in-Advance is not paid in cash -

Interest on Calls-in-Advance A/c	Dr.	(with the amount of
To Sundry Shareholders A/c		interest payable)
When payment is made,		
Sundry shareholders A/c	Dr.	
To Bank A/c		

(iii) At the end of the year, when interest on Calls-in-Advance is transferred to Profit and Loss A/c -

Profit and Loss A/c	Dr.	(with the amount of interest)
To Interest on Calls-in-Advance A/c		

Note: The liability to sundry shareholders is to be treated as outstanding liability and should be shown under the head "Current Liabilities" in the balance sheet.

Illustration 3:

Newlook Ltd. issued, 1,00,000 Equity Shares of ₹ 10 each payable as follows:

On Application (On 1st March, 2016)	*₹ 4*
On Allotment (On 1st April, 2016)	*₹ 1*
On First Call (On 1st August, 2016)	*₹ 3*
On Final Call (On 1st October, 2016)	*₹ 2*

Application were received for 2,60,000 shares. Of these 10,000 shares were in disorder; 40,000 shares in lots of 100 shares; 1,20,000 shares in lots of exceeding 100 but less than 500 shares; 60,000 shares in lots of exceeding 500 but less than 1,000 shares and the balance in lots of exceeding 1,000 shares.

Allotment was made as follows:

Application for the 10,000 shares in disorder were rejected.

Application for 100 shares in full, i.e. 100%	*40,000*
Application over 100 shares but not exceeding 500 shares - 40%	*48,000*
Application over 500 shares but not exceeding 1,000 shares - 15%	*9,000*
Applications over 1,000 shares - 10%	*3,000*

Money received in excess on shares partially allotted was retained to the extent possible. Show the cash book and journal entries assuming that all the installments were duly received and interest was paid by the directors on calls-in-advance @ 12% per annum on 1st October, 2016.

Solution:

Dr. **Cash Book (Bank Columns)** *Cr.*

Date	*Particulars*	*₹*	*Date*	*Particulars*	*₹*
1.3.2016	To Equity Share Application A/c (application money @ ₹ 4 per share)	10,40,000	1.4.2016	By Equity Share Application A/c (refund of application money)	2,80,000
1.4.2016	To Equity share Allotment A/c (balance of allotment money)	40,000	1.10.2016	By Interest on Call in Advance A/c (interest @ 12% on ₹ 1,80,000 for 4 months = 7,200 and on ₹ 1,20,000 for 6 months - ₹ 7,200)	14,400
1.8.2016	To Equity Share 1st Call A/c (balance of share 1st call money)	1,20,000	1.10.2016	By Balance c/d	9,85,600
1.10.2016	To Equity Share Final A/c	80,000			
		12,80,000			12,80,000

Journal Entries

Date	*Particulars*		*Dr. (₹)*	*(Cr. (₹)*
1.4.2016	Equity Share Application A/c	Dr.	4,00,000	
	To Equity Share Capital A/c			4,00,000
	(Being the application money on 1,00,000 shares transferred to share capital account)			
1.4.2016	Equity Share Allotment A/c	Dr.	1,00,000	
	To Equity Share Capital A/c			1,00,000
	(Being the allotment money due in respect of 1,00,000 equity shares @ Re. 1 per share)			
1.4.2016	Share Application A/c	Dr.	3,60,000	
	To Share Allotment A/c			60,000
	To Calls in Advance A/c			3,00,000
	(Being the transfer of surplus application money received on 60,000 shares)			
1.8.2016	Equity Share 1st Call A/c	Dr.	3,00,000	
	To Equity Share Capital A/c			3,00,000
	(Being the 1st call money due on 1,00,000 equity shares @ ₹ 3 per share)			
1.8.2016	Calls-in-Advance A/c	Dr.	1,80,000	
	To Equity Share 1st Call A/c			1,80,000
	(Being the amount transferred from calls in advance account)			

Date	*Particulars*		*Dr. (₹)*	*(Cr. (₹)*
1.10.2016	Equity Share Final Call A/c	Dr.	2,00,000	
	To Equity Share Capital A/c			2,00,000
	(Being the final call money due on 1,00,000 equity share @ ₹ 2 per share)			
1.10.2016	Calls-in-Advance A/c	Dr.	1,20,000	
	To Equity Share Final Call A/c			1,20,000
	(Being the amount transferred from calls-in-advance account)			

Working Note

Statement showing the adjustment of Application Money and Calls in Advance Money

Shares applied	*Shares alllotted*	*Amount received on appli-cations*	*Amount due on appli-cations*	*Balance of application money*	*Amount due on allotment*	*Amount received on allotment*	*Surplus to be trans-ferred to calls-in-advance*
1	2	3	4	5	6	7	8
		₹	₹	₹	₹	₹	₹
10,000	Nil	40,000	Nil	Nil	Nil	Nil	Nil
40,000	40,000	1,60,000	1,60,000	Nil	40,000	40,000	Nil
1,20,000	48,000	4,80,000	1,92,000	2,88,000	48,000	Nil	2,40,000
60,000	9,000	2,40,000	36,000	2,04,000	9,000	Nil	45,000
30,000	3,000	1,20,000	12,000	1,08,000	3,000	Nil	15,000
2,60,000	1,00,000	10,40,000	4,00,000	6,00,000	1,00,000	40,000	3,00,000

Amount to be refunded	*Amount due to 1st call*	*Calls-in-Advance to be adjusted against 1st call*	*Amount payable on 1st call*	*Surplus remaining in calls in advance*	*Amount due on final call*	*Calls-in-advance to be adjusted against final call*	*Amount payable on final call*
9	*10*	*11*	*12*	*13*	*14*	*15*	*16*
₹	₹	₹	₹	₹	₹	₹	₹
40,000	Nil	Nil	Nil	Nil	Nil	Nil	Nil
Nil	1,20,000	Nil	1,20,000	Nil	80,000	Nil	80,000
Nil	1,44,000	1,44,000	Nil	96,000	96,000	96,000	Nil
1,50,000	27,000	27,000	Nil	18,000	18,000	18,000	Nil
90,000	9,000	9,000	Nil	6,000	6,000	6,000	Nil
2,80,000	3,00,000	1,80,000	1,20,000	1,20,000	2,00,000	1,20,000	80,000

CALLS IN ARREAR AND INTEREST ON CALLS IN ARREAR

When calls are made upon shares allotted, the shareholders holding the shares are bound to pay the call money within the date fixed for such payment. If a shareholder makes a default in sending the call money within the appointed date, the amount thus failed is called Calls-in-Arrear.

The interest on Calls-in-Arrear is recoverable according to the provisions in this regard in Articles of the company. But if the Articles are silent, Table 'F' shall be applicable which prescribes that if a sum called in respect of shares is not paid before or on the day appointed for payment, the person who failed to pay shall pay thereof from the day appointed for payment to the time of actual payment at a rate of 10% per annum. However, the directors have the right to waive the payment of interest on Calls-in-Arrear. The interest on Calls-on-Arrear Account is transferred to the Profit and Loss Account at the end of the year.

Journal Entries

(i) When call money is in arrear:

Calls-in-Arrear A/c	Dr.	(with the amount-failed by
To Relevant Call A/c		the shareholders)

(ii) On receipt of amount of Calls-in-Arrear with interest, on a subsequent date:

Bank	Dr.	(with the amount received)
To Calls-in-Arrears A/c		
To Interest on Calls-in-Arrear		

Illustration 4:

On 1st January, 2016, New Ventures Ltd. issued 1,00,000 equity shares of ₹10 each payable as follows:

On application	*₹ 3*
On allotment	*₹ 2*
On 1st Call	*₹ 2 (Payable after 2 months, from the date of allotment)*
On Final Call	*₹ 3 (Payable after 2 months from the date of 1st call)*

Applications were received on 15th January, 2016 for 1,20,000 shares and allotment was made on 1st February, 2016. Applicants for 50,000 shares were allotted in full, those for 60,000 shares were allotted 50,000 shares and applications for 10,000 shares were rejected.

Balance of amount due on allotment was received on 15th February. The calls were duly made on 1st March, 2016 and 1st April, 2016 respectively. One shareholder did not pay the 1st call money on 3,000 shares which he paid with the final call together with interest at 10% p.a. Another shareholder holding 2,000 share did not pay the final call money till end of the accounting year which ended on 31st March, 2016. Show the Cash Book and Journal Entries.

Solution:

Journal Entries

Date	*Particulars*		*Dr. (₹)*	*Cr.(₹)*
1.2.2016	Equity Share Application A/c	Dr.	3,00,000	
	To Equity Share Capital A/c			3,00,000
	(Being the transfer of application money on 1,00,000 shares @ ₹ 3 per share transferred to share capital account)			
1.2.2016	Equity Share Allotment A/c	Dr.	2,00,000	
	To Equity Share Capital A/c			2,00,000
	(Being the amount due on allotment of 10,00,000 shares @ ₹ 1 per share)			
1.2.2016	Equity Share Application A/c	Dr.	30,000	
	To Share Allotment A/c			30,000
	(Being the transfer of excess application money)			
1.3.2016	Equity Share Ist Call A/c	Dr.	2,00,000	
	To Equity Share Capital A/c			2,00,000
	(Being the Ist call amount due on 1,00,000 shares @ ₹ 2 per share)			
1.4.2016	Calls-in-Arrear A/c	Dr.	6,000	
	To Equity Share Ist Call A/c			6,000
	(Being the transfer of Ist call money on 3,000 equity shares @ ₹ 2 per share)			
1.4.2016	Equity Share Final Call A/c	Dr.	3,00,000	
	To Equity Share Capital A/c			3,00,000
	(Being the final call amount due on 1,00,000 shares @ ₹ 3 per share)			
1.5.2016	Calls-in-Arrear A/c	Dr.	6,000	
	To Equity Share Final Call A/c			6,000
	(Being the transfer of final call money on 2,000 equity shares @ ₹3 per share)			
31.3.2016	Sundry Shareholders A/c	Dr.	400	
	To Interest on Calls-in-Arrears A/c			400
	(Being the interest due on ₹ 6,000 @ 10% for eight months)			

Dr. **Cash Book (Bank Column)** *Cr.*

Date	*Pariculars*	₹	*Date*	*Particulars*	₹
15.1.2016	To Equity Share Application A/c (application money @ ₹ 3 per share 2,20,000 shares)	3,60,000	1.2.2016	By Equity Share Application A/c (refund of application money @ ₹ 3 per share on 10,000 shares rejected)	30,000
15.2.2016	To Equity Share Allotment A/c (balance of allot-ment money on ₹ 1,00,000 shares)	1,70,000	1.5.2016	By Balance c/d	9,94,050
1.4.2016	To Equity Share 1st Call A/c (1st call money on 97,000 shares)	1,94,000			
1.5.2016	To Equity Share Final A/c (final call money on 98,000 shares)	2,94,000			
1.5.2016	To Calls-in-Arrear A/c (arrears of 1st call money @ ₹ 2 per share on 3,000 shares)	6,000			
1.5.2016	To Interest on Calls-in-Arrear A/c (interest on ₹ 6,000 for one month @ 10% p.a.)	50			
		10,24,050			10,24,050

ISSUE OF SHARES FOR CONSIDERATION OTHER THAN CASH

A company may also issue shares for consideration other than cash to vendors who sell some assets to the company or to the promoters for their services. When shares are so issued, the Companies Act requires that the same must be clearly stated in the balance sheet and must be distinguished from the issue made for cash.

ISSUE OF SHARES TO VENDORS

A company may purchase assets from the vendors and instead of paying the vendors cash, may settle the purchase price by issuing fully paid shares of the company. This type of issue of shares to the vendors is called issue of shares for consideration other than cash.

Journal Entries

(i) When assets are acquired from the vendors -

Sundry Assets A/c (individually)	Dr.	(with the purchase price
To Vendors		payable for the assets acquired)

(ii) When fully paid shares are issued to vendors at par -

Vendors	Dr.	(with the nominal value
To Share Capital A/c		of the shares allotted)

(iii) When fully paid shares are issued to vendors at a premium -

Vendors	Dr.	(with the purchase price)
To Share Capital A/c		(with the nominal value of the shares allotted)
To Securities Premium A/c		(with the amount of premium)

Illustration 5:

Rocket Ltd. purchased the business of Comet Ltd. for ₹ 2,70,000 payable in fully paid shares. Rocket Ltd. allotted equity shares of ₹ 10 each fully paid in satisfaction of the claim by Comet Ltd. Show the necessary journal entries in the books of Rocket Ltd. assuming that:

(a) Such shares are issued at par,

(b) Such shares are issued at premium of 20% and

Solution:

Journal Entries

	Particulars	*Dr. (₹)*	*Cr.(₹)*
	Sundry Assets Dr.	2,70,000	
	To Comet Ltd.		2,70,000
	(Purchase of assets from Comet Ltd. as per agreement dated.....)		
(a)	*If shares are issued at par*		
	Comet Ltd. Dr.	2,70,000	
	To Equity Share Capital A/c		2,70,000
	(Allotment of 27,000 equity shares of ₹ 10 each to vendors as fully paid-up for consideration other than cash as per Board's resolution dated...)		
(b)	*If shares are issued at a premium of 20%*		
	Comet Ltd. Dr.	2,70,000	
	To Equity Share Capital A/c		2,25,000
	To Securities Premium A/c		45,000
	(Allotment of 22,500 equity shares of ₹ 10 each at a premium of ₹2 per share to vendors as fully paid-up for consideration other than cash as per Board's resolution dated.....)		

Working Notes:

1. When shares are issued at a premium of 20%

Issue price per share = ₹ $\left(10+\frac{20}{100}\right)$ = ₹ 12

$\therefore$ No. of shares to be allotted = $\frac{₹2,70,000}{₹12} = ₹22,500$

ISSUE OF SHARES TO PROMOTERS

A company may allot fully paid shares to promoters or any other party for the services rendered by them by way of furnishing technical information, engineering services, plant layout, drawing and designing, etc. without payment. This type of issue of shares to promoters is called issue of shares for consideration other than cash. As the amount paid to promoters for services rendered by them is supposed to be utilised by the company over a long period of time, such expenditure should be treated as capital expenditure and debited to Goodwill Account. The accounting entry in such a case will be as follows:

Goodwill A/c To Share Capital A/c	Dr.	(with the nominal value of the shares allotted.)

Illustration 6:

Bright Ltd. was registered with a share capital of ₹ 10,00,000 in equity shares of ₹ 10 each. The company acquired factory building worth ₹ 1,00,000 and plant and machinery worth ₹ 80,000 from Delite Ltd. and issued 18,000 equity shares of ₹ 10 each to the vendors as fully paid-up. The directors also decided to allot 2,000 equity shares credited as full paid to the promoters for their services. Further capital was issued to the public for cash to the extent of ₹ 3,00,000 payable in full with the application. All the shares were taken up by the public and fully paid for. Show the necessary journal entries and the balance sheet.

Solution:

Journal Entries

Particulars		*Dr. (₹)*	*Cr.(₹)*
Factory Building A/c	Dr.	1,00,000	
Plant and Machinery A/c	Dr.	80,000	
To Delite Ltd.			1,80,000
(Purchase of assets from Delite Ltd. as per agreement dated.....)			
Delite Ltd.	Dr.	1,80,000	
To Equity Share Capital A/c			1,80,000
(Allotment of 18,000 equity shares of ₹ 10 each to vendors as fully paid-up for consideration other than cash as per Board's resolutions dated.....)			
Goodwill A/c	Dr.	20,000	
To Equity Share Capital A/c			20,000

(Allotment of 2,000 equity shares of ₹ 10 each to promoters as fully paid-up for consideration other than cash as per Board's Resolution dated.....)			
Bank	Dr.	3,00,000	
To Equity Share Application and Allotment A/c			3,00,000
(Application money on 30,000 equity shares ₹ 10 each per share)			
Equity Share Application and Allotment A/c	Dr.	3,00,000	
To Equity Share Capital A/c			3,00,000
(Allotment of 30,000 equity shares of ₹ 10 each as fully paid as per Board's resolution dated.....)			

Balance Sheet of Bright Ltd., as at.....

	Particulars	*Note No.*	*Amount (₹)*
I	**Equity and Liabilities**		
	Shareholders' Funds		
	Share Capital	1	5,00,000
	Total		5,00,000
II	**Assets**		
	Non-current Assets		
	Fixed Assets		
	Tangible Assets	2	1,80,000
	Intangible Assets	3	20,000
	Current Assets		
	Cash and Cash Equivalents	4	3,00,000
	Total		5,00,000

Notes:

1. **Share Capital**

Authorised	
1,00,000 Equity Shares of ₹ 10 each	10,00,000
Issued, Subscribed and Paid-up :	
50,000 Equity Shares of ₹ 10 each, fully paid-up	5,00,000
(Of the above shares, 20,000 equity shares have been issued to vendors and promoters for consideration other than cash)	

2. **Tangible Assets**

Factory Building	1,00,000
Plant and Machinery	80,000
	1,80,000

3. Intangible Assets	
Goodwill	20,000
4. Cash and Cash Equivalent	
Balance with Bank	3,00,000

FORFEITURE OF SHARES

If a shareholder fails to pay the allotment money and/or calls made on him, his shares are liable to be forfeited. Forfeiture of shares may be said to be the compulsory termination of membership by way of penalty for non-payment of allotment and/or any call money.

The Companies Act does not contain any specific provisions regarding forfeiture. The directors must follow certain procedure for forfeiting the shares. They have to give notice to the defaulting shareholder calling upon him to pay the amount due from him together with interest before a specified date (not being earlier than the expiry of fourteen days from the date of service of the notice). This notice must also state that if the shareholder fails to pay the amount along with interest due within the specified date, the shares will be forfeited. If the payment is not received within the specified time, the directors meet to consider the forfeiture and they can proceed to forfeit the shares. The directors must pass a resolution for forfeiting the shares at a duly constituted meeting of the Board of Directors and the defaulting shareholder should be informed about the forfeiture of his shares.

The effect of forfeiture of shares is that the defaulting shareholder loses all his rights in the shares and ceases to be a member. The name of the shareholder is removed from the Register of Members and the amount already paid by him is forfeited. He is not entitled in future to dividends and the rights of membership. However, the directors have the right to cancel such forfeiture before the forfeiture shares are re-issued.

Forfeited shares account is to be shown in the balance sheet by way of addition to the paid-up share capital on the 'liabilities' side, until the concerned shares are reissued.

Accounting Entries on Forfeitures of Shares

- **Issued at Par**
- **Issued at A Premium**

Forfeiture of Shares Issued at Par

JOURNAL ENTRIES

The forfeiture of shares can be recorded in two ways:

1. Where the unpaid calls have already been transferred to Calls-in-Arrear A/c and the respective call accounts have been closed:

Share Capital A/c	Dr.	(with the amount of called up value of shares forfeited i.e. no. of shares forfeited x the called up value per share.
To Shares Forfeited A/c		with the amount already paid-up by the shareholders on

		the shares forfeited.)
To Calls-in-Arrear A/c		(with the amount of unpaid calls.)

OR

2. Where the unpaid calls have not been transferred to Calls-in-Arrear A/c and the respective call accounts are showing balances representing unpaid amounts:

Share Capital A/c	Dr.	(with the amount of called up value of shares forfeited i.e., no. of shares forfeited x the called up value per share.)
To Shares Forfeited A/c		(with the amount already paid up by the shareholders on the shares forfeited.)
To Share Allotment A/c		(with the amount failed on allotment, if any.)
To Share First Call A/c		(with the amount failed on first call, if any.)
To Share Final Call A/c		(with the amount failed on final call, if any.)

Forfeiture of Shares Issued at a Premium

Case 1: Where shares to be forfeited were issued at a premium and the premium money remained unpaid:

In this case the credit already given to the 'Securities Premium A/c' will be cancelled at the time of forfeiture of the shares by debiting "Securities Premium A/c".

JOURNAL ENTRIES

Share Capital A/c	Dr.	(with the amount of called up value of shares forfeited, i.e., no. of shares forfeited x called up value per share excluding premium).
Securities Premium A/c	Dr.	(with the amount of premium money remaining unpaid on shares forfeited.)
To Shares Forfeited A/c		(with the amount already paid by the shareholders on the shares forfeited.)
To Calls-in-Arrear A/c		(with the amount unpaid on calls.)

OR

Share Capital A/c	Dr.	(with the amount of called up value of shares forfeited, i.e., no. of shares forfeited x called up value per share excluding premium.)
Securities Premium A/c	Dr.	(with the amount of premium money remaining unpaid on shares forfeited.)
To Shares Forfeited A/c		(with the amount already paid by the shareholders on the shares forfeited.)
To Share Allotment A/c		(with the amount failed on allotment, if any.)
To Share First Call A/c		(with the amount failed on first call, if any.)
To Share Final Call A/c		(with the amount failed on final call, if any.)

Case 2: Where shares to be forfeited were issued at a premium and the premium money was duly received on the shares to be forfeited:

In this case Securities Premium Account is already credited at the time of making call will not be cancelled at the time of forfeiture of the shares. In such a case, the accounting entry on forfeiture will be the same as the one passed in case of shares issued at par.

RE-ISSUE OF FORFEITED SHARES

The Board of Directors can sell/ reissue or dispose of forfeited shares on such terms as it thinks fit. However, the amount receivable on re-issue of such shares together with the amount already received from the defaulting member, shall not, in any case, be less than the face value of the shares. Forfeited shares may be re-issued at par, at a premium or even at a discount.

Re-Issue of Forfeited Shares - At Par

the forfeited shares can be re-issued at par. In such a case, the entire amount standing to the credit of Shares Forfeited Account for those shares would be treated as net gain and transferred to Capital Reserve Account.

JOURNAL ENTRIES

1. On re-issue of shares:

Bank	Dr.	(with the amount received on reissue
To Share Capital A/c		i.e. no. of shares re-issued x amount received per share.)

2. On transfer of Shares Forfeited Account to Capital Reserve Account:

Shares Forfeited A/c	Dr.	(with the forfeited amount on shares
To Capital Reserve A/c		re-issued.)

Re-Issue of Forfeited Shares - At a Premium

If forfeited shares are re-issued at a premium, the amount of such premium should be credited to Securities Premium Account. In such a case also, the entire amount standing to the credit of Shares Forfeited Account would be treated as net gain and transferred to Capital Reserve Account.

JOURNAL ENTRIES

1. On re-issue of shares:

Bank	Dr.	(with the total amount received on re-issue.)
To Share Capital A/c		(with nominal value or paid-up value of shares.)
To Securities Premium A/c		(with the premium amount received.)

2. On transfer of Shares Forfeited A/c to Capital Reserve A/c:

Shares Forfeited A/c	Dr.	(with the forfeited amount on shares

To Capital Reserve A/c	re-issued)

Re-Issue of Forfeited Shares - At a Discount

If forfeited shares are re-issued at a discount, the amount of discount can, in no case, exceed the amount credited to Shares Forfeited Account. Discount thus allowed on re-issue has to be debited to Shares Forfeited Account. If the discount allowed on re-issue is less than the forfeited amount, there will be a surplus left in the Shares Forfeited Account which will be treated as net gain on forfeiture. As this gain is in the nature of capital profits, it should be transferred to Capital Reserve Account. Capital Reserve Account will appear on the liabilities side of the balance sheet under the head "Reserves and Surplus".

JOURNAL ENTRIES

1. On re-issue of shares:

Bank	Dr.	(with the amount received on re-issue.)
Shares Forfeited A/c	Dr.	(with the discount allowed on re-issue.)
To Share Capital A/c		(with the total.)

2. On transfer of balance in Shares Forfeited Account, if any, to Capital Reserve Account:

Shares Forfeited A/c	Dr.	(with the net gain, if any, on shares re-issued.)
To Capital Reserve A/c		

Important Note: *In case only a part of the forfeited shares are re-issued, only the proportionate amount representing the net gain on the shares re-issued should be transferred to Capital Reserve Account and the balance representing the amount received on forfeited shares not yet re-issued should be left in the Shares Forfeited Account itself. This amount should be shown as addition to the paid up capital on the liabilities side of the balance sheet.*

Illustration 7:

X Ltd. forfeited 1,000 equity shares of ₹ 10 each issued at par for non-payment of the first call of ₹ 2 per share and the final call of ₹ 3 per share. Give journal entry for the forfeiture.

Solution:

In the books of X Ltd.

Journal Entries

Date	*Particulars*		*Debit (₹)*	*Credit (₹)*
	Equity Share Capital A/c (1,000 x ₹10)*	Dr.	10,000	
	To Shares Forfeited A/c (1,000 x ₹ 5)*			10,000

	To Calls-in-Arrear A/c (1,000 x ₹ 5)*		
	(Forfeiture of 1,000 equity shares for non-payment of the first call @ ₹ 2 per share and the final call @ ₹ 3 per share as per Board's resolution dated...)		
	Alternatively:		
	Equity Share Capital A/c (1,000 x ₹10)* Dr.	10,000	
	To Shares Forfeited A/c (1,000 x ₹ 5)*		5,000
	To Equity Share First Call A/c		2,000
	To Equity Share Final Call A/c		3,000
	(Forfeiture of 1000 equity shares for non-payment of the first call @ ₹ 2 per share and the final call @ ₹ 3 per share as per Board's resolution dated...)		

Illustration 8:

X Ltd. forfeited 1,500 equity shares of ₹ 10 each, issued at a premium of ₹ 5 per share for non-payment of allotment money of ₹ 8 per share (including share premium ₹ 5 per share) the first call @ ₹ 2 per share and the final call @ ₹ 3 per share. Give the journal entry for the forfeiture.

Solution

In the books of X Ltd.

Journal Entries

Date	*Particulars*	*Debit (₹)*	*Credit (₹)*
	Equity Share Capital A/c (1,500 x ₹10)* Dr.	15,000	
	Securities Premium A/c (1,500 x ₹5)* Dr.	7,500	
	To Shares Forfeited A/c (1,500 x ₹ 2)*		3,000
	To Equity Share Allotment A/c		12,000
	To Equity Share First Call A/c		3,000
	To Equity Share Final Call A/c		4,500
	(Forfeiture of 1,500 equity shares of ₹ 10 each for non-payment of allotment money @ ₹ 8 per share, including a premium @ ₹ 5 per share, first call money @ ₹ 2 per share and the final call money @ ₹ 3 per share as per Board's resolution dated...)		

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* Shown by way of explanation.

Illustration 9:

X Ltd. forfeited 1,500 equity shares of ₹ 10 each issued at a premium of ₹ 5 per share payable with the allotment money, for non-payment of the first call money of ₹ 2 per share and the final call money of ₹ 3 per share. Give journal entries.

Solution:

In the books of X Ltd.

Journal Entries

Date	*Particulars*	*Debit (₹)*	*Credit (₹)*
	Equity Share Capital A/c (1,500 x ₹10)* Dr.	15,000	
	To Shares Forfeited A/c (1,500 x ₹ 5)*		7,500
	To Equity Share First Call A/c		3,000
	To Equity Share Final Call A/c		4,500
	(Forfeiture of 1,500 equity shares of ₹ 10 each for non-payment of the first call money @ ₹ 2 per share and the final call money @ ₹ 3 per share as per Board's resolution dated...)		

Note: *As the premium has already been received on these shares, Securities Premium Account will not be debited.*

Illustration 10:

Give journal entries for the forfeiture and re-issue of shares in the following cases:

(a) P Ltd. forfeited 300 shares of ₹ 10 each, fully called up for non-payment of final call @ ₹ 4 per share. These shares were subsequently re-issued by the company @ ₹ 10 per share as fully paid-up.

(b) Q Ltd. forfeited 300 shares of ₹ 10 each, fully called up for non-payment of final call @ ₹ 4 per share. These shares were subsequently re-issued by the company @ ₹ 12 per share as fully paid-up.

(c) R Ltd. forfeited 200 shares of ₹ 10 each, ₹ 8 per share being called up on which a shareholder paid application and allotment money @ ₹ 5 per share but did not pay the first call money @ ₹ 3 per share. Of these forfeited shares, 150 shares were subsequently re-issued by the company as fully paid-up @ ₹ 8 per share.

Solution:

(a) In the books of P Ltd.

Journal Entries

Date	*Particulars*	*Debit* (₹)	*Credit* (₹)
	Share Capital A/c (300 x ₹10) Dr.	3,000	
	To Shares Forfeited A/c (300 x ₹ 6)		1,800
	To Share Final Call A/c (300 x ₹ 4)		1,200
	(Forfeiture of 300 shares of ₹ 10 each for non-payment of the final call money @ ₹ 4 per share as per Board's resolution dated...)		
Date	*Particulars*	₹	₹
	Bank Dr.	3,000	
	To Share Capital A/c (300 x ₹10)		3,000
	(Re-issue of 300 forfeited shares of ₹ 10 each fully paid-up as per Board's resolution dated...)		
	Shares Forfeited A/c Dr.	1,800	
	To Capital Reserve A/c		1,800
	(Transfer of profit on re-issue of forfeited shares to Capital Reserve A/c)		

(b) In the books of Q Ltd.

Journal Entries

Date	*Particulars*	*Debit* (₹)	*Credit* (₹)
	Share Capital A/c (300 x ₹10) Dr.	3,000	
	To Shares Forfeited A/c (300 x ₹ 6)		1,800
	To Share Final Call A/c (300 x ₹ 4)		1,200
	(Forfeiture of 300 shares of ₹ 10 each for non-payment of the		

	final call money @ ₹ 4 per share as per Board's resolution dated...)		
	Bank (300 x ₹12) Dr.	3,600	
	To Share Capital A/c (300 x ₹10)		3,000
	To Securities premium A/c (300 x ₹ 2)		600
	(Re-issue of 300 forfeited shares of ₹ 10 each at a premium of ₹ 2 per share as per Board's resolution dated...)		
	Shares Forfeited A/c Dr.	1,800	
	To Capital Reserve A/c		1,800
	(Transfer of profit on re-issue of forfeited shares to Capital Reserve A/c)		

(c) In the books of R Ltd.

Journal Entries

Date	*Particulars*	*Debit (₹)*	*Credit (₹)*
	Share Capital A/c (200 x ₹8) Dr.	1,600	
	To Shares Forfeited A/c (200 x ₹ 5)		1,000
	To Share First Call A/c (200 x ₹ 3)		600
	(Forfeiture of 200 shares of ₹ 10 each, ₹ 8 being called up for non-payment of the first call money @ ₹ 3 per share as per Board's resolution dated...)		
	Bank (150 x ₹8) Dr.	1,200	
	Shares Forfeited A/c (150 x ₹2)	300	
	To Share Capital A/c (150 x ₹10)		1,500
	(Re-issue of 150 forfeited shares of ₹ 10 each fully paid-up @ ₹ 8 per share as per Board's resolution dated...)		
Date	*Particulars*	*Debit (₹)*	*Credit (₹)*
	Shares Forfeited A/c (1000/200 x 150 – 300 = 450) Dr.	450	
	To Capital Reserve A/c		450
	(Transfer of capital profit proportionate to forfeited shares re-issued i.e. on 150 shares to Capital Reserve A/c)		

REVIEW QUESTIONS

1. A company forfeited 1,000 shares of ₹ 10 each held by Mr. X for non-payment of allotment money of ₹ 4 per share. Called up value is ₹ 9 what will be total amount debited to share capital?

2. A company forfeited 2000 shares of ₹ 10 each for non-payment of final call of ₹ 2 per share. What will be the amount of share forfeiture account?

FORFEITURE AND RE-ISSUE OF SHARES ALLOTTED ON PRO-RATA BASIS IN CASE OF OVER-SUBSCRIPTION

In case, the shares of a Company are over-subscribed, it is not possible for the company to satisfy the demand of all the applicants. In such a case allotment may be made on pro-rata basis, i.e., proportionately. For example, 10,000 shares are allotted pro-rata among the applicants for 12,000 shares. In this case, the ratio between allotment of shares and application for shares will be 10,000: 12,000 or 5:6, i.e., those applying for every 6 shares will be allotted 5 shares.

If shares are allotted on pro-rata basis, the excess application money received on shares allotted will be retained by the company and adjusted subsequently against allotment money and/or call money.

If such shares are subsequently forfeited for non-payment of allotment money and/or call money, the entries will be the same, but it may involve some difficulty in calculation. In such a case, it is to be noted carefully that if there is any excess amount received along with the application and it is adjusted against the allotment money which is failed by the shareholder, such amount should be deducted from the amount due on allotment to arrive at the net amount defaulted by the shareholder.

Illustration 11:

A limited company issued a prospectus inviting applications for 2,000 shares of ₹ 10 each at a premium of ₹ 2 per share payable as follows:

On Application	--	*₹ 2*
On Allotment	--	*₹ 5 (including premium)*
On First Call	--	*₹ 3*
On Second and Final Call	--	*₹ 2*

Applications were received for 3,000 shares and allotment was made pro-rata to the applicants of 2,400 shares. Money overpaid on applications was employed on account of sum due on allotment.

Ramesh, to whom 40 shares were allotted, failed to pay the allotment money and on his subsequent failure to pay the first call, his shares were forfeited. Mohan, the holder of 60 shares failed to pay the two calls and his shares were forfeited after the second and final call.

Of the shares forfeited, 80 shares were sold to Krishna credited as fully paid for ₹ 9 per share, the whole of Ramesh's share being included. Show journal and cash book entries and the Balance Sheet.

Solution:

Working Notes:

1. Ratio between allotment of shares and application for shares = 2,000: 2,400 = 5: 6,
2. Ramesh was allotted 40 shares.

   Therefore, Ramesh must have applied for 40 x 6/5 = 48 shares.
3. Ramesh must have paid excess application money on (48 - 40) = 8

Excess applications @ ₹ 2 per share, i.e., 8 x ₹ 2 = ₹ 16 retained by the company for adjustment against allotment money.

4. Allotment money due from Ramesh on 40 shares @ ₹ 5 per share = 40 x ₹ 5 = ₹ 200.
5. As the allotment money was failed by Ramesh against which excess money paid on application was adjusted, the net amount failed by Ramesh on Allotment = ₹ (200 - 16) = ₹ 184.
6. As Mohan paid the allotment money and the excess amount paid by him along with the application had already been adjusted, pro rata allotment in this case has no significance.
7. Amount to be transferred to Capital Reserve A/c from Shares Forfeited A/c has to be determined as follows:

	₹
Amount forfeited on 40 shares held by Ramesh (48 x ₹ 2)	96
Amount forfeited on 60 shares held by Mohan (60 x ₹ 5)	300
Total amount credited to Shares Forfeited A/c	396
Less: Amount on 20 forfeited shares held by Mohan which are not yet re-issued (20 x ₹ 5)	100
	296
Less: Discount allowed @ ₹ 1 on 80 shares (80 x ₹ 1)	80
Net gain on 80 forfeited shares which are reissued to be transferred to Capital Reserve	216

Dr. **Cash Book (Bank Column)** *Cr.*

Particulars	₹	*Particulars*	₹
To Share application A/c (Application money on 3000 shares @ ₹ 2 per share)	6,000	By Share Application A/c (Refund of application money on 600 shares rejected @ ₹ 2 per share)	1,200
To Shares Allotment A/c (Balance of allotment money on 2,000 shares less amount failed by Ramesh)	9,016*	By Balance c/d	24,036
To Share First Call A/c (First call money on 1900 shares, i.e., 2000 shares - (40 + 60) shares @ ₹ 3 per share)	5,700		
To Shares Final call A/c (Final call money on 1900 shares, i.e., 1960 shares less 60 shares held by Mohan who failed @ ₹ 2 per share)	3,800		
To Share Capital A/c (Amount received on re-issue of 80 forfeited shares @ ₹ 9 per share)	720		
	25,236		25,236
To Balance b/d	24,026		

* (10000 – 40 x 5 + 16 – 800)

Journal Entries

Particulars		Dr. (₹)	Cr.(₹)
Share Application A/c	Dr.	4,000	
To Share Capital A/c			4,000
(Transfer of application money to share capital account as per Board's resolution dated…)			
Share Allotment A/c	Dr.	10,000	
To Share Capital A/c			6,000
To Securities Premium A/c			4,000
(Allotment of 2000 shares to the applicants for 2400 shares pro-rata and allotment money due @ ₹ 5 per share including premium of ₹ 2 per share as per Board's resolution dated…)			
Share Application A/c	Dr.	800	
To Share Allotment A/c			800
(Surplus application money adjusted towards share allotment account)			
Share First Call A/c Dr.		6,000	
To Share Capital A/c			6,000
(First call money due on 2000 shares @ ₹ 3 per share as per Board's resolution dated…)			
Share Capital A/c	Dr.	320	
Securities Premium A/c	Dr.	80	
To Shares Forfeited A/c			96
To Share Allotment A/c			184
To Share First Call A/c			120
(Forfeiture of 40 shares held by Ramesh for non-payment of allotment of money @ ₹ 5 per share including premium @ ₹ 2 per share and first call money @ ₹ 3 per share as per Board's resolution dated...)			
Share Final Call A/c	Dr.	3,920	
To Share Capital A/c			3,920
(Share final call due on 1960 shares (i.e., 2000 shares-Ramesh's 40 shares forfeited) @ ₹ 2 per share as per Board's resolution dated...)			
Share Capital A/c	Dr.	600	
To Shares Forfeited A/c			300
To Share First Call A/c			180
To Share Final Call A/c			120

(Forfeited of 60 shares held by Mohan for non-payment of first call money @ ₹ 3 per share and final call money @ ₹ 2 per share as per Board's resolution dated...)			
Shares Forfeited A/c	Dr.	80	
To Share Capital A/c			80
(Discount allowed on re-issue of 80 forfeited share @ Re. 1 per Board's resolution dated...)			
Shares Forfeited A/c (296 – 80)	Dr.	216	
To Capital Reserve A/c			216
(Transfer of net gain on re-issue of 80 forfeited shares to capital Reserve A/c)			

Balance Sheet of.....Ltd. as at.....

Particulars		*Note No.*	*Amount (₹)*
I Equity and Liabilities			
Shareholders' Funds			
Share Capital		1	19,9,00
Reserves and Surplus		2	4,136
	Total		24,036
II Assets			
Current Assets			
Cash and Cash Equivalents		3	24,036
	Total		24,036

Notes:

1. Share Capital		
Authorised		
Issued:		
2,000 Equity Shares of ₹ 10 each		20,000
Subscribed and Paid-up :		
1,980 Equity Shares of ₹ 10 each, fully paid-up	19,800	19,900
Add: Shares Forfeited	100	
2. Reserves and Surplus		
Capital Reserve Account		216
Securities Premium Account		3,920
		4,136
4. Cash and Cash Equivalent		
Balance with Bank		24,036

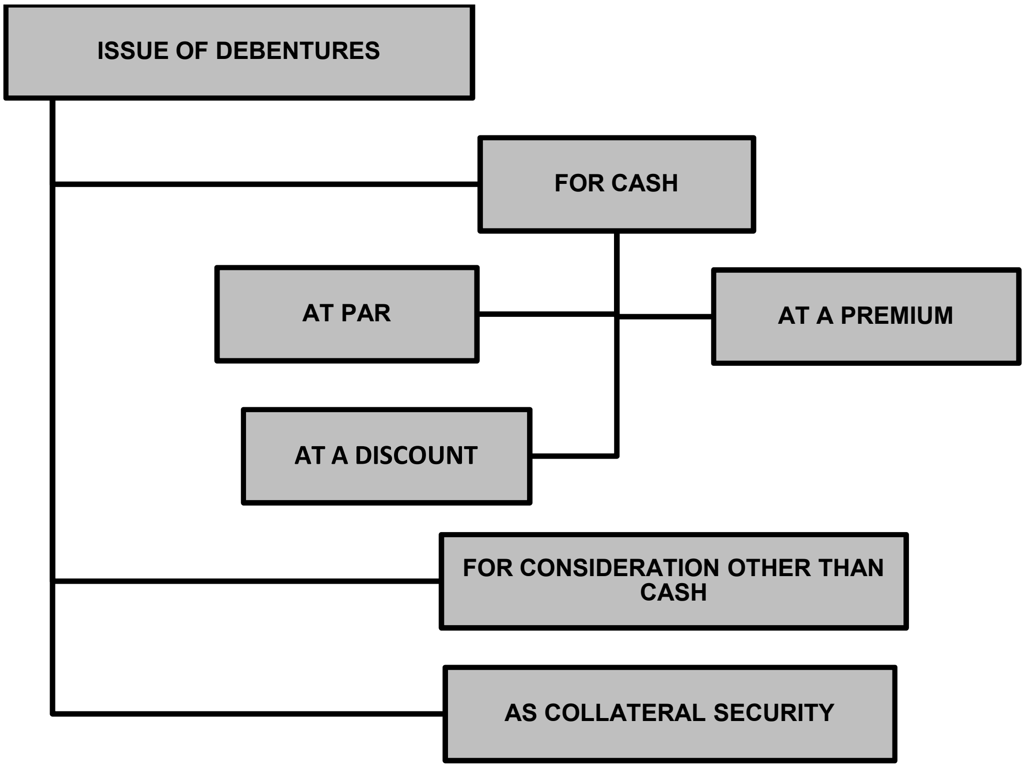
ISSUE OF DEBENTURES

Meaning of Debentures

Besides raising capital by the issue of shares, a company may supplement its capital by borrowings. Such borrowings may take the form of both short-term and long-term borrowings. Short-term borrowings by way of promissory notes, bills of exchange, bank overdrafts, cash credits, public deposits, etc., are needed by a company to provide for its working capital while long-term borrowings by way of loan on mortgage of property, term loans from financial institutions, public deposits for a long period, issue of debentures, etc., are needed by a company for financing expenditure of a capital nature. Loan capital of a company refers to the long-term borrowings of which issue of debentures is the most important and common method adopted by companies. Debentures are part of loan capital and the company is liable to pay interest thereon whether it earns profit or not.

Issue of Debentures

The procedure for issuing debentures by a company is very much similar to that of an issue of shares. Applications for debentures are invited from the public through the prospectus and the applicants are asked to pay the application money along with the applications. The company may ask for payment of the whole of the amount along with the application itself or in installments.



Issue of Debentures for Cash

When debentures are issued for cash, the amount to be collected on them may be payable in a lump sum or in installments. Where payable in installments, debenture application account is opened on receipt of applications. Then there are debenture allotment account and debenture calls account.

Issue of Debentures at Par

Debentures are said to be issued at par when the debenture-holder is required to pay an amount equal to the nominal or face value of the debentures e.g. the issue of ₹ 1,000 debenture for ₹ 1,000.

(a) If the full amount is payable along with the application:

(1) On receipt of application money:

Bank	Dr.	(with the money received on application)
To Debentures Application and Allotment A/c		

(2) On allotment:

Debenture Application and Allotment A/c	Dr.	(with the money received on debentures allotted)
To Debentures A/c		

(b) If the amount is payable in installments

1. On receipt of application money:

Bank	Dr.	(with the money received on application)
To Debentures Application A/c		

2. On Allotment:

Debenture Application A/c	Dr.	(with the application money
Debenture Allotment A/c	Dr.	(with the allotment money due on debentures)
To Debentures A/c		(with application and allotment money on debentures allotted)

3. On refund of application money:

Debenture Application A/c	Dr.	(with the excess application money refunded)
To Bank		

4. On receipt of allotment money:

Bank	Dr.	(with the money received on allotment)
To Debenture Allotment A/c		

5. On making calls:

Debenture Calls A/c	Dr.	(with the money due on respective calls)
To Debenture A/c		

6. On receipt of call money:

Bank To Debenture Calls A/c	Dr.	(with the money received on respective calls)

Note:

- *All cash transactions are generally passed through the Cash Book.*
- *It is customary to prefix the rate of interest payable on debentures with the debenture account.*
- *The company cannot allot more debentures than issued. The excess application money may be retained by the company against the allotment money due. But the excess application money received on debentures rejected has to be refunded to the applicants.*

Issue of Debentures at a Premium

If the debentures are issued at a price higher than the nominal value of the debentures, the debentures are said to be issued at a premium. The excess of issue price over the nominal value is regarded as the premium amount. In such a case, the Debentures Account should be credited only with the nominal value of the debentures and the premium should be credited to "Securities Premium Reserves".

Debenture Application A/c	Dr.	(with the money due on application)
Debenture Allotment A/c	Dr.	(with allotment money including premium)
To Debentures A/c		(with the nominal value of the debentures)
To Securities Premium A/c		(with the premium money)

Issue of Debentures at a Discount

If the debentures are issued at a price lower than the nominal value of the debentures, the debentures are said to be issued at a discount. The difference between the nominal value and the issue price is regarded as the discount. Such discount being a capital loss must be shown specifically as a deduction of general Reserve on the liabilities side of the balance sheet under the heading 'Reserves and Surplus'. If there are no Reserves, the discussion on issue of debentures is to be shown as a negative item under the heading 'Reserves and Surplus'. Such discount on issue of debentures may either be written off against revenue profits or capital profits of the company. When debentures are issued at a discount, the Debentures Account should be credited with the nominal value of the debentures and the discount allowed on issue of debentures, being a capital loss, should be debited to "Discount on Issue of Debentures Account".

Debenture Application A/c	Dr.	(with the money due on application)
Debenture Allotment A/c	Dr.	(with the money due on allotment)
Discount on Issue of Debentures A/c	Dr.	(with the amount of discount)
To Debentures A/c		(with the total)

Illustration 12:

X Ltd. made an issue of 10,000 12% Debentures of ₹ 100 each, payable as follows:

₹ 25 on Application

₹ 25 on Allotment

₹ 50 on First and Final Call.

Applications were received for 12,000 debentures and the directors allotted 10,000 debentures rejecting applications for 2,000 debentures. The money received on applications for 2,000 debentures rejected was duly refunded. The call was made and the moneys were duly received.

Show the necessary cash book and journal entries to record the above transactions and above the relevant items in the balance sheet of the company.

Solution:

Cash Book (Bank Columns)

Dr. *Cr.*

Particulars	₹	*Particulars*	₹
To 12% Debenture Application (Application money on 12,000 12% Debenture @ ₹ 25 per debenture)	3,00,000	By 12% Debenture Application A/c (Refund of Application money on 2,000, 12% Debenture @ ₹ 25 per debenture)	50,000
To 12% Debenture Allotment (Allotment money on 10,000 12% Debenture @ ₹ 25 per debenture)	2,50,000	By Balance c/d	10,00,000
To 12% Debenture First and Final Call A/c (First and final call money on 10,000 debentures @ ₹ 80 per debenture)	5,00,000		
	10,50,000		10,50,000

In the books of X Ltd.

Journal Entries

Date	*Particulars*		*Debit* (₹)	*Credit* (₹)
	12% Debenture Application A/c	Dr.	2,50,000	
	12% Debenture Allotment A/c	Dr.	2,50,000	
	To 12% Debentures A/c			5,00,000

	(Being capitalization of application money @ ₹ 25 per debenture and allotment money due on 10,000 debentures as per Boards resolution dated.....)		
	12% Debenture First and Final Call A/c Dr.	5,00,000	
	To 12% Debentures A/c		5,00,000
	(First and final call money due on 10,000, 12% debentures @ ₹ 50 per debenture as per board's resolution dated...)		

Particulars	*Note No.*	*Amount (₹)*
I Equity and Liabilities		
Non-current Liabilities		
Long-term Borrowings	1	10,00,000
Total		10,00,000
II Assets		
Current Assets		
Cash and Cash Equivalents	3	10,00,000
Total		10,00,000

Notes:

1. Long-term Borrowings

12% Debentures	10,00,000

2. Cash and Cash Equivalent

Balance with Bank	10,00,000

Illustration 13:

B Ltd. issued 2,000, 13% Debentures of ₹ 100 each at ₹ 110 payable as follows:

On Application	*₹ 25*
On Allotment	*₹ 35 (including premium)*
On First and Final Call	*₹ 50*

The debentures were fully subscribed and the moneys were duly received. Prepare cash book, pass the necessary journal entries and about the relevant portions of the balance sheet of the company.

Solution:

Cash Book (Bank Columns)

Dr. *Cr.*

Particulars	₹	*Particulars*	₹
To 13% Debenture Application	50,000	By Balance c/d	2,20,000
(Application money on 2,000 debentures @ ₹ 25 per each)			
To 13% Debenture Allotment A/c	70,000		

	(Allotment money on 2,000 debentures @ ₹ 35 per debenture including premium of ₹10 each)			
To	13% Debenture First and Final Call A/c	1,00,000		
	(First and final call money on 2,000 debentures @ ₹ 50 per debenture)			
		2,20,000		2,20,000

In the books of B Ltd.

Journal Entries

Date	*Particulars*		*Debit* (₹)	*Credit* (₹)
	13% Debenture Application A/c	Dr.	50,000	
	13% Debenture Allotment A/c	Dr.	70,000	
	To 12% Debentures A/c			1,00,000
	To Securities Premium A/c			20,000
	(Being capitalization of application money @ ₹ 25 per debenture and allotment money due on 2,000 debentures @ ₹ 35 including premium of ₹ 10 each as per Boards resolution dated.....)			
	13% Debenture First and Final Call A/c	Dr.	1,00,000	
	To 13% Debentures A/c			1,00,000
	(First and final call money due on 10,000, 12% debentures @ ₹ 50 per debenture as per board's resolution dated...)			

Balance Sheet of B Ltd. as at...

Particulars		*Note No.*	*Amount (₹)*
I	**Equity and Liabilities**		
	Shareholders' Funds		
	Reserves and Surplus	1	20,000
	Non-current Liabilities		
	Long-term Borrowings	2	2,00,000
	Total		2,20,000
II	**Assets**		

Current Assets		
Cash and Cash Equivalents	3	2,20,000
Total		2,20,000

Notes:

1. Reserves and Surplus	
Securities Premium	20,000
2. Long-term Borrowings	
13% Secured Debentures	2,00,000
3. Cash and Cash Equivalents	
Balance with Bank	2,20,000

Illustration 14:

W Ltd. issued 2,000, 14% Debentures of ₹ 100 each at discount of 5%, the discount being adjustable on allotment. The debentures were payable as follows:

On Application	-	*₹ 25*
On Allotment	-	*₹ 20*
On First and Final Call	-	*₹ 50*

The debentures were fully subscribed and the moneys were duly received. Show the cash book and journal entries and prepare the balance sheet of the company.

Cash Book (Book Columns Only)

In the books of W Ltd.

Solution:

Dr. *Cr.*

Particulars	₹	*Particulars*	₹
To 14% Debenture Application A/c (Application money on 2,000 debentures @ ₹ 25 per each)	50,000	By Balance c/d	1,90,000
To 14% Debenture Allotment A/c (Allotment money on 2,000 debentures @ ₹ 20 each)	40,000		
To 14% Debenture First and Final Call A/c (First and final call money on 2,000 debentures @ ₹ 50 per debenture)	1,00,000		
	1,90,000		1,90,000

Journal Entries

Date	*Particulars*		*Debit* (₹)	*Credit* (₹)
	14% Debenture Application A/c	Dr.	50,000	
	14% Debenture Allotment A/c	Dr.	40,000	
	Discount on issue of debentures A/c	Dr.	10,000	
	To 12% Debentures A/c			1,00,000
	(Being capitalization of application money @ ₹ 25 per debenture and allotment money due on 2,000 debentures @ ₹ 20 after adjusting discount of ₹ 5 each as per Boards resolution dated.....)			
	14% Debenture First and Final Call A/c	Dr.	1,00,000	
	To 13% Debentures A/c			1,00,000
	(First and final call money due on 2,000, debentures @ ₹ 50 per debenture as per board's resolution dated...)			

Balance Sheet (Relevant Items Only)

Particulars		*Note No.*	*Amount (₹)*
I Equity and Liabilities			
Shareholders' Funds			
Reserves and Surplus		1	(10,000)
Non-current Liabilities			
Long-term Borrowings		2	2,00,000
	Total		1,90,000
II Assets			
Current Assets			
Cash and Cash Equivalents		3	1,90,000
	Total		1,90,000

Notes:

1. Reserves and Surplus	
Discount on Issue of Debentures	(10,000)
2. Long-term Borrowings	
13% Debentures	2,00,000
3. Cash and Cash Equivalents	
Balance with Bank	1,90,000

DEBENTURES ISSUED FOR CONSIDERATION OTHER THAN CASH

The company may allot debentures to the vendors for acquiring some assets as payment for purchase consideration. This issue of debentures to vendors is known as issue of debentures for consideration other than cash.

Journal Entries

(1)	**For acquisition of assets:**		
	Sundry Assets (Individually) A/c	Dr.	(with the value of assets)
	To Vendors		(with the purchase price)
(2)	**(a) On allotment of debentures (at par)**		
	Vendors	Dr.	(with the value of debentures)
	To Debentures A/c		
	(b) On allotment of debentures (at premium)		
	Vendors A/c	Dr.	(with the purchase price)
	To Debentures A/c		(with the nominal value)
	To Securities Premium A/c		(with the amount of premium)
	(c) On allotment of debentures (at discount)		
	Vendors A/c	Dr.	(with the amount of purchase)
	Discount on Issue of Debentures A/c	Dr.	(with the amount of discount)

Notes:

(i) If the value of debentures allotted is more than the agreed purchase price, the difference is debited to Goodwill Account.

(ii) Similarly, if the value of debentures allotted is less than the agreed purchase price, credited to Capital Reserve Account.

Illustration 15:

Optimist Ltd. purchased building worth Rs.1,20,000 and plant and machinery worth Rs. 1,00,000 from Depressed Ltd. for an agreed purchase consideration of Rs. 2,00,000 to be satisfied by the issue of 2,000, 12% Debentures of Rs. 100 each. Show the necessary journal entries in the books of Optimist Ltd.

Solution:

Journal

Particulars		*Dr.(₹)*	*Cr.(₹)*
Building A/c	Dr.	1,20,000	
Plant and Machinery A/c	Dr.	1,00,000	
To Depressed Ltd.			2,00,000
To Capital Reserve A/c			20,000
(Purchase of sundry assets and transfer of capital profits as per agreement with the vendor dated...)			
Depressed Ltd.	Dr.	2,00,000	
To 12% Debentures A/c			2,00,000
(Being 2,000, 12% Debentures of Rs. 100 each allotted to vendors for consideration other than cash as per Board's resolution dated...)			

DEBENTURES ISSUED AS COLLATERAL SECURITY

The term 'Collateral Security' implies additional security given for a loan. Where a company obtains a loan from a bank or insurance company, it may issue its own debentures to the lender as collateral security against the loan in addition to any other security that may be offered. In such a case, the lender has the absolute right over the debentures until and unless the loan is repaid. On repayment of the loan, however, the lender is legally bound to release the debentures forthwith. But in case the loan is not repaid by the company on the due date or in the event of any other breach of agreement, the lender has the right to retain these debentures and to realise them. The holder of such debentures is entitled to interest only on the amount of loan, but not on the debentures. Such an issue of debentures is known as "Debentures issued as Collateral Security". There are two alternative ways by which debentures issued as collateral security can be dealt with:

(1) No accounting entry is required to be shown in the books of account at the time of issue of such debentures for the simple reason that the loan against which the debentures are issued as collateral security has already been credited, the debit being given to Bank. But the existence of such debentures issued as collateral security has to be mentioned by way of a note on the Balance Sheet under the specific loan account.

(2) If it is desired that such an issue of debentures as collateral security is to be recorded in the books of account, the accounting entries will be as follows:

(i) On issue of debentures as collateral security

Debentures Suspense A/c	Dr.	(with the nominal value of the
To Debentures A/c		debentures issued)

In this case, Debentures Suspense Account will appear on the asset side of the balance sheet under the heading Miscellaneous Expenditure. Debentures Account will appear as a liability on the liabilities side of the Balance Sheet.

(ii) On repayment of the loan and release of debentures

Debentures A/c	Dr.	(with the nominal value of the
To Debentures Suspense A/c		debentures released)

Note: The net effect of the above two entries is nil. Both the Debentures Suspense Account and the Debentures Account are cancelled on repayment of the loan. As such, this method is rarely followed in practice.

Illustration 16:

Z Ltd. secured an a long-term loan of Rs. 50,000 from the bank by issuing 600, 12% Debentures of Rs. 100 each as collateral security. Show relevant items in the Balance Sheet of the Company under both the methods.

Solution:

(First Method):

Balance Sheet (relevant items only)

Particulars	*Note No.*	*Amount (₹)*
I Equity and Liabilities		
Non-current Liabilities		
Long-term Borrowings	1	50,000
Note:		
1. Long-term Borrowings		
Long term Secured Loan		50,000
(Secured by the issue of …….		
12% Debentures of ₹ 100 each as collateral securities)		

Solution *(Second Method):*

Journal Entries

Particulars		*Dr.(₹)*	*Cr.(₹)*
Debentures Suspense A/c	Dr.	60,000	
To Debentures A/c			60,000
(Issue of 600, 12% Debentures of Rs. 100 each as collateral security for a bank overdraft of Rs. 50,000 as per Board's resolution dated.....)			

Balance Sheet (relevant items only)

Particulars		*Note No.*	*Amount (₹)*
I	**Equity and Liabilities**		
	Non-current Liabilities		
	Long-term Borrowings	1	50,000
Note:			
1.	**Long-term Borrowings**	₹	₹
	Long term Secured Loan		50,000
	(Secured by the issue of …….		
	12% Debentures of ₹ 100 each as collateral securities)	60,000	
	Less: 12% De Debentures Accounts	(60,000)	Nil
			50,000

ISSUE OF PREFERENCE SHARES

A company limited by shares may, if so authorised by its articles, issue preference shares which are liable to be redeemed within a period not exceeding twenty years from the date of their issue under section 55 of the Companies Act 2013. No company limited by shares shall, can issue any preference shares which are irredeemable.

A company may issue preference shares for a period exceeding 20 years but not exceeding 30 years for infrastructure projects (Specified in Schedule VI). However, it is subject to redemption of minimum 10% of such preference shares per year from the twenty-first year onwards or earlier, on proportionate basis, at the option of the preference shareholders.

Redemption of preference shares

The preference shares can be redeemed only when they are fully paid up-

– out of the profits of the company which would otherwise be available for dividend or

– out of the proceeds of a fresh issue of shares made for the purposes of such redemption.

CAPITAL REDEMPTION RESERVE ACCOUNT

If preference shares are proposed to be redeemed out of the profits of the company, a sum equal to the nominal amount of the shares to be redeemed, shall be transferred to a reserve called the Capital Redemption Reserve Account out of the profits of the company and the provisions of this Act relating to reduction of share capital of a company shall apply as if the Capital Redemption Reserve Account were paid-up share capital of the company

The capital redemption reserve account may be applied by the company, in paying up unissued shares of the company to be issued to members of the company as fully paid bonus shares.

Premium on Redemption of Preference Shares

(a) For the companies whose financial statements comply with the accounting standards as prescribed under section 133, *the premium payable on redemption shall be provided out of the profits of the company,* before the shares are redeemed.

(b) For redemption of any preference shares issued on or before the commencement of 2013 Act, *the premium payable on redemption shall be provided out of the profits of the company,* or out of the company's securities premium account, before such shares are redeemed.

For the companies whose financial statements need not comply with the accounting standards as prescribed under section 133, *the premium payable on redemption shall be provided out of the profits of the company,* or out of the company's securities premium account, before such shares are redeemed.

Case 1: Redemption out of the profits of the company which would otherwise be available for dividend

If the redeemable preference shares are redeemed out of the profits of the company which would otherwise be available for dividend, the "Capital Redemption Reserve Account" has to be created which will represent the redeemable preference shares in the balance sheet after the redemption. This capital redemption reserve should be equal to the amount of Preference Shares to be redeemed. The profits available for dividend have to be transferred to Capital Redemption Reserve Account.

JOURNAL ENTRIES

1. Transfer profits available for dividend to Capital Redemption Reserve Account:

General Reserve Account	Dr.	(as the case may be)
Profit and Loss Appropriation A/c	Dr.	
Dividend Equalization Account	Dr.	
To Capital Redemption Reserve A/c		(with the nominal value of the shares to be redeemed)

2. If current assets are realized to provide cash for redemption of preference shares:

Bank	Dr.	
To Respective Assets Account		(with the realized value of assets)

3. On transfer of redeemable preference share capital to be redeemed to Preference Shareholders Account:

Redeemable Preference Share Capital A/c	Dr.	(with the nominal value of the shares to be redeemed)
To Preference Shareholders A/c		

4. If preference shares are redeemed at premium:

Redeemable Preference Share Capital A/c	Dr.	
Premium on Redemption of Preference Shares A/c	Dr.	(with the amount of premium payable)
To Preference Shareholders A/c		

5. For providing premium on redemption of preference shares:

Securities Premium Account	Dr.	(with the amount of premium paid on redemption of preference shares)
or Profit and Loss A/c	Dr.	
To Premium on Redemption of Preference Shares Account		

6. On redemption of preference shares:

Preference Shareholders Account Dr. (with the amount paid)
To Bank

Case 2: If the redeemable preference shares are redeemed out of the proceeds of a fresh issue of shares made for the purpose of redemption:

If the redeemable preference shares are redeemed out of the proceeds of fresh issue of shares, the new Share Capital Account raised by fresh issue will take the place of the Redeemable Preference Share Capital Account after the redemption. Thus, in such a case, new Share Capital Account (Equity or Preference) must be equal to the redeemable preference shares redeemed.

First of all, entries for fresh issue of shares will be passed. Then, entries for redemption passed as given in previous case.

Case 3: If the redeemable preference shares are redeemed partly out of the profits of the company which would otherwise be available for dividend and partly out of the proceeds of a fresh issue of shares made for the purpose of redemption:

If the redeemable preference shares are redeemed partly out of the profits of the company which would otherwise be available for dividend and partly out of the proceeds of a fresh issue of shares equity or preference, the Capital Redemption Reserve Account and the new Share Capital Account taken together will replace the Redeemable Preference Share Capital redeemed. Thus in such a case, Redeemable Preference Share Capital redeemed = Capital Redemption Reserve Account + New Share Capital Account (Equity or Preference).

Here, all the entries shown under (1) and (2) have to be passed. But there are certain common entries which can be combined together.

<u>Illustration 17:</u>

Vanities Ltd. had an issue 1,000, 12% redeemable preference shares of ₹ 100 each, repayable at a premium of 10%. These shares are to be redeemed now out of the accumulated reserves, which are more than the necessary sum required for redemption. Show the necessary entries in the books of the company, assuming that the premium on redemption of shares has to be written off against the company's Securities Premium Account.

Solution:

In the books of Vanities Ltd.

Journal Entries

Particulars	*Dr.(₹)*	*Cr.(₹)*
General Reserve Account Dr. To Capital Redemption Reserve A/c (Transfer of reserves to Capital Redemption Reserve Account on redemption of redeemable preference shares)	1,00,000	 1,00,000

12% Redeemable Preference Share Capital A/c Dr. Premium on Redemption of Preference Shares A/c Dr. To 12% Preference Shareholders A/c (Amount payable to 12% preference shareholders on redemption of 12% preference shares at a premium of 10%)	1,00,000 10,000	 1,10,000
Securities Premium A/c Dr. To Premium on Redemption of Preference Share A/c (Application of Securities Premium Account to write off premium on redemption of preference shares)	10,000	 10,000
12% Preference Shareholders A/c Dr. To Bank (Amount due to 12% preference shareholders on redemption paid)	1,10,000	 1,10,000

Note: Capital Redemption Reserve Account replaces the 12% Redeemable Preference Shares Capital Account and the capital structure of the company remains unchanged.

<u>Illustration 18:</u>

Sure and Fast Ltd. has part of its share capital in 12% redeemable preference shares of ₹ 100 each, repayable at a premium of 5%. The shares have now become due for redemption. It is decided that the whole amount will be redeemed out of a fresh issue of 20,000 equity shares of ₹ 10 each at ₹ 11 each. The whole amount is received in cash and the 12% preference shares are redeemed. Show the necessary journal entries in the books of the company.

Solution:

In the books of Sure and Fast Ltd.

Journal Entries

Particulars	*Dr.* *(₹)*	*Cr.* *(₹)*
Bank Dr. To Equity Share Application and Allotment A/c (Application money on 20,000 equity shares @ ₹ 11 per share including a premium of Re. 1 per share)	2,20,000	 2,20,000
Equity Share Application and Allotment A/c Dr. To Equity Share Capital A/c To Securities Premium A/c (Allotment of 20,000 equity shares ₹ 10 each issued at a premium of ₹ 1 per share as per Board's Resolution dated....)	2,20,000	 2,00,000 20,000
Particulars	₹	₹
12% Redeemable Preference Share Capital A/c Dr. Premium on Redemption of Preference Share A/c Dr. To 12% Preference Shareholders A/c (Amount due to 12% preference shareholders on	2,00,000 10,000	 2,10,000

redemption of 8% preference shares at a premium of 5%)	10,000	10,000
Securities Premium A/c Dr. To Premium on Redemption of Preference Shares A/c (Application of Securities Premium Account to write off Premium on Redemption of Preference Shares)	2,10,000	2,10,000
12% Preference Shareholders A/c Dr. To Bank (Payment of amount due to 12% preference shareholders on redemption)		

Note: Equity Share Capital Account replaces the 12% Redeemable Preference Share Capital Account and the capital structure of the company remains unchanged.

Illustration 19:

The following is the balance sheet of Oscar India Ltd. as on 31st March 2015:

Particulars		*Note No.*	*Amount (₹)*
I	**Equity and Liabilities**		
	Shareholders' Funds		
	Share Capital	1	5,48000
	Reserves and Surplus	2	1,65,000
	Current Liabilities		
	Trade Payable	3	1,27,000
	Total		**8,40,000**
II	**Assets**		
	Non-Current Assets		
	Fixed Assets		6,00,000
	Current Assets		
	Investment		50,000
	Inventories		1,10,000
	Cash and Cash Equivalents	4	80,000
	Total		**8,40,000**

Notes:

1.	**Share Capital**	₹	₹
	Authorised		
	Issued, subscribed and paid-up:		………
	30,000 Equity Shares of ₹ 10 each fully paid-up		3,00,000
	2,500 Preference share of ₹ 100 each fully called-up	2,50,000	
	Less: Final Call on 100 preference shares @ ₹ 20 per share unpaid	2,000	2,48,000
			5,48,000

2. Reserves and Surplus	
Securities Premium	15,000
Surplus	1,50,000
	1,65,000
3. Trade Payable	
Trade Creditors	1,10,000
Outstanding Expenses	17,000
	1,27,000
4. Cash and Cash Equivalent	
Balance with Bank	80,000

On 30th June, 2016, the Board of Directors decided to redeem the preference shares at a premium of 10% and to sell the investments at its market price of ₹ 40,000. They also decided to issue sufficient number of equity shares of ₹ 10 each at a premium of Re. 1 per share, required after utilizing the profit and loss account leaving a balance of ₹ 50,000. Premium on redemption is required to be set off against securities premium account.

Repayments on redemption were made in full except to one shareholder holding 50 shares only due to his leaving India for good.

You are required to show the journal entries and the balance sheet of the company after redemption. Assumption made should be shown in the working.

Solution:

In the books of Oscar Ltd.

Journal Entries

Particulars	*Dr. (₹)*	*Cr. (₹)*
Bank Dr.	40,000	
Profit and Loss A/c Dr.	10,000	
To Investments		50,000
(Being the sale of investments at a loss of ₹ 10,000)		
Bank Dr.	1,65,000	
To Share Capital A/c		1,50,000
To Securities Premium A/c		15,000
(Being the issue of required number of equity shares at a premium of 10%)		
Preference Share Capital A/c Dr.	2,40,000	
Premium on Redemption A/c Dr.	24,000	
To Preference Shareholders A/c		2,64,000
(Being the transfer of the amount due to preference shareholders on redemption)		

Securities Premium A/c Dr. To Premium on Redemption A/c (Being the transfer of securities premium account to write off premium on redemption of preference shares account)	24,000	24,000
Profit and Loss A/c Dr. To Capital Redemption Reserve A/c (Being the transfer of profit used for redemption of preference shares to capital redemption reserve account)	90,000	90,000
Preference Shareholders A/c Dr. To Bank (Being the payment to preference shareholders except to a holder of 50 shares)	2,58,500	2,58,500

Balance Sheet of Oscar India Ltd. as on 1st July, 2011

(After redemption)

Particulars	*Note No.*	*Amount (₹)*
I Equity and Liabilities		
Shareholders' Funds		
Share Capital	1	4,58,000
Reserves and Surplus	2	1,46,000
Current Liabilities		
Trade Payable	3	1,27,000
Preference shareholders		5,500
Total		7,36,500
II Assets		
Non-Current Assets		
Fixed Assets		6,00,000
Current Assets		
Inventories		1,10,000
Cash and Cash Equivalents	4	26,500
Total		7,36,500

Notes:

1. Share Capital	₹	₹
Authorised		
Issued, subscribed and paid-up:		………
45,000 Equity Shares of ₹ 10 each fully paid-up		4,50,000
In preference share of ₹ 100 each fully called-up	10,000	
Less: Final Call @ ₹20 per share unpaid	2,000	8,000
		4,58,000

2. Reserves and Surplus

Capital Redemption Reserve	90,000
Securities Premium	6,000
Surplus	50,000
	1,46,000

3. Trade Payable

Trade Creditors	1,10,000
Outstanding Expenses	17,000
	1,27,000

4. Cash and Cash Equivalent

Balance with Bank	26,500

Working Notes:

Calculation of required number of fresh issue of equity shares:

	₹	₹
Balance of Profit and Loss A/c		1,50,000
Less: Loss on Sale of Investment	10,000	
Balance required	50,000	60,000
Profit available for redemption		90,000
Amount required for redemption		2,40,000
Amount available from Profit and Loss A/c		90,000
New issue required 15,000 shares		1,50,000

Dr. **Bank Account** *Cr.*

Particulars	₹	*Particulars*	₹
To Balance b/d	90,000	By Preference Share-holders A/c	2,58,500
To Investment	40,000	By Balance b/d	36,500
To Share Capital A/c	1,50,000		
To Securities Premium A/c	15,000		
	2,95,000		2,95,000

Illustration 22:

The Balance Sheet of Producers Ltd. as at 31st March, 2016 is as follows:

Particulars	*Note No.*	*Amount (₹)*
I Equity and Liabilities		
Shareholders' Funds		
Share Capital	1	3,50,000
Reserves and Surplus	2	64,000
Current Liabilities		
Trade Payable	3	72,500
Short-term provision	4	39,500
Total		**5,26,000**

II	**Assets**		
	Non-Current Assets		
	Fixed Assets	5	2,80,000
	Current Assets		
	Short-term Investment		60,000
	Inventories		1,30,500
	Trade Receivables		50,550
	Cash and Cash Equivalents	6	4,950
	Total		**5 26,000**

Notes:

		₹	₹
1.	**Share Capital**		
	Authorised		
	Issued, subscribed and paid-up:		………
	40,000 Equity Shares of ₹ 10 each fully paid-up		4,00,000
	10,000 10% Preference share of ₹ 100 each		1,00,000
			5,00,000
	Issued, subscribed and paid-up:		………
	25,000 Equity Shares of ₹ 10 each, fully paid-up		2,50,000
	10,000 10% Preference share of ₹ 100 each, fully paid-up		1,00,000
			3,50,000
2.	**Reserves and Surplus**		
	Securities Premium		10,000
	Surplus		54,000
			64,000
3.	**Trade Payable**		
	Supplies of Goods		66,000
	Outstanding Expenses		6,500
			72,500
4.	**Short-term Provision**		
	Provision for Income Tax		18,000
	Staff Provision Fund		21,500
			39,500
5.	**Tangible Assets**		
	Plant and Machinery		2,40,000
	Staff Provision Fund		40,000
			2,80,000
6.	**Cash and Cash Equivalent**		
	Balance with Bank		4,900
	Cash on hand		50
			4,950

In order to redeem its preference shares, the company issued 5,000 equity shares of ₹ 10 each at a premium *of 10% and sold all of its investment for ₹ 70,800. Preference shares were redeemed at a premium of 10%. Show the necessary journal entries in the books of the company and prepare the balance sheet of the company immediately after redemption of preference shares.*

Solution:

In the books of Producers Ltd.

Journal Entries

Particulars	*Dr. (₹)*	*Cr.(₹)*
Bank Dr. To Equity Share Application and Allotment Account (Application money received on 5,000 equity shares of ₹ 10 issued at a premium of 10%)	55,000	55,000
Equity Share Application and Allotment A/c Dr. To Equity Share Capital A/c To Securities Premium A/c (Allotment of 5000 equity shares of ₹ 10 each issued at a premium of 10% as per Board's resolution dated....)	55,000	50,000 5,000
Profit and Loss A/c Dr. To Capital Redemption Reserve A/c (Transfer of the balance of the nominal value of preference shares to be redeemed not covered by fresh issue, i.e., ₹ 1,00,000 - ₹ 50,000 on redemption to Capital Redemption Reserve A/c)	50,000	50,000
Bank Dr. To Investments A/c To Profit and Loss A/c (Sale of Investments at a profit and transfer of profit on sale to Profit and Loss A/c)	70,800	60,000 10,800
10% Redeemable Preference Share Capital A/c Dr. Premium on Redemption of Preference Shares A/c Dr. To 10% Preference Shareholders A/c (Amount due to 10% preference shareholders on redemption)	1,00,000 10,000	1,10,000
Securities Premium A/c Dr. To Premium on Redemption of Preference Shares A/c (Application of securities premium to write off premium on redemption of preference shares)	10,000	10,000
10% Preference Shareholders A/c Dr. To Bank (Amount due to 10% Preference Shareholders on redemption of their shares paid)	1,00,000	1,10,000

Balance Sheet of Producers Ltd. as at 31st March, 2016
(After redemption preference shares)

Particulars		*Note No.*	*Amount (₹)*
I	**Equity and Liabilities**		
	Shareholders' Funds		
	Share Capital	1	3,00,000
	Reserves and Surplus	2	69,800
	Current Liabilities		
	Trade Payable	3	72,500
	Short-term provision	4	39,500
	Total		**4,81,800**
II	**Assets**		
	Non-Current Assets		
	Fixed Assets		
	Tangible assets	5	2,80,000
	Current Assets		
	Inventories		1,30,500
	Trade Receivables		50,550
	Cash and Cash Equivalents	6	20,750
	Total		**4,81,800**

Notes:

		₹	₹
1.	**Share Capital**		
	Authorised		
	Issued, subscribed and paid-up:		………
	40,000 Equity Shares of ₹ 10 each		4,00,000
	10,000 10% Preference share of ₹ 10 each		1,00,000
			5,00,000
	Issued, subscribed and paid-up:		………
	30,000 Equity Shares of ₹ 10 each, fully paid-up		3,00,000
2.	**Reserves and Surplus**		
	Capital Redemption Reserve		50,000
	Securities Premium		5,000
	Surplus		14,800
			69,800
3.	**Trade Payable**		
	Supplies of Goods		66,000
	Outstanding Expenses		6,500
			72,500
4.	**Short-term Provision**		
	Provision for Income Tax		18,000
	Staff Provision Fund		21,500

		39,500
5.	**Tangible Assets**	
	Plant and Machinery	2,40,000
	Staff Provision Fund	40,000
		2,80,000
6.	**Cash and Cash Equivalent**	
	Balance with Bank	20,700
	Cash on hand	50
		20,750

Working Notes:

(i) *Dr.* **Bank Account** *Cr.*

	Particulars	₹		*Particulars*	₹
To	Balance b/d	4,900	By	8% Preference	
To	Equity Share Application			Shareholders A/c	1,10,000
	and Allotment A/c	55,000	By	Balance c/d	20,700
To	Investment A/c	60,000			
To	Profit and Loss A/c	10,800			
		1,30,700			1,30,700

(ii) *Dr.* **Securities Premium A/c** *Cr.*

	Particulars	₹		*Particulars*	₹
To	Premium on Redemption of		By	Balance b/fd	10,000
	Preference Shares Account	10,000	By	Equity Share Application	
To	Balance c/d	5,000		and Allotment A/c	5,000
		15,000			15,000

(iii) *Dr.* **Profit and Loss A/c** *Cr.*

	Particulars	₹		*Particulars*	₹
To	Capital Redemption		By	Balance b/fd	54,000
	Reserve A/c	50,000	By	Bank (Profit on sale	
To	Balance c/d	14,800		of investments)	10,800
		64,800			64,800

Note: Equity Share Capital issued of ₹ 50,000 and Capital Redemption Reserve Account ₹ 50,000 jointly replace 8% Redeemable Preference Share Capital of ₹ 1,00,000. Hence, the capital structure of the company remains unchanged.

LESSON ROUND UP

- There are two basic types of share capital which can be issued by a company under the Companies Act, 2013 i.e. (a) preference shares and (b) equity shares.
- Preference shares are those which carry preferential rights as to the payment of dividend at a fixed rate; and the return of capital on winding up of the company.
- An equity share is one which is not a preference share. Equity shares are risk bearing shares.
- Share capital of a company can be categorized as: Nominal or Authorised Capital; Issued Capital; Subscribed Capital; Called up Capital and Paid-up Capital.
- Shares of a company may be issued at par, at a premium or at a discount.
- When shares are issued at a price higher than the face value, they are said to be issued at a premium.
- When shares are issued at a price lower than the face value, they are said to be issued at a discount. Only sweat equity shares can be issued at discount u/s 54.
- Forfeiture of shares may be said to be the compulsory termination of membership by way of penalty for non-payment of allotment and/or any call money.
- The forfeited shares may be re-issued at par, at a premium or even at a discount. If forfeited shares are re-issued at a discount, the amount of discount can, in no case, exceed the amount credited to Shares Forfeited Account.
- A company limited by shares may, if authorised by its articles, issue preference shares, which are, or at the option of the company liable to be redeemed. They have to be redeemed within 20 years of the date of issue.
- Debentures may be issued at par, or at a premium, or at a discount.
- Debentures may be issued by a company for cash, for consideration other than cash, or as a collateral security.
- The issue of debentures to vendors is known as issue of debentures for consideration other than cash.
- A company may issue debentures on any specific condition as to its redemption such as: issued at par and redeemable at par, issued at a discount redeemable at par, issued at a premium and redeemable at par, issued at par and redeemable at a premium, issued at a discount, but redeemable at a premium.
- When a company issues debentures it undertakes to pay interest thereon at a fixed percentage. The payment of interest on the debt is obligatory on the part of the company issuing them irrespective of the fact whether the company earns profit or not and the interest payable on debentures is a charge against the profits of the company.
- Discount on issue of debentures is a capital loss of the company and it is required to be shown on the liabilities side of the Balance Sheet under the heading “Redemption and Surplus” until it is written off.
- When a company issues debenture at par or at a discount which are redeemable at a premium, the

premium payable on redemption of the debentures is treated as a capital loss.

– The preference shares can be redeemed out of profits or out of the proceeds of fresh issue of equity or preference shares or a combination of both. The preference shares can be redeemed at a premium also.

– If the redeemable preference shares are redeemed out of the profits of the company which would otherwise be available for dividend, the "Capital Redemption Reserve Account" has to be credited which will represent the redeemable preference shares in the balance sheet after the redemption.

– If the redeemable preference shares are redeemed out of the proceeds of a fresh issue of shares, the new Share Capital Account raised by fresh issue takes the place of the Redeemable Preference Share Capital Account after the redemption.

GLOSSARY

Shares	The total share capital is divided into a number of units known as 'shares'.
Authorized Capital	The Company is registered with this amount of capital.
Issued Capital	That part of the authorized capital of the company which has actually been offered to the public for subscription in cash.
Subscribed Capital	It refers to that part of the issued capital which has actually been subscribed by the public and subsequently allotted to them.
Called Up Capital	It is that portion of the subscribed capital which the shareholders are called upon to pay on the shares allotted to them.
Paid Up Capital	It refers to that part of the called up capital which has actually been paid by the shareholders.
Forfeiture	The compulsory termination of membership by way of penalty for non-payment of allotment and/or any call money.

SELF TEST QUESTIONS

Theory Questions

1. What do you mean by shares? What are the types of shares?
2. Explain types of share capital in a company.
3. Briefly describe issue of shares at a premium.
4. What do you mean by forfeited shares? Can forfeited shares be re-issued? Explain.
5. What are debentures? What are the type of debentures?
6. Explain various methods of redemption of preference shares.

Practical Questions

1. The authorised capital of a company is 1,00,000 shares of ₹ 10 each. On April 10, 2016, 50,000 shares are issued for subscription at a premium of ₹ 2 per share. The share money is payable as follows: ₹ 5 (including the premium of ₹ 2) with application, ₹ 3 on allotment; ₹ 2 on first call and ₹ 2 on second call. The subscription list closes on May 11, 2016 and directors proceed to allotment on May 18, 2016. The shares are fully subscribed and the application money (including the premium) is

received in full. The allotment money is received by June 30, 2016, except as regards 500 shares. It is expected that the allotment money on these 500 shares will not be received and hence shares are forfeited. The first call and second call money is received by September 30, 2016 and December 31, 2016 respectively, barring the second call money on 200 shares which is not received hence the shares are forfeited. Show the cash book and the structure of the share capital in the balance sheet.

2. X Ltd. forfeited 100 shares of ₹ 10 each for non-payment of the final call of ₹ 2; the shares were re-issued @ ₹ 9 per share. How much was credited to shares forfeited account and what amount was transferred to capital reserve?

   [**Ans.:** ₹800; ₹700]

3. Z Ltd. forfeited 150 shares of ₹ 10, issued at a premium of ₹ 2, for non-payment of the final call of ₹ 3. Of these 100 shares were re-issued @ ₹ 11 per share. How much would be transferred to capital reserve?

   [**Ans.:** ₹700]

4. Redemption of 100,000 preference shares of ₹ 10 each was carried out by utilisation of reserves and by issue of 40,000 equity shares of ₹10 each at ₹12.5. How much should be credited to capital redemption reserve account?

   [Ans.: ₹ 6,00,000]

   In the above case, the redemption was carried out of reserves and out of the issue of 4,000 shares of ₹10 each @ ₹ 9.5. What is the amount of capital redemption reserve account that is required?

   [**Ans.:** ₹6,20,000]

5. A company having free reserves of ₹ 30,000 want to redeem rupees one lakh preference shares. Calculate the face value of fresh issue of shares of ₹ 10 each to be made at a premium of 10%.

   *[**Ans.:** ₹ 70,000]*

6. Bhalla and Co. Ltd. has an authorised equity capital of ₹ 20 lakhs divided into shares of ₹ 10 each. The paid-up capital was ₹ 12,50,000. Besides this, the company had 9% preference shares of ₹ 10 each for ₹ 2,50,000. Balance on other accounts were - Securities Premium ₹ 18,000; Profit and Loss Account ₹ 72,000 and General Reserve ₹ 3,40,000. Included in Sundry Assets were investments of the face value of ₹ 30,000 carried in the books at a cost of ₹ 34,000. The company decided to redeem the preference shares at 10% premium, partly by the issue of equity shares of the face value of ₹ 1,20,000 at a premium of 10%. Investments were sold at 105% of their face value. All preference shareholders were paid off except 3 holding 2500 shares. Give the necessary journal entries bearing in mind that the Directors wanted a minimum reduction in free reserves, while effecting the above transactions. Working should form part of your answer.

   [**Ans.:** Amount paid to preference shareholders: ₹2,72,250]

7. Krishna Ltd issued 10,000 12% Debentures of ₹10 each at a discount of 6%. Applications were received for 7,500 debentures. Journalise the transactions assuming all money has been received.

Lesson 11
Accounting for Non-Profit Organisation

LESSON OUTLINE

- Basic Concepts of Partnership
- Meaning
- Specific items
- Receipts and payments Accounts
- Income and Expenditure Accounts
- Illustrations
- Objectives Questions

LEARNING OBJECTIVES

Not-for-Profit Organisations (NPO) are set up with the prime objective of providing services and not to earn profit thereby enhancing the welfare of society. Such organisations include schools, hospitals, trade unions, religious organisations, etc. The person/s or the groups of individuals who govern and manage the working of an NPO are known as trustees. NPO's main sources of income are donations, subscriptions, life membership fees, grants etc. As these organisations are not set up with profit motive, they do not prepare Trading and Profit and Loss Account. Instead, they maintain Receipt and Payments Account, Income and Expenditure Account and Balance Sheet.

From temples to youth organizations to the local chambers of commerce, nonprofit organizations make our communities more livable places. Unlike for-profit businesses that exist to generate profits for their owners, nonprofit organizations exist to pursue missions that address the needs of society. Nonprofit organizations serve in a variety of sectors, such as religious, education, health, social services, commerce, amateur sports clubs, and the arts.

In this lesson we will learn some basic concepts of accounting of not for profit organisations along with illustrations and objective questions.

ACCOUNTING FOR NON-PROFIT ORGANISATIONS

There are certain organisations that are not established for making profit but to provide some service. These services are generally given to members who make subscriptions to avail them. These are also called as non-trading entities. The examples of such organisations are: Gymkhana / sports clubs; Educational institutions; Public hospitals; Libraries; Cultural clubs like Rotary or Lions club; Religious institutions; Charitable trusts

Meaning of Non-Profit Organisations

Non-Profit Organisations refer to the organisations that are used for the welfare of the society and are set up as charitable institutions. which function without any profit motive. Their main aim is to provide service to a specific group or the public at large. Normally, they do not manufacture, purchase or sell goods and may not have credit transactions. Hence they need not maintain many books of account (as the trading concerns do) . The funds raised by such organisations are credited to capital fund or general fund. The major sources of their income usually are subscriptions from their members donations, grants-in-aid, income from investments, etc. The main objective of keeping records in such organisations is to meet the statutory requirement and help them in exercising control over utilisation of their funds. They also have to prepare the financial statements at the end of each accounting period and ascertain their income and expenditure and the financial position.

Special Items

There are a few items of revenue and expenses of such non-profit organisations are somewhat different in nature and need special attention in their treatment in final accounts. Some of the common special items are explained as under:

(a) *Entrance Fees* – These are received at the time of admission of a new member and thus are onetime fees. They are non-recurring in nature. It could be either capitalized as they are non-recurring or taken as revenue as per the rules of the institution. There's a view that addition of member is an ongoing activity and thus every year the institute will get entrance fees. So it may be taken as a normal revenue receipt.

(b) *Donations* – They could be used for meeting capital or revenue expenses. If donations are received for a special purpose, the amount is credited to a fund from which the amounts are disbursed. The fund may be invested in specified securities. Income from such investments is credited to the fund A/c only. Small donation amounts which are not earmarked for any specific purpose may be treated as revenue receipts.

(c) *Legacy* – Many times trusts are formed in the memory of certain persons by their will. In such case after the demise of the person, the funds pass on to the institution. Such legacies are of course one-time and therefore should be taken to the capital fund.

(d) *Endowments* – Sometimes, donations are also in the form of endowments to be used as per instructions of the donor. These are to be treated as capital receipts.

(e) *Life membership fees* – These could be taken as capital receipts and every year a charge is debited based on some logic. In other words, when received, it could be treated as deferred receipt in the balance sheet and every year a specific amount is credited to Income& Expenditure Account.

(f) *Subscriptions* – Subscription is a membership fee paid by the member on annual basis. This is the main source of income of such organisations These are taken as revenue receipts. These must be recognised as revenue on the accrual concept.

Accounting Records of Non-Profit Organisations

Normally such organisations are not engaged in any trading or business activities. The main sources of their income are subscriptions from members, donations, financial assistance from government and income from investments. Most of their transactions are in cash or through the bank. These institutions are required by law to keep proper accounting records and keep proper control over the utilization of their funds. This is why they usually keep a cash book in which all receipts and payments are duly recorded. They also maintain a ledger containing the accounts of all incomes, expenses, assets and liabilities which facilitates the preparation of financial statements at the end of the accounting period

Final Accounts or Financial Statements:

The Non-Profit Organisations are also required to prepare financial statements at the end of the each accounting period. Although these organisations are non-profit making entities and they are not required to make Trading and Profit & Loss Account but it is necessary to know whether the income during the year was sufficient to meet the expenses or not. Not only that they have to provide the necessary financial information to members, donors, and contributors and also to the Registrar of Societies. For this purpose, they have to prepare their final accounts at the end of the accounting period and the general principles of accounting are fully applicable in their preparation. The final accounts of a 'non-profit organisation' consist of the following:

(i) Receipts and Payments Account

(ii) Income and Expenditure Account, and

(iii) Balance Sheet.

Receipts and Payments Account

It is prepared at the end of the accounting year on the basis of cash receipts and cash payments recorded in the cash book. It is a summary of cash and bank transactions under various heads. For example, subscriptions received from the members on different dates which appear on the debit side of the cash book, shall be shown on the receipts side of the Receipts and Payments Account as one item with its total amount. Similarly, salary, rent, electricity charges paid from time to time as recorded on the credit side of the cash book but the total salary paid, total rent paid, total electricity charges paid during the year appear on the payments side of the Receipts and Payments Account. Thus, Receipts and Payments Account gives summarised picture of various receipts and payments, irrespective of whether they pertain to the current period, previous period or succeeding period or whether they are of capital or revenue nature. It may be noted that this account does not show any non-cash item like depreciation. The opening balance in Receipts and Payments Account represents cash in hand/cash at bank which is shown on its receipts side and the closing balance of this account represents cash in hand and bank balance as at the end of the year, which appear on the credit side of the Receipts and Payments Account. However, if it is bank overdraft at the end it shall be shown on its debit side as the last item.

Features of Receipts and Payments Account

1. It is an Account which contains all Cash and Bank transactions made by a non-profit organization during a particular financial period.
2. It starts with the opening balances of Cash and Bank. All Cash Receipts both capital & revenue during the period are debited to it.
3. All Cash Payments both capital & revenue during the period are credited to this Account. It ends with the closing Cash and Bank Balances.
4. While recording the Cash and Bank transactions all entries are made on Cash Basis.
5. It is a summary of Cash Book.
6. It follows Real Account.

Steps in the preparation of Receipts and Payments Account

1. Take the opening balances of cash in hand and cash at bank and enter them on the debit side. In case there is bank overdraft at the beginning of the year, enter the same on the credit side of this account.
2. Show the total amounts of all receipts on its debit side irrespective of their nature (whether capital or revenue) and whether they pertain to past, current and future periods.
3. Show the total amounts of all payments on its credit side irrespective of their nature (whether capital or revenue) and whether they pertain to past, current and future periods.
4. None of the receivable income and payable expense is to be entered in this account as they do not involve inflow or outflow of cash.
5. Find out the difference between the total of debit side and the total of credit side of the account and enter the same on the credit side as the closing balance of cash/bank. In case, however, the total of the credit side is more than that of the total of the debit side, show the difference on the debit as bank overdraft and close the account.

Income and Expenditure Account

It is the summary of income and expenditure for the accounting year. It is just like a profit and loss account prepared on accrual basis in case of the business organisations. It includes only revenue items and the balance at the end represents surplus or deficit. The Income and Expenditure Account serves the same purpose as the profit and loss account of a business organisation does. All the revenue items relating to the current period are shown in this account, the expenses and losses on the expenditure side and incomes and gains on the income side of the account. It shows the net operating result in the form of surplus (i.e. excess of income over expenditure) or deficit (i.e. excess of expenditure over income), which is transferred to the capital fund shown in the balance sheet.

The Income and Expenditure Account is prepared on accrual basis with the help of Receipts and Payments Account along with additional information regarding outstanding and prepaid expenses and depreciation etc. Hence, many items appearing in the Receipts and Payments need to be adjusted.

Features of Income and Expenditure Account

1. It follows Nominal Account.
2. All expenses of revenue nature for the particular period are debited to this account on accrual basis.
3. Similarly all revenue incomes related to the particular period are credited to this account on accrual basis.
4. All Capital incomes and expenditures are excluded.
5. Only current year's incomes and expenses are recorded. Amounts related to other periods are deducted. Amounts outstanding for the current year are added.
6. Profit on sale of asset is credited. Loss on sale of asset is debited. Annual depreciation on assets is also debited.
7. If income is more than expenditure, it is called a surplus, and is added with Capital or General Fund etc. in the Balance Sheet.
8. If expenditure is more than income, it is a deficit, and is deducted from Capital or General Fund etc. in the Balance Sheet.

Steps in the Preparation of Income and Expenditure Account

Following steps may be helpful in preparing an Income and Expenditure Account from a given Receipts and Payments Account:

1. Exclude the opening and closing balances of cash and bank as they are not an income.
2. Exclude the capital receipts and capital payments as these are to be shown in the Balance Sheet.
3. Consider only the revenue receipts to be shown on the income side of Income and Expenditure Account. Some of these need to be adjusted by excluding the amounts relating to the preceding and the succeeding periods and including the amounts relating to the current year not yet received.
4. Take the revenue expenses to the expenditure side of the Income and Expenditure Account with due adjustments as per the additional information provided relating to the amounts received in advance and those not yet received.
5. Consider the following items not appearing in the Receipt and Payment Account that need to be taken into account for determining the surplus/ deficit for the current year :

   (a) Depreciation of fixed assets.

   (b) Provision for doubtful debts, if required.

   (c) Profit or loss on sale of fixed assets.

Difference between Receipts and Payments Account and Income and Expenditure Account

Basis of distinction	**Receipt and Payment Account**	**Income and Expenditure Account**
Nature	It is the summary of the cash book	It is like as profit and loss account
Nature of Items	It records receipts and payments of revenue as well as capital nature	It records income and expenditure of revenue nature only.
Period	Receipts and payments may also relate to preceding and succeeding periods.	Income and expenditure items relate only to the current period
Debit side	Debit side of this account records the receipts.	Debit side of this account records expenses and losses
Credit side	Credit side of this account records the payments	Credit side of this account records income and gains.
Depreciation	Does not includes depreciation.	Includes depreciation
Opening Balance	Balance in the beginning represents cash in hand /cash at bank or overdraft at the beginning	There is no opening balance.
Closing Balance	Balance at the end represents cash in hand at the end and bank balance (or bank overdraft).	Balance at the end represents excess of income over expenditure or vice-versa.

Illustration 1:

From the following Cash Book entries of Shiva Entertainment Club, prepare Receipts and Payments Account:

Shiva Entertainment Club
Cash Book (Columnar)

Date	***Receipts***	***LF***	***Bank Amount (Rs.)***	***Cash Amount (Rs.)***	***Date***	***Payments***	***L.F.***	***Bank Amount (Rs.)***	***Cash Amount (Rs.)***
2016					*2016*				
April 1	Balance b/d		35000	20000	April 15	Insurance premium		15000	
April 10	Subscriptions		120000		May 10	Printing and		10750	
						stationery			
April 15	Entrance fees		13000		May 20	Postage and			1430
May 20	Life membership		12000			courier fees			
	fees				June 10	Telephone			2810
June 15	Hall rent			42000		expenses			
July 23	Life membership		8000		July 15	Wages and salaries			32000
	fees				July 15	Rates and Taxes		17000	
Aug. 12	Donation for		60000		July 31	Fixed Deposit		100000	
	building				Aug. 10	Printing and		15000	
Sept. 10	Subscriptions		30000			stationery			
	(2015-2016)				Aug. 15	Postage and			1480
Sept. 13	Subscription		145000			courier service			
					Sept. 8	Lighting		12250	
Oct. 14	Entrance fees		40000		Sept. 13	Telephone exp.			2830
Nov. 9	Subscription		35000		Oct. 1	Wages and salaries		20000	12000
2017					Oct. 18	Printing and		13000	
Jan.10	Subscription		10000			stationary			
	(2017 -2018)				Nov. 30	Fixed Deposit		100000	
					Dec. 31	Wages and Salaries		32000	
Feb. 07	Subscription		25000		*2017*				

					Jan. 10	Postage charges			240
Mar. 28	Interest on Fixed Deposit		18000		Feb. 2	Telephone expenses			2960
					Feb. 10	Postage and Courier fees			850
					Mar. 15	Lighting		14000	
					Mar. 27	Wages and Salaries		32000	
					Mar. 31	Balance c/d		170000	5400
			551000	**62000**				**551000**	**62000**

Solution:

Item wise Aggregation of various Receipts

Subscriptions (2016-2017)

Date	**Amount (Rs..)**
April 10, 2016	120000
Sept. 10, 2016	145000
Nov. 9, 2016	35000
Feb. 7, 2017	25,00
Total	325000

Subscriptions (2015–16)

Date	**Amount (Rs.)**
Sept. 10, 2016	30000
Total	30000

Subscription (2017-18)

Date	Amount (Rs.)
Jan. 10, 2017	10000
Total	10000

Entrance Fees

Date	Amount (Rs.)
April 15, 2016	13000
Sept.14, 2016	40000
Total	53000

Hall Rent

Date	Amount (Rs.)
June 15, 2016	42000
Total	42000

Life Membership fee

Date	Amount (Rs.)
May 20, 2016	12000
July 23, 2016	8000
Total	20000

Donation for Buildings

Date	Amount (Rs.)
Aug. 12, 2016	60000
Total	60000

Interest on Fixed Deposits

Date	Amount (Rs.)
March 28, 2017	18000
Total	18000

Item wise Aggregation of various Payments

Insurance Premium

Date	Amount (Rs.)
April 15, 2016	15000
Total	15000

Printing and Stationery

Date	Amount (Rs.)
May 10, 2016	10750
Aug. 10, 2016	15000
Oct. 18, 2016	13000
Total	38750

Lighting

Date	Amount (Rs.)
Sept. 8, 2016	12250
March 15, 2017	14000
Total	26250

Telephone Expenses

Date	Amount (Rs.)
June 10, 2016	2810
Sept. 13, 2016	2830
Feb. 2, 2017	2960
Total	8600

Rates and Taxes

Date	Amount (Rs.)
July 15, 2016	17000
Total	17000

Fixed Deposits

Date	Amount (Rs.)
July 31, 2016	100000
Nov. 30, 2016	100000
Total	200000

Wages and Salaries

Date	Amount (Rs.)
July 15, 2016	32000
Oct. 1, 2016	32000
Dec. 31, 2016	32000
March 27, 2017	32000
Total	128000

Postage and Courier Service

Date	Amount (Rs.)
May 20, 2016	1430
Aug. 15, 2016	1480
Jan. 10, 2017	240
Feb.10, 2017	850
Total	4000

Shiva Entertainment Club

Receipt and Payment Account for the year ending March 31, 2017

Dr. Cr.

Receipts		*Amount (Rs.)*	*Payments*	*Amount (Rs.)*
Cash in hand as on April 1, 2016		20000	Printing and Stationery	38750
			Lighting	26250
Cash at bank as on April 1, 2016		35000	Rates and Taxes	17000
			Telephone charges	8600
Subscription:			Postage and Courier	4000
2015–16	30000		Wages and Salaries	128000
2016–17	325000		Insurance Premium	15000
2017–18	10000	365000	Investment in Fixed Deposits	200000
Donation for building		60000	Cash in hand as on 31.3.17	5400
Entrance fees		53000		
Life membership fee		20000	Cash at bank as on 31.3.17	170,000
Interest on investment in Fixed Deposits		18000		
Hall rent		42000		
		613000		613000

Illustration 2:

From the following particulars relating to Sports Point, prepare a Receipt and Payment account for the year ending March 31, 2017.

Particulars		*Amount (Rs.)*	*Particulars*	*Amount (Rs.)*
Opening cash balance		10000	Sale of old sports materials	22000
Opening bank balance		72000	Donation received for pavilion	146000
Subscriptions collected for:	*Rs.*		Rent paid	30000
2015-16	5000		Sports materials purchases	48000
2016-17	76000		Purchase of refreshments	16000
2017-18	9000	90000	Expenses for maintenance	20000
Sale of refreshments		20000	of sports ground	
Entrance fees received		10000	Salary paid	55000
			Tournament expenses	24000
			Furniture purchased	15000
			Office expenses	12000
			Closing cash in hand	4000

Solution:

Books of Sports Point

Receipt and Payment Account for the year ending March 31, 2017

Dr. *Cr.*

Receipts		*Amount (Rs.)*	*Payments*	*Amount (Rs.)*
Balance b/d			Rent	30000
Cash		10000	Sports materials purchased	48000
Bank		72000	Purchase of refreshments	16000
Subscriptions	Rs.		Maintenance expenses for	20000
2015-16	5000		Spots ground	
2016-17	76000		Salary	55000
2017-18	9000	90000	Tournament expenses	24000
Sale of refreshments		20000	Furniture purchased	15000
Entrance fees		10000	Office expenses	12000
Sale of old sports materials		22000	Balance c/d	
Donation for pavilion		146000	Cash	4000
			Bank (balancing figure)	146000
		370000		370000

Illustration 3:

From the following Receipts and Payments Account for the year ending March 31, 2017 of Senior Citizen Club, prepare Income and Expenditure Account for the same period:

Receipt and Payment Account for the year ending March 31, 2017

Dr. *Cr.*

Expenditure		*Amount (Rs.)*	*Income*	*Amount (Rs.)*
Balance c/d (Cash & Bank)		261500	Purchase of furniture (1.7.16)	50000
Subscriptions			Salaries	120000
2015-16	25000		Telephone expenses	3000
2016-17	200000		Electricity charges	16000
2017-18	15000	240000	Postage and Stationery	11500
Donation		20000	Purchase of books	25000
Hall rent		33000	Entertainment expenses	9000
Interest on bank deposits		14500	Purchase of 8% government	80000
Entrance fees		10000	papers (1.7.16)	
			Miscellaneous expenses	16000
			Balance c/d:	
			Cash	3000
			Bank	245500
		579000		579000

The following additional information is available:

(i) Salaries outstanding – Rs. 15000;

(ii) Entertainment expenses outstanding – Rs. 5000;

(iii) Bank interest receivable – Rs. 4500;

(iv) Subscriptions accrued – Rs. 14000;

(v) 50 per cent of entrance fees is to be capitalised;

(vi) Furniture is to be depreciated at 10 per cent per annum.

Solution

Books of Senior Citizen Club

Income and Expenditure Account for the year ending 31.3.2017

Dr. *Cr.*

Expenditure		*Amount (Rs.)*	*Income*		*Amount (Rs.)*
Salaries	120000		Subscriptions		214000
Add: Outstanding	15000	135000	Donation		20000
Telephone expenses		3000	Entrance Fees (50% of Rs. 1,0000)		5000
Electricity charges		16000	Bank interest	14500	
Postage and Stationery		11500	*Add:* Outstanding interest	4500	19000
Entertainment expenses	9000		Interest on investment		4800
Add: Outstanding expenses	5000	14000	Hall rent		33000
Miscellaneous expenses		16000			
Depreciation on furniture		3750			
Surplus (Excess of Income over Expenditure)		96550			
		295800			295800

Working Notes:

1. Interest on Investment (Accrued): 80000x8% x9/12 = Rs. 4800
2. Subscription for the year ending 31st March, 2017:

   Received during 2016-17 Rs.200000 + Outstanding on 31-3-17 Rs. 14000 = Rs. 214000

Illustration 4:

From the Receipts and Payments Account given below, prepare the Income and Expenditure Account of Jaipur Club for the year ended March 31, 2017:

Receipts and Payments Account for the year ending March 31, 2017

Dr. *Cr.*

Receipts	*Amount (Rs.)*	*Payments*		*Amount (Rs.)*
To Balance b/d	32000	By Salary		315000
		By Rent		18000
To Subscriptions	825000	By Electricity		35000
To Entrance Fees	12500	By Taxes		17000
To Donations for Building	125000	By Printing and Stationery		13800
To Rent of hall	17500	By Sundry expenses		29200
To Sale of investments	30000	By Books purchased		175000
		By Fixed deposit with bank (on 31.03.2017)		150000
		By Balance c/d		
		Cash in hand	14000	
		Cash at bank	275000	289000
	1042000			1042000

Solution:

Books of Jaipur Club

Income and Expenditure Account for the year ending March 31, 2017

Dr. *Cr.*

Expenditure	*Amount (Rs.)*	*Income*	*Amount (Rs.)*
To Salary	315000	By Subscriptions	825000
To Rent	18000	BY Entrance fees	12500
To Electricity	35000		
To Taxes	17000	By Rent of hall	17500
To Printing & Stationery	13800		
To Sundry Expenses	29200		
To Surplus	427000		
(excess of income over expenditure)			
	855000		855000

Illustration 5:

Following is the Receipt and Payment Account of Patel Entertainment Club for the year ending March 31, 2017

Receipt and Payment Account for the year ending March 31, 2017

Receipts		*Amount (Rs.)*	*Payments*	*Amount (Rs.)*
Balance b/d			Salaries	44000
Cash	7500		Electricity	21000
Bank	70000	77500	Restaurant expenses	70000
Member's subscriptions:			Telephone	35000
2015-2016	12500		Subscription for periodicals	14500
2016-2017	100000		Printing and stationery	13,000

2017-2018	10000	122500	Sports expenses		50,000
Sale of furniture			Secretary's honorarium		30,000
(book value: *Rs.* 8,000)		10000	Invest. In 8% Securities (31.3.17)		100000
Sale in restaurant		100000	Balance c/d:		
Sale of old periodicals		3200	Cash	6500	
and newspapers			Bank	20000	26500
Hire of ground used		48750			
for marriage					
Donation for sports fund		25000			
Locker Rent		17050			
		404000			404000

Additional Information

1. The club had 150 members, each paying an annual subscription of Rs. 750. Subscription outstanding as on 31 March 2017 Rs.20000.
2. Telephone bill outstanding for the year 2016-2017 is Rs.2,000.
3. Locker Rent Rs.4050 outstanding for the year 2015-16 and Rs.2500 for 2016-17.
4. Salary outstanding for the year 2016-17 Rs.4,000.
5. Opening Stock of Printing and stationery Rs. 2,000 and closing stock of printing and stationery is Rs.3,000 for the year 2016-17.
6. On 1st April 2016 other balances were as under:

	Rs.
Furniture	92000
Building	650000
Sports fund	15000

7. Depreciation to be charged on Furniture and Building @ 10% and 5% respectively.

Prepare Income and Expenditure account for the year ended 31st March, 2017.

Solution:

Book of Patel Entertainment Club

Income and Expenditure Account for the year ending on March 31, 2017

Expenditure		*Amount (Rs.)*	*Income*		*Amount (Rs.)*
Salary	44000		Subscriptions	100000	
Add: Outstanding	4000	48000	*Add:* Outstanding	12500	112500
Electricity Bill		21000	Sale of old periodicals		3200
Telephone	35000		Profit on sale of furniture		2000
Add: Outstanding	2000	37000	Hire of ground		48750
Subscription for periodicals		14500	Locker rent	17050	
Printing and Stationery	13000		*Less:* Opening o/s	4050	
Add: Opening Stock	2000			13000	
	15000		*Add:* Closing o/s	2500	15500
Less: Closing stock	3000	12000			
Secretary's honorarium		30000	Sale in restaurant	100000	
Sports Expenses	50000		Less: Restaurant exp.	70000	30000
Less: Opening Balance			Deficit (Excess of Expenditure over Income)		4550
of sports fund	15000				
	35000				
Less: Donation for					
Sports	25000	10000			
Depreciation On:					
Furniture	11500				
Building	32500	44000			
		216500			216500

Illustration 6:

From the following Receipts and Payments Account and additional information relating to Sikar Cricket Club, prepare Income and Expenditure Account for the year ended March 31, 2017:

Sikar Cricket Club

Receipts and Payments Account

Dr. *Cr.*

Receipts	*Amount (Rs.)*	*Payments*	*Amount (Rs.)*
Balance b/d (Cash in Hand)	18000	Balance b/d (bank overdraft)	16000
Member's subscriptions	250000	Upkeep of field and pavilion	115000
Member's entrance fee	15000	Tournament expenses	40000
Sale of old sports materials	2500	Rates and Insurance	10000
Hire of ground	28000	Telephone	3500
Subscription for tournament	60000	Postage charges	4000
Life membership fee	20000	Printing and Stationery	26000
Donations	600000	Miscellaneous expenses	14400
		Secretary's honorarium	50000
		Grass seeds	2600
		Investments	600000
		Purchase of sports materials	68000
		Balance c/d	44000
	993500		993500

Assets at the beginning of the year were:

	Rs.
Stock of sports materials	85,000
Printing and Stationery	11,000
Subscriptions receivable	28,000

Donations and Surplus on account of tournament are to be kept in Reserve for a permanent pavilion. Subscriptions due on March 31, 2017 were Rs. 42,000. Write-off fifty per cent of sports materials and thirty per cent of printing and stationery.

Solution:

Books of Sikar Cricket Club

Income and Expenditure Account for the year ending on March 31, 2017

Dr. *Cr.*

Expenditure		*Amount (Rs.)*	*Income*		*Amount (Rs.)*
Upkeep of field and pavilion		115000	Subscriptions	250000	
Rates and Insurance		10000	*Add:* Outstanding		
Telephone		3500	(closing)	42000	
Postage charges		4000		292000	
Printing & stationery	26000		*Less:* Outstanding		
Add: Opening stock	11000		(opening)	28000	264000
Available for use	37000		Admission fees		15000
Less: Closing stock	25900		Sale of old sports material		2500
Stationery consumed		11100	Hire of grounds		28000
Miscellaneous expenses		14400			
Secretary's honorarium		50000			
Grass seeds		2600			
Sports materials consumed:					
Opening stock	85000				
Add: Purchases	68000				
	153000				
Less: Closing stock	76500	76500			
Surplus (Excess of income over expenditure)		22400			
		309500			309500

Illustration 7:

From the following extract of Receipts and Payments Account and the additional information given below, compute the amount of income from subscriptions and show as how they would appear in the Income and Expenditure Account for the year ending March 31, 2017 and the Balance Sheet.

Receipts and Payments Account for the year ending March 31, 2017

Receipts		*Amount (Rs.)*	*Payments*	*Amount (Rs.)*
Subscriptions:				
2015-16	17000			
2016-17	230000			
2017-18	50000	297000		

Additional Information: Rs.

1. Subscriptions outstanding March 31, 2016 18500
2. Total Subscriptions outstanding March 31, 2017 118500
3. Subscriptions received in advance as on March 31, 2016 40000

Solution:

Income and Expenditure Account for the year ending on March 31, 2017

Expenditure	*Amount (Rs.)*	*Income*	*Amount (Rs.)*
		Subscriptions	230000
		Received for 2016-17	
		Add: Outstanding for 2016-17	117000
		Add: Received in advance for 2016-17	40000
			387000

Note : Total amount of subscriptions outstanding as on 31-3-2017 are Rs. 118500. This, includes Rs. 1,500 (Rs. 18500 – Rs. 17000) for subscriptions still outstanding for 2015–16. Hence, the subscriptions outstanding for 2016–17 are Rs. 117000 (Rs. 118500 – Rs. 1500).

Illustration 8:

As per Receipts and Payments Account for the year ended on March 31, 2017, the subscriptions received were Rs. 450000. Additional Information given is as follows:

1. Subscriptions Outstanding on 1.4.2016 Rs. 50000
2. Subscriptions Outstanding on 31.3.2017 Rs.35000
3. Subscriptions Received in Advance as on 1.4.2016 Rs.45000
4. Subscriptions Received in Advance as on 31.3.2017 Rs.40,000

As certain the amount of income from subscriptions for the year 2016–17.

Solution:

Details	*Amount (Rs.)*
Subscriptions Received as per Receipt and Payment account	450000
Add: Subscriptions outstanding on 31.3.2017	35000
Add: Subscriptions received in advance on 1.4.2016	45000
	530000
Less: Subscriptions outstanding on 1.4.2016	50000
	480000
Less: Subscriptions received in advance on 31.3.2017	40000
Income from subscription for the year 2016–17	440000

Alternatively, income received from subscriptions can be calculated by preparing a Subscriptions account as under.

Subscription Account

Dr. *Cr.*

Date	*Particulars*	*J.F.*	*Amount (Rs.)*	*Date*	*Particulars*	*J.F.*	*Amount (Rs.)*
	Balance b/d (outstanding)		50000		Balance b/d (advance)		45000
	Income and				Receipts and Payments A/c		450000
	Expenditure Account		440000		Balance b/d (outstanding)		35000
	(balancing figure)						
	Balance c/d (advance)		40000				
			530000				530000

Self Examination Questions (Multiple Choice Questions):

Choose the most appropriate answer from the given options:

1. Which of the following consist in the final accounts of a non-profit organisation-
   (a) Trading and Profit and Loss Account; and Balance Sheet
   (b) Income Statement; and Statement of Financial Position
   (c) Receipts and Payments Account; and Income and Expenditure Account
   (d) Receipts and Payments Account; Income and Expenditure Account; and Balance Sheet
2. Receipts and Payments Account is a
   (a) Income Statement
   (b) Cash Book
   (c) Summary of the Cash Book
   (d) Statement of Financial Position
3. Receipts and Payments Account is prepared on
   (a) Accrual basis of accounting
   (b) Cash basis of accounting
   (c) Hybrid basis of accounting
   (d) Either (a) or (b)

4. Which of the following items are included in the Receipts and Payments Account
   (a) Only revenue nature receipts and payments relating to a particular accounting period
   (b) Only capital nature receipts and payments relating to a particular accounting period
   (c) All kinds of receipts and payments of during a particular accounting period
   (d) All kinds of receipts and payments relating to a particular accounting period
5. Income and Expenditure Account is prepared on
   (a) Cash basis
   (b) Accrual basis
   (c) Hybrid basis
   (d) Either (a) or (b)
6. Income and Expenditure Account records income and expenditure items of
   (a) Both capital and revenue nature
   (b) Only capital nature
   (c) Only revenue nature
   (d) Only revenue nature related to a particular accounting period
7. Income and Expenditure Account is equivalent to
   (a) Profit and Loss Account
   (b) Receipts and Payments Account
   (c) Balance Sheet
   (d) None of the above
8. Receipts and Payments Account is in nature of
   (a) Personal Account
   (b) Artificial Personal Account
   (c) Real Account
   (d) Nominal Account
9. Income and Expenditure Account is a
   (a) Nominal Account
   (b) Real Account
   (c) Representative Personal Account
   (d) Personal Account
10. Which of the following is not recorded in the Receipts and Payments Account
   (a) Outstanding subscription

(b) Prepaid insurance premium

(c) Depreciation

(d) All the above

11. Depreciation includes in

(a) Receipts and Payments Account

(b) Income and Expenditure Account

(c) Both (a) and (b)

(d) Either (a) or (b)

12. Life membership fee is a

(a) Revenue nature receipt

(b) Capital nature receipt

(c) Revenue nature expenditure

(d) Capital nature expenditure

13. Excess of income over expenditure is also known as

(a) Profit

(b) Surplus

(c) Loss

(d) Deficit

14. Excess of expenditure over income is also known as

(a) Profit

(b) Loss

(c) Surplus

(d) Deficit

15. A Club is of 200 members. Subscription per member is Rs. 3000 per annum. Outstanding subscription at the beginning of the year and end of the year were Rs.18000 and Rs.28000 respectively. Amount of subscription to be shown in Receipts and Payments Account will be

(a) Rs.600000

(b) Rs.618000

(c) Rs.572000

(d) Rs. 590000

16. A Club is of 200 members. Subscription per member is Rs. 3000 per annum. Outstanding subscription at the beginning of the year and end of the year were Rs.18000 and Rs. 28000 respectively. Amount of subscription to be shown in Income and Expenditure Account will be

(a) Rs. 600000

(b) Rs.618000

(c) Rs.572000

(d) Rs. 590000

17. A Club is of 150 members. Subscription per member is Rs. 500 per month. Subscription of 8 members of whole year's was not received and subscription from 5 members has been received in advance for six months of the next year. The amount of subscription to be shown in Receipts and Payments Account will be

(a) Rs. 900000

(b) Rs.867000

(c) Rs.963000

(d) Rs. 933000

18. A Club is of 100 members. Subscription per member is Rs. 2500 per annum. Rs. 218000 are received during the year 2016-17 which includes Rs. 20000 and Rs. 15000 subscription for the years 2015-16 and 2017-18 respectively. At the end of the year 2016-17, the amount of outstanding subscription will be

(a) Rs. 32000

(b) Rs.52000

(c) Rs.35000

(d) Rs. 67000

19. A Club is of 100 members. Subscription per member is Rs. 2500 per annum. Rs. 218000 are received during the year 2016-17 which includes Rs.20000 and Rs. 15000 subscription for the years 2015-16 and 2017-18 respectively. At the end of the year 2016-17, the amount of subscription received in advance will be

(a) Rs. 20000

(b) Rs.15000

(c) Rs.35000

(d) Rs. 32000

20. An institution received Rs. 180000 as rent during the year 2016-17 which includes Rs. 36000 received in advance for the year 2017-18. Outstanding rent at the end of the years 2015-16and 2016-17 were Rs.24000 and Rs.28000 respectively. Amount of rent to be shown in Income and Expenditure Account for the year 2016-17 will be

(a) Rs. 180000

(b) Rs.144000

(c) Rs.140000

(d) Rs. 148000

21. In a Club, subscription received for current year is Rs. 250000, Subscription of current year received in the previous year is Rs. 25000, Subscription outstanding for current year isRs.45000, Subscription received in advance in current year isRs.11000 and subscription of previous year received in current year is Rs. 35000. The amount of subscription to be shown in Receipts and Payments Account will be

(a) Rs. 250000

(b) Rs.296000

(c) Rs.274000

(d) Rs. 226000

22. In a Club, subscription received for current year Rs. 250000, Subscription of current year received in the previous year Rs. 25000, Subscription outstanding for current year Rs.45000, Subscription received in advance in current year Rs.11000 and subscription of previous year received in current year Rs. 35000. The amount of subscription to be shown in Income and Expenditure Account will be

(a) Rs. 274000

(b) Rs.226000

(c) Rs.309000

(d) Rs. 320000

23. In a Club, subscription received for current year Rs. 250000, Subscription of current year received in the previous year Rs. 25000, Subscription outstanding for current year Rs.45000, Subscription received in advance in current year Rs.11000 and subscription of previous year received in current year Rs. 35000. If the beginning of the current year the outstanding subscription is Rs.42000 then the amount of outstanding subscription at the end of the current year will be

(a) Rs. 45000

(b) Rs.87000

(c) Rs. 52000

(d) Rs. 55000

24. In a Club, subscription received for current year Rs. 250000, Subscription of current year received in the previous year Rs. 25000, Subscription outstanding for current year Rs.45000, Subscription received in advance in current year Rs.11000 and subscription of previous year received in current year Rs. 35000. At the end of the current year amount of subscription received in advance will be

(a) Rs. 11000

(b) Rs.46000

(c) Rs. 36000

(d) Rs. 60000

25. Without adjusting the items of: Outstanding subscription Rs. 5600;Outstanding rent Rs. 3500; and Prepaid insurance Rs.1500, the Income and Expenditure Account of Poova Entertainment Club shown

a surplus of Rs. 67000. The amount of surplus after above adjustments will be

(a) Rs. 59400

(b) Rs.63400

(c) Rs. 70600

(d) Rs.66400

26. Which of the following is generally considered as a non profit oriented organization?

    (a) Charitable organization

    (b) Corporation

    (c) Audit firms

    (d) Insurance companies

27. Outstanding subscription for a non-profit organization is considered as a/an

    (a) Expense

    (b) Liability

    (c) Equity

    (d) Asset

28. Non-profit organizations prepare all of the following accounts except the

    (a) Receipts and payment accounts

    (b) Income and Expenditure accounts

    (c) Balance sheet

    (d) Income statement

29. Expenditure greater than income of a non-profit organization give rise to a

    (a) Loss

    (b) Profit

    (c) Surplus

    (d) Deficit

30. Rent expense of a non-profit organization paid in advance. Which of the following is the correct classification of rent?

    (a) Expense

    (b) Liability

    (c) Equity

    (d) Asset

31. An advance receipt of subscription from a member of the non-profit organization is considered as a/an

(a) Expense

(b) Liability

(c) Equity

(d) Asset

32. Purchase of a fixed asset by a non-profit organisation will be shown in

(a) Income and Expenditure account

(b) Receipts and Payments Account

(c) Both (a) and (b)

(d) Neither(a) or(b)

33. Which of the following is to be recorded in an income and expenditure account?

(a) Purchase of a fixed asset

(b) Capital expenditure incurred on a fixed asset

(c) Profit on the sale of a fixed asset

(d) Sale of a fixed asset

34. Honorarium is a kind of remuneration paid to a person who is not the employee of a non-profit organization. Which of the following statements is true about the honorarium payment?

(a) It's a revenue expenditure

(b) It's a capital expenditure

(c) It's a deferred revenue expenditure

(d) It is not recorded in the books of accounts

35. The capital of a non-profit organization is generally known as

(a) Equity

(b) Accumulated fund/ Capital fund

(c) Cash fund

(d) Financial reserve

36. In case of a non-profit organisation, life membership fee is treated as

(a) a revenue expenditure

(b) a capital expenditure

(c) a deferred revenue expenditure

(d) Either (a) or (b)

37. XYZ club has a restaurant that maintains a separate trading account for its trading activities. Which of the following is the treatment of profit or loss on restaurant trading activities?

(a) Profit or loss is directly shown in the balance sheet

(b) Profit or loss is to be presented in income and expenditure account

(c) Profit and loss is credit in income statement

(d) Profit or loss is added to accumulated fund

38. Which of the following is the accounting equation for a non-profit organization?

    (a) Asset = Capital + Liabilities

    (b) Capital + Liabilities = Assets

    (c) Accumulated fund + Liabilities = Assets

    (d) Liabilities = Asset + Accumulated fund

39. In case of a non-profit organisation rent of building is due but not yet received is considered as a/an

    (a) Asset

    (b) Liability

    (c) Income

    (d) Expenditure

40. A non-profit organization received Rs.10,000 as the entrance fee of a new member. If 20% of the fee has to be capitalized, what is the amount of fee needs to be shown in the income and expenditure account?

    (a) Rs.2000

    (b) Rs.8000

    (c) Rs.9000

    (d) Rs.10000

41. Rs.100000 received as the annual membership subscription. Out of this, Rs.20000 is pertaining to the previous accounting period, whereas Rs.10000 is receivable at the end of the current accounting period. Calculate the amount of subscription that will be shown in the income and expenditure account for this accounting year

    (a) Rs.100000

    (b) Rs.90000

    (c) Rs.120000

    (d) Rs.80000

42. Income and expenditure accounts show

    (a) Cash available to an organization

    (b) Closing capital of an organization

    (c) Cash available in the bank account

(d) Surplus or deficit for the current accounting period

43. The amount or property received by a non- profit organization as stated by the will of a deceased person is commonly referred to as

    (a) Donation

    (b) Honorarium

    (c) Legacy

    (d) Endowment

44. Investment in sinking fund by a non-profit organization is a/an

    (a) Liability

    (b) Accumulated fund

    (c) Asset

    (d) Equity

45. In accounting of non-profit organisations, the sale of old newspapers is generally considered as a/an

    (a) Revenue expenses

    (b) Capital expenditure

    (c) Revenue income

    (d) Capital receipt

ANSWERS

1 (d)	2 (c)	3 (b)	4 (c)	5 (b)	6 (d)
7 (a)	8 (c)	9 (a)	10 (d)	11 (b)	12 (b)
13 (b)	14 (d)	15 (d)	16 (a)	17 (b)	18 (d)
19 (b)	20 (d)	21 (b)	22 (d)	23 (c)	24 (a)
25 (c)	26 (a)	27 (d)	28 (d)	29 (d)	30 (d)
31 (b)	32 (b)	33 (c)	34 (a)	35 (b)	36 (b)
37 (b)	38 (c)	39 (b)	40 (b)	41 (b)	42 (d)
43 (c)	44 (c)	45 (c)			

Lesson 12
Computerized Accounting Environment

LESSON OUTLINE

- Computerized accounting environment
- Tally
- ERP
- SAP Business One

LEARNING OBJECTIVES

The global accounting environment has presence of accounting software's and packages. Professionals closely related to management of business need to have adequate exposure to the computerized accounting environment.

In this lesson a preliminary exposure to the computerized accounting environment has been presented.

Computerized Accounting System and its awareness among professional has become a necessity in the globalised environment. Businesses of whatever orientation and size are shifting from the practice of maintaining accounts manually. The manual process is more time-consuming, cumbersome and exposed to human error. Storage and retrieval of information and generation of report cannot be ensured in real time in the traditional system. The shift to computerized accounting systems has revolutionized the way businesses are managed. They have empowered organizations to project accurate information of financial performance.

Important Features of Computerized Accounting Systems

1. Simple and Integrated

Computerized accounting is designed to facilitate all businesses by automating and integrating all the business activities. Such activities may include sales, finance, purchase, inventory and manufacturing etc. Computerized accounting helps arrangement of accurate and up-to-date business information in a readily usable form.

2. Accuracy & Speed

Computerized accounting has customized templates for users which provide fast and accurate data entry. Once the transactions are recorded documents and reports can be generated automatically through selective commands.

3. Scalability

The system has flexibility to record the transactions with changing volume of business.

4. Instant Reporting

Quality report in real time can be generated because of speed and accuracy.

5. Security

Highly secured data and information can be kept confidential as compared to manual accounting system.

6. Quick Decision Making

Generates real-time, comprehensive MIS reports and ensures access to complete and critical information, instantly.

7. Reliability

Computerised accounting makes sure that the reports are generated with consistency. Minimization of errors makes the system reliable.

Introduction to Tally

Tally is most popular software for accounts and inventory management. It offers different feature for maintaining accounts. Latest version of Tally has lots of advanced features like better data migrating, fast data speed, payroll management, TDS, TCS, job costing and point- of sale invoicing etc. It has a synchronized multilingual integrated business accounting software, enables to maintain accounts in any Indian language, view it in other and print it in yet other language of choice.

Some of the basic commands of Tally

Functions Key Combination

F1

- This function is used to select a company .It is also used to select inventory buttons and accounts button.
- It is available at all masters menu screen. Appears at the Accounting/ Inventory vouchers creation and alteration screen..

F2

- It is used to change the menu period

F3

- To select the company
- To change the menu period

F4

- Selection of Contra Voucher
- Appears at the Accounting/ Inventory vouchers creation and alteration screen..

F5

- To select the Payment voucher
- Appears at the Accounting/ Inventory vouchers creation and alteration screen..

F6

- To select the Receipt voucher
- Appears at the Accounting/ Inventory vouchers creation and alteration screen.

F7

- To select the Journal voucher
- Appears at the Accounting/ Inventory vouchers creation and alteration screen.

F8

- To select the Sales voucher
- Appears at the Accounting/ Inventory vouchers creation and alteration screen

(CTRL+F8)

- To select the Credit Note voucher
- Appears at the Accounting/ Inventory vouchers creation and alteration screen

F9

- To select the Purchase voucher
- At Accounting / Inventory Voucher creation and alteration screen

(CTRL + F9)

- To select the Purchase voucher
- At Accounting / Inventory Voucher creation and alteration screen

F10

- To select the Memorandum voucher
- At Accounting / Inventory Voucher creation and alteration screen

(CTRL + F10)

- To select the Memorandum vouche
- At Accounting / Inventory Voucher creation and alteration screen

F11

- To select the Functions and Features screen
- At almost all screens in TALLY

F12

- To select the configure screen
- At almost all screens in TALLY

Voucher Entry Shortcut Keys of Tally

ALT + D: To delete a voucher / To delete a master / To delete a column in any columnar report

ALT + E: To export the report in ASCII, HTML OR XML format

ALT + I: To insert a voucher (To toggle between Item and Accounting invoice)

ALT + L: To select the Language Configuration

ALT + K: To select the Keyboard Configuration

ALT + O: To upload the report at your website

ALT + L: To select language for Tally Interface

ALT + M: To Email the report

ALT + N: To view the report in automatic columns

ALT + P: To print the report

ALT + R: To remove a line in a report

ALT + S: To bring back a line you removed using ALT + R

ALT + U: To retrieve the last line which is deleted using Alt + R

ALT+ V: From Invoice screen to bring Stock Journal screen

ALT + W: To view the Tally Web browser.

ALT + X: To cancel a voucher in Day Book/List of Vouchers

ALT + R: To Register Tally

CTRL + A: To accept a form

CTRL + B: To select the Budget

CTRL + ALT + B: To check the Company Statutory details

CTRL + C: To select the Cost Centre / To select the Cost Category

CTRL+ E: To select the Currencies

CTRL + G: To select the Group

CTRL + I: To select the Stock Items

Ctrl + Alt + I: To import statutory masters

CTRL + L: To select the Ledger / To mark a Voucher as Optional

CTRL + O: To select the Godowns

CTRL + Q: To abandon a form

CTRL + R: To repeat narration in the same voucher type

CTRL + Alt + R: Rewrite data for a Company

Key Combination used for navigation

Windows	Functionality	Availability
PgUp	Display previous voucher during voucher entry/alter	At voucher entry and alteration screens
PgDn	Display next voucher during voucher entry/alter	At voucher entry and alteration screens
ENTER	To accept anything you type into a field. To accept a voucher or master To get a report with further details of an item in a report.	You have to use this key at most areas in TALLY At the receivables report – press Enter at a pending bill to get transactions relating to this bill (e.g., original sale bill, receipts and payments against this bill, etc)
ESC	To remove what you typed into a field To come out of a screen To indicate you do not want to accept a voucher or master.	At almost all screens in TALLY.
SHIFT + ENTER	Collapse next level details	At Voucher Register screen and Trial Balance report
SHIFT + ENTER	To explode a line into its details	In almost all Reports: At a Group/Stock Group/Cost Category/Godown/Stock Category – displays Sub Groups and Ledgers/Stock Items/Cost Centres/Secondary Godowns/Secondary Stock Categories At a Voucher – displays its entries and narration At a Stock Item- displays its godowns and batch details At Voucher Register screen – displays the next level details At Trial Balance report - displays the next level details
CTRL + ENTER	To alter a master while making an entry or	At voucher entry and alteration screens At all reports

	viewing a report	

ERP

Since the global economy has integrated rapidly since the Information Technology revolution a sea of change has appeared in business management software. In such an environment businesses have considered accounting software and enterprise resource planning (ERP) software almost interchangeably. However, an understanding of the difference between accounting software and ERP software can be developed by looking at the range of functionality traditionally offered by each of them. Accounting software, as indicated by its name, deals with accounting transactions such as payroll, accounts receivable, accounts payable, and trial balances. ERP software is a resource management system, tracking tangible and intangible assets, materials, human resources, and financial resources. ERP software covers a range of functionality not generally offered by accounting software, often factoring in intangibles like human work hours, product lifecycles, performance units, and customer relations.

The reason that accounting software and ERP software have come to mean the same thing in today's market is that accounting software as we traditionally understand it is fading away. Some of the popular ERP accounting packages are being mentioned here.

- Sage 300 (formerly ACCPAC)
- Microsoft Dynamics NAV
- SAP Business One
- Epicor 9 (formerly Vantage)
- Microsoft Dynamics GP
- Macola ES (Exact Software)
- Sage 100 (formerly MAS 90 & MAS 200)
- Netsuite (updated 8/8/2016)
- SysPro
- Sage X3

SAP Business One

It is one of the most widely used and popular accounting package. 'SAP Business One' offers fully integrated financial and banking functionality for complete, across-the board tracking, management, reporting, and control of all key financial and accounting processes. Important Functions of SAP Buniess one are being mentioned here.

Accounting: The chart of accounts indexes all general ledger accounts that are used by one or more companies. A chart-of-accounts template is available for every country. You can also use this template to define individual charts of up to 10 segments if desired.

Journal entries: Journal entries are posted automatically from the sales, purchasing, and banking functions, allowing you to create new journal entries and search for existing ones.

Journal vouchers: You can save multiple manual journal entries and process them simultaneously, allowing verification of the postings before they are entered in the general ledger.

Posting templates: You can define general ledger account assignment models, saving time and avoiding mistakes during the manual posting of journal entries.

Recurring postings: You can define your own postings for regular execution in accounting and specify a frequency for each recurring posting.

Reversing journals: Reversals of specified postings occurs on the first day of the following calendar month, but you can specify a different reversing date for each posting.

Exchange rate differences: You can evaluate your open items in foreign currencies, then identify differences and choose the appropriate correction transaction.

Financial report templates: You can generate any number of financial report templates.

Budgets: You can define and manage budgets on existing accounts to compare actual and planned figures. The software alerts you whenever a transaction exceeds a monthly or annual budget limit.

Profit center definitions: You can define different profit centers or departments and allocate the revenue and cost accounts to a predefined profit center in the chart of accounts.

Distribution rule definitions: You can define different distribution rules to characterize business activities and then allocate a revenue or cost account to the corresponding distribution rule.

Profit center report: Reports are based on revenues and costs, both direct and indirect. You can run reports for any profit centre annually or monthly to compare the results with the figures of previous period.

SELF TEST Questions

1. Which of the following is not an advantage of a computerized accounting system?

   A) Computers process transactions uniformly.

   B) Computers help alleviate human errors.

   C) Computers can process many transactions quickly.

   D) Computers leave a thorough audit trail which can be easily followed.

2. One of the greatest difficulties in auditing a computerized accounting system is:

   A) Data can be erased from the computer with no visible evidence.

   B) Because of the lack of an audit trail, computer systems have weaker controls and more substantive testing is required.

   C) Because of the uniform nature of transaction processing, computer systems have strong controls and less substantive testing is required.

   D) The large dissemination of entry points into the computer system leads to weak overall reliance on information generated by a computer.

3. How have electronic data interchange (EDI) systems affected audits?

   A) Since orders and billing transactions are done over the computer, source documents cannot be obtained.

B) Auditors often need to plan ahead to capture information about selected transactions over the EDI.

C) There is no audit trail in an EDI system, so controls are typically assessed as weak.

D) Since all transactions occur over the computer, reliability is high and little substantive testing is needed.

4. Since the computer can do many jobs simultaneously, segregation is not as defined as it is in a manual system. How can a computer system be modified to compensate for the lack of segregation of duties?

A) The computer system should be under the direction of the internal audit department.

B) The computer system should be accessible to various competent parties so they can check on each others' work.

C) Strong controls should be built into both the computer software and hardware to limit access and manipulation.

D) Many companies run complete parallel manual and automated accounting systems for a cross check on input and output.

5. One key control in the organization of the information systems department is the:

A) Separation of the systems development group and the operations (data processing) group.

B) Operating personnel should strictly control access to the client's database.

C) Controller should manage the information system since it supplements the accounting work already done under the supervision of the controller.

D) Information systems department should be under the direction of systems development personnel since they are responsible for the overall performance of the system.

6. Which of the following represent examples of general, application and user control activities, respectively, in the computer environment?

A) Control over access to programs, computer exception reports, and manual checks of computer output.

B) Manual checks of computer output, control over access to programs, and computer exception reports.

C) Computer exception reports, control over access to programs, and manual checks of computer output.

D) Manual checks of computer output, computer exception reports, and control over access to programs.

7. When would an auditor typically not perform additional tests of a computer systems controls?

A) When the assessed level of control risk is at a minimum.

B) When computer controls appear to be strong and risk is at a minimum.

C) When controls appear to be weak.

D) When inherent risk is at a maximum.

8. When would "auditing around the computer" be appropriate?

   A) When controls over the computer system are strong.

   B) When controls over the computer system are non-existent.

   C) When controls over the computer system are adequate.

   D) It is never appropriate to audit around the computer.

9. Which of the following would not be an appropriate procedure for testing the general control activities of an information system?

   A) Inquiries of client personnel.

   B) Inspecting computer logs.

   C) Testing for the serial sequence of source documents.

   D) Examination of the organizational chart to determine the segregation of duties.

10. If an auditor is using test data in a client's computer system to test the integrity of the systems output, which of the following type of controls is the auditor testing:

    A) General controls.

    B) User controls.

    C) Quantitative test controls.

    D) Application controls.

11. Which of the following is not a function of generalized audit software?

    A) To aid in the random selection of transactions for substantive testing

    B) To run in parallel with the client's application software and compare the output

    C) To test the mathematical accuracy by footing and cross-foot items in the accounting system

    D) To keep an independent log of access to the computer application software.

PART B
FUNDAMENTALS OF AUDITING

LESSONS

10.	Concepts of Auditing
11.	Types of Auditing
12.	Tools of Auditing
13.	Audit and Auditors under Companies Act, 2013 – Basic Provisions

LEARNING OBJECTIVES

From the time of ancient Egyptians, Greeks and Romans, the practice of auditing the accounts of public institutions existed. Checking clerks were appointed in those days to check the public accounts. To locate frauds as well as to find out whether the receipts and payments are properly recorded by the person responsible was the main objective of Auditing of those days.

During the 18th century, the Company form of organizations comes into existence. In these companies capital is contributed by shareholders but they do not have control over the day to day working of the company. The shareholders who have invested their money would naturally be interested in knowing the financial position of the company. This originated the need of an independent person who would check the accounts and report the shareholders on the accuracy of the accounts and the safety of their investment.

Now days many forms of organisations are mandatorily required by the legislation to get their accounts audited. So there is a need to have understanding of the subject of auditing.

Lesson 13
Concept of Auditing

LESSON OUTLINE

- Introduction
- Meaning of Audit
- Principle aspects to be covered under audit
- Benefits of auditing
- Limitations of auditing
- Review Questions
- Investigation
- Difference between Auditing and Investigation
- Lesson Round UP
- Glossary
- Self-Test Questions

LEARNING OBJECTIVES

The basic purpose of auditing is to confirm the authenticity of books of accounts prepared by an Accountant. It is well known saying that "where the function of Accountant ends, audit begins to determine the true and fair picture of such accounts".

Audit is performed to ascertain the validity and reliability of information. Examination of books of accounts with supporting vouchers and documents in order to detect and prevent error and fraud is the main function of auditing. Auditor has to check the effectiveness of internal control system for determining the extent of checking to be done for carrying out the audit. Other than internal control system auditor has to follow certain other principal aspects of auditing. Audit safeguards the financial interest of persons not associated with the management like partners, shareholders, etc. Auditing also have some inherent limitations such as the obtained evidences are persuasive rather than conclusive. Investigation and auditing are two different areas not linked with each other.

In this lesson, you will learn the meaning of audit; principle aspects of auditing, advantages and Limitations of audit and what is investigation and how is it different from auditing.

I'm not suggesting there are any errors at all. I'm saying that without a proper audit, there's no way to be sure.

Pete Williams

INTRODUCTION

Evolution of Auditing

The term audit is derived from the Latin term 'audire,' which means to hear. In early days a person used to listen to the accounts read over by an accountant in order to check them. He was known as auditor. Auditing is as old as accounting and there are signs of its existence in all ancient cultures such as Mesopotamia, Greece, Egypt. Rome, U.K. and India. Arthshastra by Kautilya detailed rules for accounting and auditing of public finances.

Audit is performed to ascertain the validity and reliability of information. Examination of books of accounts with supporting vouchers and documents in order to detect and prevent error and fraud is the main function of auditing. The goal of an audit is to express an opinion on the financial or non-financial areas. Audit safeguards the financial interest of persons not associated with the management like partners or shareholders, acts as a moral check on the employees and prevents from committing fraud. However, due to constraints, an audit seeks to provide only reasonable assurance that the statements are free from material error. In case of financial audit, a set of financial statements are said to be true and fair when they are free of material misstatements. But recently, argument that auditing should go beyond just true and fair is gaining momentum in view of recent frauds by high profile organizations in connivance with the reputed audit firms.

Traditionally, audits were mainly associated with gaining information about financial systems and the financial records of a company or a business. However, recently auditing has begun to include non-financial subject areas, such as safety, security, information systems performance, and environmental concerns. With non-profit organizations and government agencies, there has been an increasing need for performance audit, examining their success in satisfying mission objectives of business.

In India the Companies Act, 2013 made audit of company accounts compulsory. With the increase in the size of the companies and the volume of transactions, the main objective of audit shifted to ascertaining whether the accounts were true and fair rather than true and correct. Hence the emphasis was not on arithmetical accuracy but on a fair representation of the financial efforts. The Companies Act, 2013 also prescribed for the first time about the qualification of auditors. After the independence. The Indian Companies Act, 1956 was implemented and detailed provisions were made in the Act regarding Audit and auditors. Recently Companies Act, 2013 has been implemented w.e.f. 1st April, 2014 and this contains detailed provisions about statutory audit, Cost Audit, Internal Audit and Secretarial Audit.

MEANING AND DEFINITIONS OF AUDITING

It is a bit difficult to give a precise definition of word audit in a word or two, originally its meaning and use was confined merely to cash audit and the auditor had to ascertain whether the person responsible for the maintenance of accounts had properly accounted for all the cash receipts and payment on behalf of this principle. But the word "audit" has a wide usage and now it means a thorough scrutiny of the books of accounts and its ultimate aim is to verify the financial position disclosed by the balance sheet and the profit and loss account of a company. The following are some of the definitions of audit given by some writers

Lawrence R. Dicksee – "An audit is an examination of accounting records undertaken with a view to establishing whether they correctly and completely reflect the transactions to which they purport to relate."

Taylor and Perry – "Audit is defined as an investigation of some statements of figures involving examination of certain evidence, so as to enable an auditor to make a report on the statement.

F.R.M. De Paula – "An audit denotes the examination of Balance Sheet and Profit and Loss Account prepared by others together with the books of accounts and vouchers relating there to in such a manner that the auditor may be able to satisfy himself and honestly report that, in his opinion, such Balance Sheet is properly drawn up so as to exhibit a true and correct view of the state of affairs of the particular concern according to the information and explanations given to him and as shown by the books".

Prof. Montgomery – "Auditing is a systematic examination of the books and records of business or other organization in order to ascertain or verify and to report upon the facts regarding its financial operations and the result thereof."

Spicer & Pegler – "Audit such an examination of the books of accounts and vouchers of a business, as will enable the auditor to satisfy himself that the Balance Sheet is properly drawn up, so as to give a true and fair view of the state affairs of the business, and whether the profit and loss account gives a true and fair view of the profit or loss for the financial period according to the best of his information and explanations given to him and as shown by the books, and if not, in what respect he is not satisfied."

Institute of Chartered Accountants of India (ICAI) defines Auditing as – "Auditing is defined as a systematic and independent examination of data, statements, records, operations and performance of an enterprise for a stated purpose. In any auditing situation, the auditor perceives and recognizes the propositions before him for examination, collect evidences, evaluates the same and on this basis formulates his judgement which is communicated through his audit report."

In the close scrutiny of the different definitions, we found that there are different ways of expressing the concept of auditing but having lot of similarity therein.

The meaning of an Audit contains

(i) an intelligent and critical examination of the books of accounts of business;

(ii) it is done by an independent qualified person;

(iii) it is done with the help of vouchers, documents, information and explanations received from the clients;

(iv) the auditor satisfies himself with the authenticity of the financial accounts prepared for a particular period;

Features of Auditing

(i) Audit is a systematic and scientific examination of the books of accounts of a business;

(ii) Audit is undertaken by an independent person or body of persons who are duly qualified for the job.

(iii) Audit is a verification of the results shown by the profit and loss account and the state of affairs as shown by the balance sheet.

(iv) Audit is a critical review of the system of accounting and internal control.

(v) Audit is done with the help of vouchers, documents, information and explanations received from the authorities.

(vi) The auditor has to satisfy himself with the authenticity of the financial statements and report that they exhibit a true and fair view of the state of affairs of the concern.

(vii) The auditor has to inspect, compare, check, review, scrutinize the vouchers supporting the transactions and examine correspondence, minute book of share holders, directors, Memorandum of Association and Articles of Association etc., in order to establish correctness of the books of accounts.

Objectives of Auditing

The objectives of auditing may be classified into two parts:

(i) The primary objective

(ii) The secondary or incidental objective.

Primary objective – As per Section 143 of the Companies Act 2013, the primary duty (objective) of the auditor is to report to the owners that the accounts, financial statements give a true and fair view of the state of the company's affairs as at the end of its financial year and profit or loss and cash flow for the year and such other matters as may be prescribed.

Secondary objective – It is also called the incidental objective as it is incidental to the satisfaction of the main objective. The incidental objectives of auditing are:

(i) Detection and prevention of frauds, and

(ii) Detection and prevention of errors.

Detection of material frauds and errors as an incidental objective of independent financial auditing flows from the main objective of determining whether or not the financial statements give a true and fair view. As the Statement on auditing Practices issued by the Institute of Chartered Accountants of India states, an auditor should bear in mind the possibility of the existence of frauds or errors in the accounts under audit since they may cause the financial position to be mis-stated. Fraud refers to intentional misrepresentation of financial information with the intention to deceive. Frauds can take place in the form of manipulation of accounts, misappropriation of cash and misappropriation of goods. It is of great importance for the auditor to detect any frauds, and prevent their recurrence. Errors refer to unintentional mistake in the financial information arising on account of ignorance of accounting principles i.e. principle errors, or error arising out of negligence of accounting staff i.e. clerical errors.

Basic Principles Governing an Audit

SA 200 "Basic Principals Governing an Audit", describes the basic principles which govern the auditor's professional responsibilities and which should be complied with wherever an audit is carried. They are described below:

(i) ***Integrity objectivity and independence*****:** An auditor should be honest, sincere, impartial and free from biasness. He should be a man of high integrity and objectivity.

(ii) ***Confidentiality*****:** The auditor should respect confidentiality of information acquired during the course of his work and should not disclose the information without the prior permission of the client, unless there is a legal duty to disclose.

(iii) ***Skill and competence*****:** The auditor must acquire adequate training and experience. He should be competent, skillful and keep himself abreast of the latest developments including pronouncements of ICAI on accounting and auditing matters.

(iv) ***Work performed by others***: If the auditor delegates some work to others and uses work performed by others including that of an expert, he continues to be responsible for forming and expressing his opinion on the financial information.)

(v) ***Documentation*****:** The auditor should document matters which are important in providing evidence to ensure that the audit was carried out in accordance with the basic principles.

(vi) ***Planning***: The auditor should plan his work to enable him to conduct the audit in an effective, efficient and timely manner. He should acquire knowledge of client's accounting system, the extent of reliance that could be placed on internal control and coordinate the work to be performed.

(vii) ***Audit evidence*****:** The auditor should obtain sufficient appropriate evidences through the performance of compliance and other substantive procedures to enable him to draw reasonable conclusions to form an opinion on the financial information.

(viii) ***Accounting system and internal control*****:** The management is responsible for maintaining an adequate accounting system incorporating various internal controls appropriate to the size and nature of business. The auditor should assure himself that the accounting system is adequate and all the information which should be recorded has been recorded. Internal control system contributes to such assurance.

(ix) Audit conclusions and reporting: On the basis of the audit evidence, he should review and assess the audit conclusions. He should ascertain:

(i) as whether accounting policies have been consistently applied;

(ii) whether financial information complies with regulations and statutory requirements; and

(iii) there is adequate disclosure of material matters relevant to the presentation of financial information subject to statutory requirements.

The auditor's report should contain a clear written opinion on the financial information. A clean audit report indicates the auditor's satisfaction in all respects and when a qualified, adverse or a disclaimer of opinion is to be given or reservation of opinion on any matter is to be made, the audit report should state the reasons thereof.

PRINCIPLE ASPECTS TO BE COVERED UNDER AUDITING

The following aspects are required to be covered by an auditor while doing audit of any organization. The principle aspects can also be called the functions of audit:

(i) Review of System and Procedures: Review of system and procedure is the primary function of auditing exercise. First an auditor needs to understand the system and procedures adopted by the entity to go further in the auditing exercise.

(ii) Review of *Internal Control System:* Review of internal control system is very important for the auditor as the effectives of internal control system will determine the extent of checking to be done by the auditor. The compliance test and substantive procedures performed by the auditor will determine the effectiveness of internal control system. If internal control system is effective, less checking is required and vice-versa. Moreover As per Company Audit Report Order, 2003, an auditor need to comment on the effectiveness of internal control system in the organization so the review of internal control is necessary for carrying out the auditing exercise.

(iii) *Routine Checking/Arithmetical Accuracy:* It is the duty of the auditor to check the arithmetical accuracy of the books of account by checking the proper posting and balances of the books of accounts.

(iv) *Accounting Principles*: Auditor has to ascertain whether proper distinction has been made between the item of capital and revenue nature and also whether the item of income and expenditure of a particular period has been adjusted in the books of accounts of that accounting period.

(v) *Books and Statements*: Auditor has to compare the balance sheet and profit and loss account or other statement with the books of accounts and supporting vouchers to ascertain that the final accounts have been made in accordance with the underlying records.

(vi) *Verification of Assets*: It is the duty of the auditor to physically inspect the assets and their recording in the books of accounts and verify the legal and official documents to ascertain the existence, ownership, possession, classification and valuation of assets of an entity.

(vii) *Verification of Liabilities*: It is the duty of the auditor to inspect the books of accounts and verify the legal and official documents to ascertain the existence, obligation, completeness, valuation and disclosure of liabilities of an entity.

(viii) *True and Fair View*: The auditor has to give its opinion whether the financial statements depicts the true and fair view of the state of affairs of the organization.

(ix) *Vouching:* Auditor has to inspect documentary evidence that supports and substantiate a transaction

(x) ***Statutory Compliance*****:** Auditor has to ensure that all the statutory requirements has been complied by the entity like provisions of Income Tax Act, 1961, the Companies Act, 2013 and other acts, if any.

(xi) ***Reporting*****:** The auditor has to report to the authority appointing him for conducting the audit whether the financial statements of accounts examined actually reveals true and fair view of the state of affairs and of the profit or loss earned during the period by the organization.

ADVANTAGES OF AUDIT

(i) ***Satisfaction of Owner*****:** It is because of audit that the owner will be satisfied about the business operations and working of its various departments.

(ii) ***Detection and Prevention of Errors and Frauds*****:** The errors whether committed innocently or deliberately are discovered by the process of audit and its presence prevents their occurrence in the future. No one will try to commit error or fraud as the accounts are subject to audit and hence they will have a fear of being detected. Just like errors, frauds are discovered by audit and its presence minimizes future possibility if not eliminated totally.

(iii) ***Verification of Books*****:** Another advantage of audit is the verification of the books of accounts, this helps in maintaining the records up to date at all times.

(iv) ***Independent Opinion*****:** Auditing is very useful in obtaining the independent opinion of the auditor about business condition. If the accounts are audited by an independent auditor, the report of the auditor will be true and fair in all respects and it will be of extreme importance for the management of the company.

(v) ***Moral Check*****:** The process of audit will establish a check on the minds of the staff working in the business and they will not be able to commit any irregularity, as they will have a fear and will also be aware that the accounts will be examined in the near future and that action would be taken against them if any irregularity is discovered. Thus the audit prevents the happening of any irregularity before it starts and the staff hence becomes more active and responsible.

(vi) ***Protection of the Rights and Interests of Shareholders*****:** Audit helps in protecting the interests of shareholders in case of joint stock company. Audit gives assurance to the shareholders that the accounts of the company are being maintained properly and their interest will not suffer under any circumstances.

(vii) ***Create confidence among stakeholders*** **:** Outsiders like creditors, debenture holders and banks etc. can rely on the books of accounts and financial statements of the business if the accounts and financial statements are audited by an independent authority (external auditor).

(viii) ***Ensures Compliance with Legal Requirements:*** Audited statements are necessary to fulfill certain legal requirements i.e. listing requirements of stock exchange etc.

(ix) ***Reinforce and Strengthen Internal Control****:* Since auditing exercise involves the review of internal control system, an auditor will identify the gaps in internal control system and can suggest the necessary changes in the internal control system.

(x) ***Loan Facility*****:** Money can easily be borrowed on the basis of audited financial statement. If accounts are audited, the true picture will be visible to banks and it will be easy for them to issue loans as early as possible.

LIMITATIONS OF AUDIT

Besides having various advantages, there are some inherent limitations of auditing. These are as follows :

(i) ***Higher Cost Burden*****:** Due to Higher Cost Burden, the auditor limits his scope of work to selective testing or sampling thus in depth checking of books of accounts is not possible.

(ii) ***Based on test checks.*** Generally an auditing exercise is based on test checking. Inferring a result on the basis of test check always need not to be true.

(iii) Insufficient Time: Generally an auditor needs to release the report up to a specified timeline. Sometime this timeline become a constraint for auditor in carrying out the auditing exercise effectively. This time constraint may affect the amount of evidence that can be obtained from concerned events and transactions after the balance sheet date.

(iv) ***Inconclusiveness of Evidences***: The evidences obtained by an auditor are persuasive rather than conclusive. For example, an architect's certificate of valuation for a newly constructed building of a client may not be conclusive evidence of the correct value of building.

(v) ***Based on Estimates***: Estimates are an inherent part of the accounting process, and no one, including auditors, can foresee the outcome of uncertainties. Estimate range from the allowance for doubtful accounts and an inventory obsolescence reserve to impairment tests of fixed assets and goodwill. An audit cannot add exactness and certainty to financial statements when these factors do not exist.

(vi) ***Based on the Information provided by the Management***: The audit opinion is based on the information provided by the management. Hence, outsiders cannot fully rely on the auditor's report.

REVIEW QUESTION

1. The evidence obtained by an auditor is __________rather than conclusive.
2. The term 'Audit' originated from the Latin word "audire" means _________.
3. Auditing can be defined as an _______________ examination of records (financial or non-financial).
4. If internal control system is effective, ___________ checking is required and vice-versa.

INVESTIGATION

The investigation is related to critical checking of particular records. Investigation is done when a lapse already exists to pin point the reason and person involved in it so that responsibility for such lapse could be fixed whereas, audit is a process to check whether the accounts are properly maintained as per required norms or not following all the procedures etc. and to point out any lapses in this line. The purpose of auditing and investigation is different.

DIFFERENCE BETWEEN AUDITING AND INVESTIGATION

PARTICULARS	INVESTIGATION	AUDITING
1. Meaning	Investigation implies systematic, critical and special examination of the records of a business for a specific purpose.	An audit is independent examination of financial information of any entity, when such an examination is conducted with a view to expressing an opinion thereon.
2. Nature	Voluntary	Mandatory for Companies. For others, it is voluntary.
3. Conducted by	Any person, who may not be a Chartered Accountant.	A Chartered Accountant within the meaning of the Chartered Accountants Act 1949.

4. Appointing Agency	Owners or Management or even third parties may appoint the investigator.	Owners/Shareholders of the enterprise.
5. Protection of Interests	Work is carried out from the viewpoint of the appointing agency.	Work is carried out on behalf of the owners, even if the power of appointment is delegated to Board of Directors.
6. Scope and Coverage	Specific – Seeks to answer only those questions laid down in the engagement letter.	General – when compared to investigation – seeks to form an opinion on the Financial Statements.
7. Period Covered	Not necessarily restricted to a financial year. It may be extended to a period more than one year. Even it may be less than one year.	Generally a period of one financial year.
8. Pre conceptions	Its essence lies in going into the matter with some pre-conceived notion suited to the objective.	Audit is not based on suspicion unless circumstances exist to arouse suspicion.
9. Evidence	Seeks conclusive and corroborative evidence.	Much of audit evidence is persuasive rather than conclusive.
10. Form of Reporting	There is no statutory form of investigation report.	The matters to be covered in the audit report are sometimes prescribed by law.

LESSON ROUND UP

- **An Audit** is an independent examination of financial or non-financial information of any entity; when such an examination is conducted with a view to express an opinion thereon.
- **Principle Aspects to be Covered under Audit:** internal control system, review of system and procedures, accounting principles, books and statements, verification of assets, verification of liabilities, true and fair view, statutory compliance and report.
- **Advantages of Audit:** satisfaction of owner, detection and prevention of errors and frauds, verification of books of accounts, independent opinion, moral check, protection of the rights and interests of shareholders, ensures compliances with legal requirements, reinforce and strengthen internal control system and reliance by outsiders
- **Limitations of an Audit:** Involves higher cost, audit involves reasonable length of time, based on test checks, evidence obtained by an auditor are persuasive rather than conclusive, auditors cannot determine the appropriateness of accounting estimates because of uncertainties involved in it and audit is based on information provided by management.
- **Difference between Investigation and Auditing:** Investigation implies systematic, critical and special examination of the records of a business for a specific purpose whereas, audit is an independent examination of financial information of any entity, where examination is conducted with a view to express an opinion thereon.

GLOSSARY

Connivance	Agreement on a secret plot, collusion
Persuasive	Intended or having the power to induce action or belief, convincing.

Conclusive	Forming an end or termination; especially putting an end to doubt or question; "conclusive proof"; "the evidence is conclusive"
GAAP	Generally Accepted Accounting Principles, a collection of rules and procedures and conventions that define accepted accounting practice; includes broad guidelines as well as detailed procedures.
Statutory	Relating to or created by statutes; "statutory matters"; "statutory law". Statute means a law enacted by a government.
Corroborative	To strengthen or support with additional evidence.

SELF-TEST QUESTIONS

1. What is the meaning of Auditing?
2. What are the principal aspects to be covered in auditing?
3. Why the need of auditing arises and what are advantages of auditing?
4. "The evidences obtained by the auditor are persuasive rather than conclusive". Explain.
5. What do you mean by investigation and how is it different from auditing?

SUGGESTED READINGS

1. Fundamentals of Auditing – By Kamal Gupta
2. Auditing: Principles and Practice - By Ravinder Kumar, Virender Sharma
3. An Insight into Auditing- By Dr. B. K. Basu

MULTIPLE CHOICE QUESTION

1. Audit Note Book contains: (A) Various dates of reference (B) Details of work done (C) Notes regarding item requiring clarification explanations, etc. (D) All of the above
2. Which of the following has a broader scope?

   (A) Internal control (B) Internal audit (C) Internal checking (D) None of the above

   An Internal Auditor is:

   (A) Temporary Employee (B) Permanent Employee (C) Daily wager (D) None of the above
3. The main object of vouching is :

   (A) To prepare trial balance (B) conduct routine checking (C) verify authenticity and authority of transactions (D) Checking of vouchers
4. Valuation is the base of:

   (A) Verification (B) Marketing (C) Internal checking (D) Vouching
5. The first auditor or auditors are appointed by:

   (A) Central Government

   (B) Company Law Board

   (C) Board of Directors

   (D) Shareholders

6. A number of checks and controls exercised in a business to ensure its efficient working is known as ________.

   A) Internal check.

   B) Internal control.

   C) Internal audit.

   D) Interim check.

7. Voucher relates to _________.

   A) cash receipt.

   B) cash payment.

   C) credit transactions.

   D) all the above.

8. Internal check is meant for ___________.

   A) prevention of frauds.

   B) detection of frauds.

   C) helping audit is depth.

   D) detection of errors.

9. Internal auditor is appointed by ________.

   A) the management.

   B) the shareholders

   C) he government.

   D) he statutory body.

10. Auditing begins where ______ ends.

    A) Selling.

    B) inventory valuation.

    C) Accounting.

    D) Purchases.

11. A good audit report must at least meet one of the following qualifications __________.

    A) it should offer constructive and timely suggestions to the management.

    B) it should not point out mistakes.

    C) it should not be based on factual information.

    D) it should not be based on balance sheet.

12. The work of one clerk is automatically check by another clerk is called _________.

    A) Internal control.

    B) Internal check.

C) Internal audit.

D) None of the above.

13. The owners of the company are called __________.

    A) Debenture holders.

    B) Debtors.

    C) Shareholders.

    D) None of the above.

14. Verification is __________.

    A) the art of recording the business transaction.

    B) an examination of the books of accounts.

    C) the act of establishing the accuracy of entries in the books of accounts.

    D) none of the above.

15. The main objects of investigation is _________.

    A) to discover errors and frauds.

    B) to prevent errors and frauds.

    C) to verify statements.

    D) all the above.

16. Internal controls and internal check are ____________.

    A) one and the same.

    B) different.

    C) internal control includes internal check.

    D) None of the above.

17. An auditor is like a ______.

    A) Watchman.

    B) foolish dog.

    C) mad dog.

    D) watch dog.

18. Special audit is necessary for _________.

    A) inefficient concern.

    B) processing concern.

    C) trading concern.

    D) manufacturing concern.

19. The company's auditor is expected to give _____________.

    A) his expert opinion about the accounts.

B) a factual position about the accounts.

C) a critical review of the accounts.

D) financial assistance.

20. Auditors of a joint stock company are appointed by ______________.

A) directors of the company.

B) annual general meeting.

C) election at the annual general meeting.

D) Debenture Holders

21. A company auditor can be removed by _________________.

A) board of directors.

B) managing director.

C) any director.

D) general meeting.

22. A vacancy caused by resignation of an auditor is filled by _________.

A) board of directors.

B) managing director.

C) general meeting.

D) central government.

23. Audit in depth means __________.

A) audit of each and every item.

B) intensive audit of each and every item.

C) intensive audit of a few items.

D) audit of a few selected items.

24. Concurrent audit is a part of ______________.

A) internal check system.

B) continuous audit.

C) internal audit system.

D) final audit.

25. Audit in depth is synonymous for ____________.

A) complete audit.

B) completed audit.

C) final audit.

D) detailed audit.

26. Balance sheet audit included verification of ________.

A) assets.

B) liabilities.

C) income and expenditure accounts where appropriate.

D) all of the above.

27. Which of the following statements is not true about continuous audit?

A) It is conducted at regular interval.

B) It may be carried out on daily basis.

C) It is needed when the organisation has a good internal control system.

D) It is expensive.

28. Which of the following is not a fact of EPA?

A) Economic audit.

B) Efficiency audit.

C) Expenditure audit.

D) Effectiveness audit.

29. Balance sheet does not include ___________.

A) verification of assets and liabilities.

B) vouching of income and expense accounts related to assets and liabilities.

C) examination of adjusting and closing entries.

D) routine checks.

30. When issuing unqualified opinion the auditor who evaluated the audit findings should be satisfied that the ______________.

A) amount of known misstatement is documented in working papers.

B) estimates of the total likely misstatement is less than materiality level.

C) estimated of the total likely misstatement is more than materiality level.

D) estimates of the total likely misstatement cannot be made.

Lesson 14
Types of Auditing

LESSON OUTLINE

- Financial/Statutory Audit
- Internal Audit
  - Advantages of Internal Auditing
  - Limitations of Internal Auditing
- Secretarial Audit
- Cost Audit
- Tax Audit
- Bank Audit
- Co-operative Society Audit
- Insurance Audit
- Partnership Audit
- Sole Proprietorship Audit, etc.
- Government Audit
- Management Audit
- Propriety Audit
- Efficiency Audit
- Lesson Round Up
- Glossary
- Self-Test Questions

LEARNING OBJECTIVES

In the last lesson the meaning, benefits and limitations of audit is discussed. Here, we will see the different types of audit. The requirement of getting the books of accounts audited became mandatory due to legislation. The nature and scope of audit vary due to various factors such as the size of organisation, the strength of internal control system, legal requirement etc. In internal Audit, the books of accounts may be audited by internal department of the organisation while in other types of audit; such as statutory audit, secretarial audit, cost audit, tax audit, bank audit, insurance audit, co-operative society audit, trust audit, sole proprietorship audit etc., the audit is done by independent person. In internal audit, the area of work is determined by the management whereas, in other types of audit, the area of work is determined by the legislation.

In this lesson, you will learn the different types of audit such as internal audit, financial audit, tax audit, secretarial audit, cost audit, bank audit, trust audit, insurance audit, etc.

Companies will not receive a rubber stamp certification; this is an in-depth program that requires an exhaustive and thorough audit of one's processes.

John Kania

INTRODUCTION

Up to early decades of Twentieth Century, Auditing exercise was considered limited to auditing of books of accounts i.e. finance audit, internal audit. After the advancement of trade/technology various types of audit have come into existence i.e. operation audit, management audit, efficiency audit, propriety audit, information system audit etc. Types of audit depend upon various factors such as the nature of work undertaken, approach used for conducting audit, organization structure, legal requirements etc. The different types of audit have different objectives. Here, now we will study the different types of audit along with their characteristics, merits and limitation.

TYPES OF AUDIT

AUDIT UNDER THE COMPANIES ACT, 2013

Companies Act, 2013 is focused on transparency and disclosure and gives audit its due recognition. In the new Act, attempt has been made to cover each aspect of corporate functioning under audit by prescribing various types of audits like internal audit and secretarial audit.

Statutory Audit

Statutory Audit is often called Financial Audit. Independent financial audit is generally conducted to ascertain whether the Balance Sheet and Profit & Loss Account presents a true and fair view of the financial position of the organization. The need for financial audit arises as the control of the company is vested in the hands of the management of the company and the financial statements are also prepared by the management. The owners (shareholders), therefore, need assurance that the financial statements prepared by the management are reliable. The opinion of the auditor – an independent expert – assures the owners about the reliability of the financial statements. Similarly, investors wish to invest their moneys in the shares of companies on the basis of their profitability and financial position. They will also place greater reliance on financial statements if the statements are audited by the external auditor. Other users of financial statements, e.g., trade creditors, banks, financial institutions, tax authorities, other government authorities, labour unions, etc., also place greater reliance on audited accounts.

Sections 139 to 147 covered under chapter X of the Companies Act, 2013 contain provisions regarding statutory audit and auditors. Section 139 contains that at the first annual general meeting every company shall appoint an individual or firm as it auditor who will hold office from the conclusion of that meeting till the conclusion of the sixth annual general meeting. Section 141 contains that a person shall be eligible for appointment as an auditor of a company only if, he is a chartered accountant and in case of a firm whereof majority of partners practising in India are qualified for appointment as aforesaid may be appointed by its firm name to be auditor of a company. Section 143 which contains provisions regarding powers and duties of auditors contains that, the statutory auditor shall make a report to the members of the company on the accounts and financial statements examined by him. The main provisions regarding statutory audit are:

- Auditor will have access to books of accounts and vouchers etc. at all times and he can seek information from officers of the company as may be deemed necessary.
- In his report he must state, besides other things, whether the financial statements represent a true and fair view of the state of company's affairs as at the end of the financial year.
- In case of any qualifications in the audit report, the reason for same must be stated in the report.
- Auditor is required to comply with Auditing Standards.
- In case auditor suspects any fraud, he must immediately report the same to the Central Government.

INTERNAL AUDIT

Internal audit is an evaluation and analysis of the business operation conducted by the internal audit staff. It is the part of overall system of internal control established in an organization.

Internal audit is the independent appraisal activity within an organization for the review of accounting, financial and other business practices as protective and constructive arms of management. It is a type of control which functions by measuring and evaluating the effectiveness of other type of controls.

According to Professor Walter B. Meigs, Internal Auditing means "Internal auditing consist of a continuous, critical review of financial and operating activities by a staff of auditors functioning as full time salaried employees."

In a big organization, an internal audit is carried out by the team of professionals in the organization. The internal audit is not mandatory but organization gets the internal audit done with a view to evaluate the effectiveness of internal control, the soundness of financial system, effectiveness of business processes etc. This provides management an assurance about the control process in the organization and it aids in early detection of inefficiencies/fraud etc. It helps the statutory auditor to conduct the statutory audit effectively.

Section 138 of the Companies Act, 2013 contains provisions regarding internal audit. As per Companies Act, 2013, certain class or classes of company as may be prescribed shall appoint an internal auditor, who will conduct an audit of the functions and activities of the company and make a report thereon to the Board of Directors. Any Chartered Accountant (except statutory auditor of the company) or Cost Account or other professional as may be decided by the Board, can be appointed to conduct the internal audit.

According to Rule 13 of The Companies (Accounts) Rules, 2014 following class or classes of companies shall be required to appoint an internal auditor or firm of internal auditors, namely:

(a) Every listed company;

(b) Every unlisted public company having-

  (i) Paid up share capital of **Rs.50** crore or more during the preceding financial year; or

  (ii) Turnover of **Rs.200** crore or more during the preceding financial year; or

  (iii) Outstanding loans or borrowings from banks or public financial institutions exceeding **Rs.100** crore or more at any point of time during the preceding financial year; or

  (iv) Outstanding deposits of **Rs.25** crore or more at any point of time during the preceding financial year; and

(c) Every private company having-

  (i) Turnover of **Rs.200** crore or more during the preceding financial year; or

  (ii) Outstanding loans or borrowings from banks or public financial institutions exceeding **Rs.100** crore or more at any point of time during the preceding financial year:

The rules also provide that every existing company covered under above criteria in Financial Year 2013-14 shall comply with requirements of Section 138 and Rule 13 of Companies (Accounts) Rules, 2014 before 30th September, 2014 (within 6 months of the commencement of Section 138, i.e. 01st April, 2014).

OBJECTIVES OF INTERNAL AUDIT

(i) ***Proper Control***: The purpose of internal Audit is to keep proper control over business activities. The internal control can determine the degree of control over work.

(ii) ***Accounting System***: The purpose of internal audit is to evaluate the accounting system. It is concerned with checking proper authority for transactions like purchase, retirement and disposal of fixed assets. The voucher can be compared with entries in order to determine that figures and facts.

(ii) ***Help Management*****:** The purpose of internal audit is to help the management by pointing out the weaknesses. Once the weaknesses are identified, management functions can be performed properly.

(iv) ***Working Review*****:** The purpose of internal audit is to review the working of business. The working of current year can be reviewed in detail. There is a need to locate the weak points. The corrective measures can be taken for proper working.

(v) ***Asset Protection*****:** The purpose of internal audit is to protect the assets by examinig the valuation, verification and possession of the assets. The purchase and sale of assets must be made under proper authority.

(vi) ***Internal Check*****:** The purpose of internal audit is to evaluate the internal check system. There is division of duties among the employees. When all staff member are working properly, it means there is effective internal check system. The work of an auditor is reduced. He can apply test checks to complete audit duty.

(vii) ***Fair Statements*****:** The purpose of internal audit is to detect and remove the error in the accounting records. The work of internal audit can help the management by ensuring that accounting record is in proper order.

(viii) ***Check Error*****:** The purpose of internal audit is to detect the errors in the accounting records. Internal audit goes side by side, therefore, it reduces the chances of errors. The accounting staff can rectify mistake to prepare accounts at the end of year in order to help the external auditor.

(ix) ***Detect Fraud*****:** The purpose of internal audit is to detect frauds in the books of accounting. When the work of accounting staff is over, the internal audit is started. Accounting staff remains alert because there is no time gap between recording and checking. Thus detection of fraud is possible with it.

(x) ***Determine Liability*****:** The purpose of internal audit is to determine the accountability of employees. The duties are divided among the staff. It is easy to note the negligence on the part of employees. The internal audit can pin point the person responsible for carelessness.

(xi) ***Help in Independent Audit*****:** The purpose of internal audit is to extend the help for independent audit. The external auditor can rely on internal auditor and there is no need of cent percent checking as internal audit helps in detecting the errors at ealry stage. In this way there is saving of time and money due to internal audit.

(xii) ***Performance Appraisal*****:** The purpose of internal audit is to check the performance appraisal. The management must achieve the targets fixed in budgets and plans. The internal audit is a tool to evaluate the working of each management function.

(xiii) ***Provide Suggestions*****:** The purpose of internal audit is to provide suggestions for improvement of business activities. The internal audit staff can suggest the ways and means to remove the difficulties. Anyhow the internal auditor cannot compel the management to implement suggestions.

(xiv) ***New Ideas*****:** The purpose of internal audit is to seek new ideas relating to procedures, marketing, financing and other business matters. The internal audit staff can provide new ideas about various business matters. The viable ideas can be put in to practice for the benefit of business.

(xv) ***Use of Resources*****:** The purpose of internal audit is to determine the proper use of resources. The misuse of resources can increase the cost of doing the business. Early detection of errors helps the management in maximising the use of resources.

(xvi) ***Accounting Policies*****:** The purpose of internal audit is to examine the accounting policies. The understanding of accounting system and procedure is helpful to device the effective audit plans & procedures.

(xvii) ***Special Investigation*****:** The purpose of internal audit may be to conduct special investigation about any business matter. Internal audit can be used as a tool to note the effectiveness of management function.

BENEFITS OF INTERNAL AUDIT

(i) *Proper Accounting System*: The benefit of internal audit is that proper accounting system is introduced. Accounting system is a chain of activities in an entity by which transactions are processed for maintaining financial record. There is a need of orderly devices to achieve desirable results.

(ii) *Better Management*: The benefit of internal audit is that there is better management of business concern. The auditor can point out the weak areas of management. The goals of business can be achieved if there is proper internal control, internal check and internal audit. It should be noted that management could rely on internal audit for best results.

(iii) *Progressive Review*: The internal audit is beneficial to review progress of a business concern. The figures of previous years are compared with this year. Moreover the performance result of similar companies can be compared to determine the progress made by the entity. The management can review progress through internal audit.

(iv) *Effective Control*: The internal audit is helpful to have effective control over business activities. Control is a management function, which is related to supervision and direction of ongoing activities. The manager concerned can remove the difficulties for smooth working of business.

(v) *Assets Protection*: The assets protection is possible through internal audit. The management can use the assets for the benefit of business only. The assets cannot be used for private purposes. The embezzlement of cash, misappropriation of stock and misuse of other assets is not possible as the internal auditor keeps close watch over assets.

(vi) *Division of Work*: The internal audit is helpful to apply division of labour. The division of labour is necessary to watch the activities of all employees including management. The auditor can suggest the way and means to improve the performance of business.

(vii) *No Error and fraud*: The internal audit is used to protect accounting records from errors and fraud. The accounting and auditing go side by side when accounting work is over the audit will start. In such situation errors and fraud committed by the accounting staff will easily be detected and rectified.

(viii) *Fixing Responsibility*: Internal audit is used to fix the responsibility of people having poor performance. The management establishes the performance standards. The internal auditor can evaluate the result of all persons. The people can be held responsible for below standard work and action can be taken against them.

(ix) *Helps External Auditing*: The work performed by internal auditor can help external auditor in carrying out the audit. The audit procedure of internal and external audit is almost the same. The auditor can go through the internal audit report at the time of starting audit work. Anyhow external auditor is responsible for external audit.

(x) *Performance Improves*: Internal auditor is helpful to improve the performance of the organization. The achievements of previous year are the basis of preparing budget for the next years. The projected income statement and balance sheet are drawn up. An attempt is made to get the positive result. Thus internal audit improves performance of business and employees.

(xi) *Proper Use of Resources*: Internal audit is used to check the proper use of resources. The misuse of resources can increase the cost of organization. The optimum use of resources can be determined to control the cost of output. In this way internal audit is a tool to use the resources in the best interest of the business.

(xii) *Investigation*: Internal audit is of help to investigate in to the business matters. In case of doubt internal auditor can be asked to examine the facts and figures to confirm or clear any doubt. The internal auditor can investigate the matter in any manner. Such investigation can be made at the request of management or owners.

LIMITATIONS OF INTERNAL AUDIT

(i) *Staff Shortage*: Internal audit requires reasonable audit staff to examine the record. Lack of adequate staff creates hurdle to get benefit of internal audit.

(ii) *Time Lag*: The limitation of internal audit is that it starts when accounting ends. Thus, there is a time lag between recording and checking of entries.

(iii) *Error*: Due to lack of expertise in internal audit staff, certain erros may remain undetected as it depends upon the expertise of internal audit staff to detect such errors. If audit staff is competent there is less chance of error being undetected. In case of poor audit staff there is no guarantee that audited accounts are free from errors.

(iv) *Responsibility*: The limitation of internal audit is that management may not feel their responsibility in completing the audit formalities. The audit staff may give suggestion for proper working of business. The top-level management may not pay attention to suggestions. In this way, the audit work cannot help the business.

(v) *Duties*: If the duties of audit staff are not properly divided, then the purpose of internal audit may be defeated.

Secretarial Audit

Secretarial Audit is a process to check compliance with the provisions of various laws and rules/regulations/ procedures, maintenance of books, records etc., by an independent professional to ensure that the company has complied with the legal and procedural requirements and also followed the due processes. It is essentially a mechanism to monitor compliance with the requirements of stated laws. It helps to detect non-compliance and to take corrective measures.

A Company Secretary in Practice has been assigned the role of Secretarial Auditor under section 2(2)(c)(v) of the Company Secretaries Act, 1980.

Ever-increasing complexities of laws and responsibilities of directors (especially non-executive directors) make it imperative that a Practicing Company Secretary (PCS) reports whether or not there exists proper compliance mechanism and systems in the corporate structure. PCS has also to verify whether diverse requirements under applicable laws have been duly complied with or not and if there is a need for any corrective measures or improvement in the system.

Secretarial Audit on a continuous basis would help the company in initiating corrective measures and strengthening its compliance mechanism and processes. It is recommended that the Secretarial Audit be carried out periodically (quarterly / half yearly) and adverse findings if any, be communicated to the Board for corrective action.

The multiplicity of laws, rules, regulations, etc. has necessitated introduction of a compliance management system to ensure compliances of laws applicable to a company. This has a two-fold objective:

(i) to protect the interests of all the stakeholders;

(ii) to avoid any legal action against the company and its management.

As of now Secretarial Audit is not mandatory on the Companies. However, it is optionally undertaken by the companies for maintaining good Corporate Governance practices.

Secretarial Audit is a new requirement which has been prescribed under Section 204 of the Companies Act, 2013. The provisions regarding secretarial audit are as follows :

Every listed company and other class of companies as may be prescribed is required to annex to the Board's Report, a Secretarial Audit Report.

As per rule 9 of the Companies (Appointment and Remuneration of Managerial Personnel) Rules, 2014, other class of companies for the purpose of section 204 of the Companies Act, 2013 include:

(a) Every public company having a paid-up share capital of fifty crore rupees or more; or

(b) Every public company having a turnover of two hundred fifty crore rupees or more; or

Secretarial Audit has to be conducted by a Practising Company Secretary in respect of the secretarial and other records of the company. Company is required to give all necessary information and assistance to the Practising Company Secretary to conduct the audit.

The Board is required to provide explanation in the Board's Report to every qualification, observation or other adverse remark made by the company secretary in his report. The secretarial Auditor will submit his report in Form MR-3.

If a company or any officer of the company or the company secretary in practice, contravenes the provisions of this section, the company, every officer of the company or the company secretary in practice, who is in default, shall be publishable with fine which shall not be less than one lakh rupees and can be extend to five lakh rupees

As per Section 143(14), all provisions regarding rights, duties and obligations of statutory auditors shall also apply to Company Secretary in Practice conducting secretarial audit.

Cost Audit

The Institute of Cost and Works Accountants of India defines cost audit as "a system of audit introduced by the Government of India for the review, examination, and appraisal of the cost accounting records and attendant information, required to be maintained by specified industries." According to CIMA, London, cost audit is "the verification of the correctness of cost accounts and of adherence to the Cost Accounting Plan". Thus, cost audit comprises of:

(i) The verification of the cost accounting records such as the accuracy of the cost accounts, cost reports, cost statements, cost data, costing techniques and

(ii) Examining these records to ensure that they adhere to the cost accounting, plans, procedures and objectives.

Ministry of Corporate Affairs has issued mandatory cost audit orders on Companies engaged in Bulk drugs, fertilization, sugar, telecommunications, industrial alcohol, and electricity & petroleum and if in immediate previous year aggregate value of Net Worth exceeds the specified limits.

The cost auditor has to judge :

(i) Whether the planned expenditure is designed to give optimum results.

(ii) Whether the size and channels of expenditure were designed to produce the best results, and

(iii) Whether the return from expenditure on capital as well as current operations could be improved by some other alternative plan of action.

Cost Audit is useful for the purpose of cost control; cost reduction and proper utilization of scarce resources. Moreover, cost audit also ensures that proper records are kept as to purchases and utilisation of material and expenses incurred on wages, overheads, etc. It also ensures that the unit has been run economically and efficiently.

Section 148 of the Act contains provisions regarding cost audit and contains that a cost audit wherever conducted is in addition to statutory audit conducted under section 143.

The main provisions regarding cost audit as contained in the Act are :

- Certain class of companies engaged in the production of such goods or providing such services as may be prescribed and which have a net worth or turnover of such amount as may be prescribed may be directed to get their cost audit records audited.

- Cost audit has to be conducted by a Cost Accountant in practice, who is required to comply with cost auditing standards
- It shall be the duty of the company to give all assistance and facilities to the Cost Auditor.
- As per Section 143(14), the qualifications, disqualifications, rights, duties and obligations applicable to statutory auditors will also apply to a cost auditor.
- Cost auditor has to submit his report to the Board of Directors, who in turn shall file it with the Central Government within 30 days of the receipt of the report.

OTHER FORMS OF AUDIT

Tax Audit

In India, the Income Tax Act, 1961, Section 44AB provides for the compulsory audit of the accounts of certain income tax assessee whose turnover or receipts exceed the specified limits. The objective of such audit is to assist the tax authorities in making the correct income tax assessment of the assessee concerned. The tax auditor has to specifically report on certain transactions which have an effect on the income tax liability of the assessee concerned and are, thus important to the tax authorities. The Income Tax Act, 1961 also contains various other provisions whereby audit report is required to be submitted to get certain deductions, exemptions etc.

As per the income tax Act, every person carrying on business whose turnover or gross receipts exceeds Rs. 1,00,00,000 (Rs. 25,00,000 if carrying on profession) in the previous year shall get his accounts audited.

Bank Audit

The huge amount of public monies handled by the banks, make it imperative that the activities of the industry are closely monitored and regulated without strangulating the spirit of entrepreneurship. Audit forms an integral and important part of such monitoring and regulation. The Auditors have to certify that statement of accounts of the bank as at the closure of the financial year reveal true and fair view of the Bank' financial position, adequate provision for Non-Performing Asset(NPA)/bad debts has been made in the books. All expenses/income have been duly accounted for and profit is correctly worked out. The Banking Regulation Act, 1949 contains the provisions relating to the maintenance of accounts and their audit.

Co-Operative Society Audit

There are certain features of co-operative which are similar to those of companies. As in the case of companies, in co operative societies also, there is a separation of ownership from management while the capital of a co-operative society is contributed by all the members. The management of its affairs is in the hands of only some of the members' elected for this purpose. This necessitates an independent financial audit of accounts of co-operative societies. Considering this, audit of co-operative societies is required by law in India. However, an important feature of co operative societies is that, unlike most companies, the affairs of co-operative societies are often managed by persons who do not possess adequate managerial, technical or accounting skills. The independent financial auditors of co-operative societies are, therefore, required to report on some aspects also.

Insurance Audit

The insurance audit is an examination of the operations, records and books of account of the insurance company. Auditor performs an audit to ensure that the customer has paid the appropriate premium for risk cover provided to him. The auditor should be conversant with the provisions of the Insurance Regulatory and Development, Act 1999, which contains the provision of the maintenance of accounts and audit of the insurance companies.

Partnership Firm Audit

Partnership Act, 1932 does not provide compulsory audit of Partnership Firms in India. But on satisfying the prescribed criterion, partnership firms are required to get their accounts audited under the provisions of Income Tax Act, 1961. Many partnership firms voluntarily gets their accounts audited as audited accounts helps in proper valuation of goodwill, distribution of share of the deceased Partner to their legal heirs etc. The audited accounts are also useful to get the loan sanctioned from the banks. The audit should be carried out as per the terms of partnership deed and Partnership Act.

Sole Proprietorship Audit

Like partnership firms, sole proprietary concerns are also not legally required to get their financial statements audited by independent financial auditors but on satisfying the prescribed criterion, partnership firms are required to get their accounts audited under the provisions of Income Tax Act, 1961. However, many such concerns get their financial statements audited voluntarily as it helps the sole proprietor to manage its books of accounts properly and the audited books of accounts are relied well by the statutory authority like banks, insurance companies etc.

Government Audit

Government audit aims at ensuring that the financial transactions of the government are executed properly under sanctions and authorities and are correctly recorded in the books of accounts. It is the duty of Comptroller and Auditor General of India (C&AG) to audit the receipts and expenditure of the Union Government and State Government.

Further, government audit also includes the audit of government companies conducted by C&AG in accordance with the provisions of Companies Act, 2013 and other relevant legislations.

Management Audit

Management audit is an emerging concept of auditing. It has been originated from America. Management audit is an act of evaluation of all the activities of all the departments with a view to provide appropriate suggestions to the management to help their work. In other words, management auditing is a future oriented task which evaluates timely at all the levels of management like production management, sales management etc. The main objective of management audit is to improve the profit earning capacity, work of management, objectives of program, social objectives and human resource development so that organizational goal can be easily attained. It refers to the existence of control system, compliance of rules and regulations, process of managerial decisions etc. Generally management audit/operational audit are not mandatory but it is recommendatory.

Propriety Audit

Kohler has defined propriety as that which meets the test of public interest, commonly accepted customs and standard of conduct and particularly as applied to professional performance, requirements of Govt. regulations and professional codes. Propriety Audit would mean whether the transactions have been done in conformity with established rules, principles and some established standard.

The Propriety Audit would mean the verification of following main aspects to find out whether:

(i) Proper recording has been done in appropriate books of accounts.

(ii) The assets have not been misused and have been properly safeguarded.

(iii) The business funds have been utilized properly.

(iv) The concern is yielding the expected results.

The system of Propriety Audit is applied in respect to Government companies and Government Department because public money and public interest are therein involved. It is an essential function of audit to bring to light not only cases of clear irregularity but also every matter which in its judgement appears to involve improper expenditure or waste of public money or stores, even though the accounts themselves may be insufficient to see that sundry rules or orders of competent authority have been observed. It is of equal importance to ensure that the broad principles of orthodox finance are borne in mind not only by disbursing officers but also by sanctioning authorities.

Efficiency Audit

In essence, efficiency indicates how well an organization uses its resources to produce goods and services. It focuses on resources (inputs), goods and services (outputs), and the rate (productivity) at which inputs is used to produce or deliver the outputs. To understand the meaning of "efficiency", it is necessary to understand the following terms: inputs, outputs (including quantity and quality), productivity, and level of service.

Inputs are resources (e.g., human, financial, equipment, material, facilities, information, energy and land) used to produce outputs

Outputs are goods and services produced to meet client needs. Outputs are defined in terms of quantity and quality and are delivered within parameters relating to level of service

Quantity refers to the amount, volume, or number of outputs produced.

Quality refers to various attributes and characteristics of outputs such as reliability, accuracy, timeliness, service courtesy, safety, and comfort.

Productivity is the ratio of the amount of acceptable goods and services produced (outputs) to the amount of resources (inputs) used to produce them. Productivity is expressed in the form of a ratio such as cost or time per unit of output.

Efficiency is a relative concept. It is measured by comparing achieved productivity with a desired norm, target, or standard. Output quantity and quality achieved and the level of service provided are also compared to targets or standards to determine to what extent they may have caused changes in efficiency. Efficiency is improved when more outputs of a given quality are produced with the same or fewer resource inputs, or when the same amount of output is produced with fewer resources.

Efficiency audit refers to comparing the actual results with the desired/projected results. It is directed towards the measurement of whether plans have been effectively executed. It is concerned with the utilisation of the resources in economic and most remunerative manner to achieve the objectives of the concern. It comprises of studying the plans of organisation, comparing actual performance with plans and investigating the reasons for variances to take remedial action

LESSON ROUND UP

In this lesson, we have discussed various types of audit such as internal audit, financial audit, secretarial audit, cost audit, tax audit etc.

– **Internal Audit-** Internal audit is an evaluation and analysis of the business operation conducted by the internal audit staff. It is the part of overall system of internal control established in an organization.

– **Objective of Internal Audit-** proper control, accounting system, help management, working review, asset protection, internal check, fair statements, check error, detect fraud, determine accountability, help in independent audit, performance appraisal, provide suggestions, new ideas, use of resources, accounting policies, special investigation.

– **Advantages of Internal Audit-** proper accounting system, better management, progressive review, effective control, assets protection, division of work, no error and fraud, fixing responsibility, helps external auditing, performance improves, investigation, proper use of resources.

- **Limitations of Internal Audit-** staff shortage, time lag, error, responsibility, duties.
- **Financial Audit-** Independent financial audit is generally conducted to ascertain whether the balance sheet and profit & loss account present a true and fair view of the financial position and working result of the organization under audit.
- **Secretarial Audit-** Secretarial Audit is a process to check compliance with the provisions of various laws and rules/regulations/procedures, maintenance of books, records etc., by an independent professional to ensure that the company has complied with the legal and procedural requirements and also followed the due process. It is essentially a mechanism to monitor compliance with the requirements of stated laws. A Company Secretary in Practice has been assigned the role of Secretarial Auditor under section 2(2)(c)(v) of the Company Secretaries Act, 1980.
- **Cost Audit-** A system of audit introduced by the Government of India to the review, examination, and appraisal of the cost accounting records and attendant information, required to be maintained by specified industries.
- **Tax Audit:** The objective of such audit is to assist the tax authorities in making the correct income tax assessment of the assesses concerned.
- **Bank Audit:** The Banking Regulation Act, 1949 contains the provisions relating to the maintenance of accounts and their audit.
- **Co-Operative Society Audit:** The management of the affairs of the co-operative societies is in the hands of only some of the elected members. This necessitates an independent financial audit of accounts of co-operative societies.
- **Insurance Audit:** Insurance Regulatory and Development Act, 1999, contains the provision of the maintenance of accounts and audit of the insurance companies.
- **Partnership Firm Audit:** At present, partnership firms in India are not legally required to get their financial statements audited. Still, many firms get their financial statements audited
- **Sole Proprietorship Audit:** Like partnership firms, sole proprietary concerns are also not legally required to get their financial statements audited by independent financial auditors.
- **Government Audit:** It is the duty of Comptroller and Auditor General of India (C&AG) to audit the receipts and expenditure of the Union Government and State Government.
- **Management Audit:** It is a structured review of the systems and procedures of an organization in order to evaluate whether they are being conducted efficiently and effectively.
- **Propriety Audit:** Under this type of audit, the expenditure is analyzed with a view to ascertain the cases of improper, avoidable or in fructuous expenditure even though the expenditure has been incurred in conformity with the existing rules and regulations.
- **Efficiency Audit:** Efficiency audit or performance audit is a form of audit which is being carried out for ascertaining the efficiency/performance of a system/process/input.

GLOSSARY

Constructive Arm	Improve or promote development
Independence	Free from the influence, guidance, or control of another or others; self-reliant :

	an independent mind.
Practicing Company Secretary	The member of ICSI who hold certificate of practice.
Check	An action or influence that stops motion or expression; a restraint

SELF-TEST QUESTIONS

1. What are the types of audit? Explain in brief.
2. What is meant by Internal Audit and what are its benefits and limitations?
3. What is meant by Financial Audit?
4. What is the difference between Internal Audit and Financial Audit?
5. What is Secretarial audit and who can be appointed as secretarial auditor?
6. What are the objectives of secretarial audit?
7. What do you mean by tax audit and on whom it is applicable?
8. What is cost audit and explain its usefulness in brief?

SUGGESTED READINGS

1. Fundamentals of Auditing – By Kamal Gupta
2. Auditing: principles and practice - By Ravinder Kumar, Virender Sharma
3. An Insight into Auditing- By Dr. B. K. Basu

Lesson 15
Tools of Auditing

LESSON OUTLINE

- Audit Plan
- Audit Programme
  - Advantages of Audit Programme
  - Disadvantages of Audit Programme
  - Remedies of Disadvantages of Audit Programme
- Difference between Audit Plan and Audit Programme
- Review Questions
- Audit Evidence
  - Essentials of Audit Evidence
  - Factors considered while obtaining audit evidence
  - Techniques of obtaining audit evidence
- Working papers
- Types of working paper
- Review Questions
- Lesson Round-Up
- Glossary
- Self-Test Questions

LEARNING OBJECTIVES

In the last lesson, the various types of audit have been discussed. In this lesson, the steps taken by the auditor while carrying out an audit will be dealt. Auditor uses various types of tools such as audit plan, audit programme etc. for carrying out an audit. An audit plan lays down the strategies to be followed for carrying out an audit. It is the first step of audit. After preparing an audit plan, the auditor will make an audit programme which contains the instructions to be followed by the audit staff. This helps the auditor in proper supervision of the audit. While doing an audit the auditor has to collect evidences in support of his opinion. The audit evidence provides grounds for believing that a particular thing is true or not by providing support for a fact or a point in question. Audit working papers are used to support the audit work done in order to provide assurance that the audit was performed in accordance with the relevant auditing standards.

In this lesson, you will learn how the Audit Plan is important in an audit, the ways of laying down an audit Programme, importance of evidence and working papers.

It's an independent audit of the work and all the contracting issues to determine whether existing procedures were complied with and whether there should be any changes in those procedures.

John Mullen

AUDIT PLAN

An audit plan lays out the strategies to be followed to conduct an audit. It includes the nature, timing and extent of audit procedures to be performed by the team members. The auditor shall develop an audit plan while considering the following:

(a) The nature, timing and extent of planned risk assessment procedures.

(b) The nature, timing and extent of audit procedures at the assertion level.

(c) Other planned audit procedures that are required to be carried out so that the engagement complies with Standard on Auditing (SA).

The objective of the auditor is to plan the audit so that it may be performed in an effective manner.

The auditor should consider the following matters before planning for an audit:

(i) ***Terms of Engagement and any Statutory Responsibilities:*** While framing an audit plan, auditor should ascertain his terms of appointment and responsibilities cast by various legislations on him. The auditor should then prepare his audit plan based on what he is required to do.

(ii) ***Nature and Timing of Report or other Communications:*** Auditor should determine the form and the timing of the report. This will help auditor in determining the scope and time schedule of the audit.

(iii) ***Accounting Policies followed by the Enterprise and Change in those Policies:*** Accounting policies followed by the enterprise affect the audit plan. While preparing an audit plan due consideration may be given to the areas where there is any change in accounting policies.

(iv) ***Effect of New Accounting or Auditing Requirements*****:** Any change in accounting and auditing standards may affect the scope of audit or the manner in which it is conducted. Therefore, these should be carefully considered while drawing up the audit plan.

(v) ***Identification of Significant Audit Areas:*** It is important for the auditor to identify the areas which involves greater audit risk, so that the audit can be planned in such a way that overall audit risk will be less. More risky areas should be checked in detail and vice-versa.

(vi) ***Setting of Materiality Levels for Audit Purposes:*** At the planning stage, the auditor sets the materiality levels. For example, the auditor may decide that in the case of audit of sales, he will examine all sales transactions above Rs.5000.

(vii) ***Degree of Reliance Expected to be placed on Accounting System and Internal Control:*** While laying down an audit plan, the auditor shall assess the effectiveness of accounting systems and internal controls. On the basis of assessment, the auditor has to decide whether he will do test checking or more extensive checking of transaction and balances.

(viii) ***Nature and Extent of Audit Evidence:*** The nature and extent of audit evidence will vary in different auditing situations. For example, in one situation the auditor may rely more on physical examination, confirmation from third parties whereas in another situation he may rely more on examination of documentary evidence.

(ix) ***Work of Internal Auditors:*** Statutory auditor has to review the work done by the internal auditors to determine the extent of reliance they can place on. It will help the auditor in determining the scope of work under the audit plan.

(x) ***Establishing and Coordinating Staffing Requirements:*** Auditor shall determine the exact requirements of the staff along with the broad estimate of time required by each staff members. So that the audit work will be completed on time.

AUDIT PROGRAMME

An audit programme is a set of instructions which are to be followed for proper execution of audit. After the development of audit plan, a detailed written audit programme containing the various steps and procedures shall be required. The audit programme contains the measures that are generally employed to determine what, and how much evidence must be collected and evaluated. It also lays down the responsibilities for the whole audit team for carrying out different tasks.

The prepared audit program may be revised if needed in accordance with the prevailing circumstances. An audit program largely depends on the size of the organization and other relevant factors. Minimum essential work to be done is Standard Programme and rest is according to circumstances. There is no standard audit programme applicable to all situations.

Audit programme is documented in the Audit Working Papers, which are the official record that contains the planning and execution of the audit agreement.

ADVANTAGES OF AUDIT PROGRAMME

1. It helps in ensuring that all important areas are appropriately covered during audit.
2. It helps in distributing the work among the assistants in accordance with the level of their competence and experience.
3. It provides instructions to the audit staff and reduces scope for misunderstanding.
4. It helps in fixing the responsibility for the work done among the audit staff as work done may be traced back to the individual staff member.
5. It helps in assessing the progress of work by ascertaining what part of audit work has been completed and how much is left.
6. It serves as evidence against charge of negligence.
7. On completion of an audit, it serves the purpose of audit record which may be useful for future reference.

DISADVANTAGES OF AUDIT PROGRAMME

1. ***Rigidity:*** Audit programme can not be same for different types of organisation. Each business has separate problems. So a single/same audit programme can not be laid down for each type of business.
2. ***Reduces the Initiative of Efficient Staff:*** It kills the competency of taking initiative of capable persons. Assistant can not suggest any improvement in the plan.
3. ***Audit Work becomes Mechanical:*** The Audit programme becomes mechanical when it ignores other aspects like internal control.
4. ***New Areas may be Overlooked:*** With the passage of time new problems arising during the audit may be over looked in the audit Programme.

REMEDY OF DISADVANTAGES

1. The remedy in such situations is that audit programme should be flexible. It must always be open to changes and improvements.

2. The audit staff should be encouraged to draw the attention of the auditor to locate the defects in the programme.
3. The staff should be encouraged to explore fully unusual transaction and do not get restricted with the audit programme.

DIFFERENCE BETWEEN AUDIT PLAN AND AUDIT PROGRAMME

Audit Plan	Audit Programme
It lays down the audit strategies to be followed for conducting an audit such as identifying the areas where special audit attention in required to obtain the knowledge of business etc.	Audit programme is an outline of how the audit is to be done, who is to do what work and within what time.
Plans should be made to cover, other necessary things :	It lays down the following audit procedure to be followed :
(i) Acquiring knowledge of accounting systems, policies and internal control procedures	(i) Evaluation of internal control
(ii) Establishing the expected degree of reliance to be paced on the internal control	(ii) Ascertain arithmetical accuracy of books of accounts
(iii) Determining the nature, timing and extent of the audit procedures to be performed	(iii) Vouching of transactions’
(iv) Co-ordinating the work to be done	(iv) Verification and valuation of assets and liabilities
	(v) Ledger scrutiny
	(vi) Checking of overall disclosure and presentation of all items in the final accounts.
	(vii) Preparation and submission of audit report.

REVIEW QUESTION

1. At the ___________ stage the auditor sets the materiality levels.
2. While laying down an audit plan, the auditor shall assess the effectiveness of accounting systems and _______________.
3. An audit programme is a set of ______ which are to be followed for proper execution of audit.
4. Audit programme is documented in the ______________, which are the official record that contains the planning and execution of the audit agreement.

AUDIT EVIDENCE

The auditor has to obtain sufficient and appropriate evidence to substantiate his opinion on the financial statements. The audit evidence provides grounds for believing that a particular thing is true or not by providing support for a fact or a point in question. The evidences collected by the auditor must support the contents of the auditor’s report.

Essentials of good audit evidence

(a) ***Sufficient***: The audit evidence are said to be sufficient when they are in adequate quantity. The audit evidence enables the auditor to form an opinion on the financial information. Sufficient evidence can be obtained by test checking instead of 100% checking.

(b) ***Reliable***: Evidences obtained by auditor are persuasive rather than conclusive in nature, therefore, evidence cannot be100% reliable. The reliability of audit evidence depends upon:

(i) ***Source***: whether the evidence obtained within the organisation i.e. internal and obtained from outside i.e. external (confirmation by third party)

(ii) ***Nature:*** whether the evidence is verbal (explanation from clients staff), visual (physical verification of stock) or documentary (bills attached to vouchers)

(c) ***Relevant:*** Audit evidence obtained must be relevant to the matter being checked i.e. the balance of in hand to be checked then the relevant evidences have to be verified.

The following rules of thumb have proven helpful in judging the appropriateness of evidence:

(a) documentary evidence is usually better than testimonial evidence;

(b) audit evidence is more reliable when the auditor obtains consistent evidence from difference sources or of a different nature.

(c) original documents are better than photocopies;

(d) evidence from credible third parties may be better than evidence generated within the audited organization;

(e) the quality of information generated from the audited organization is directly related to the strength of the organization's internal controls (the auditors should have a good understanding of internal controls as they relate to the objectives of the audit); and

(f) evidence generated through the auditor's direct observation, inspection and computation is usually better than evidence obtained indirectly.

Important factors to be considered while obtaining audit evidence:

– the quality of the evidence (its relevance, reliability and validity);

– the level of materiality (Rupees terms) or the significance of the observation or conclusion (in general, the higher the level of significance or materiality, the higher the standard that evidence will have to meet);

– whether an audit level of assurance (high) or a review level of assurance(moderate) is required (for example, a higher level of assurance is required for evidence in order to support observations.

– the risk involved in making an incorrect observation or reaching an invalid conclusion (for example, if any risk of legal action against the auditee results from reporting an observation, the standard of evidence demanded will be high); and

TECHNIQUES OF OBTAINING EVIDENCE

(i) ***Inspection:*** Inspecting the documentary evidence like deed papers, certificates etc relating to the audit whether in possession of the entity or the third parties.

(ii) ***Observation:*** Observing the process or procedure being performed by others. Like physical verification and counting of inventory.

(iii) ***Enquiry:*** Enquiring from the client, his staff or third parties having knowledge about a particular item or activity.

(iv) ***Confirmation:*** Seeking information from third party having knowledge about a particular transaction.

(v) ***Computation:*** It involves checking of the arithmetical accuracy of a source documents and accounting records.

(vi) ***Analytical Review Procedures:*** Analysis of significant ratios and trends for investigating unusual fluctuation and items.

(vii) ***Independent Execution:*** In this, auditor performs the procedure and controls that were originally performed as part of entity's internal control system.

WORKING PAPERS

Audit working papers are the documents prepared or obtained by the auditors and retained by him in connection with the audit. Audit working papers are used to support the audit work done in order to provide assurance that the audit was performed in accordance with the relevant auditing standards. Working papers include all the evidence gathered by auditor indicating what work has been done by him and the procedure he has followed in verifying a particular asset or a liability and also provide information that whether:

– audit was properly planned;

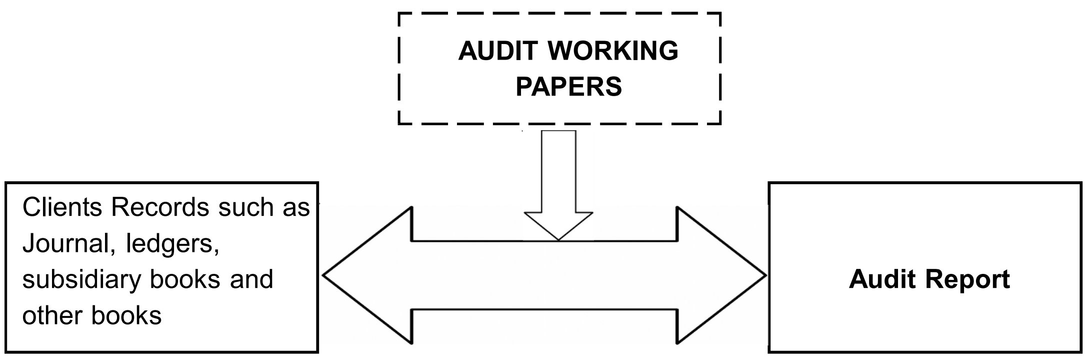
– audit was carried out;

– audit was adequately supervised;

– the appropriate review was undertaken;

– the evidence is sufficient and appropriate to support the audit opinion.

Working papers are the connecting link between the client's records and the audited accounts. These provide permanent historical record. These also serve as a great guide to the staff to whom the work of audit has been assigned after the previous year audit. These would come to the help of the auditor in future in case the client files a suit against the auditor's negligence. The working papers are the property of the auditor and the client cannot ask the auditor for their custody. However it is the duty of the auditor to maintain confidentiality of the client information. Further, if audit working papers are disclosed than it will amount to professional misconduct.



Advantages of maintenance of working papers

1. Working papers helps in proper planning and performance of audit.
2. Seniors can supervise the audit work performed by the juniors by examining their working papers.
3. It provide as evidence of the audit work performed to support the auditor's opinion.

TYPES OF WORKING PAPERS

The Auditors Working Papers are divided into two parts:

1. Permanent Audit file
2. Current Audit file

Permanent File

The data in these file are the information, which is of continuous interest and relevant to succeeding audits. Data in this file can include the following:

– Articles of incorporation

- Loan agreements
- Documents related to understanding internal control
- Leases
- Significant audit observation of earlier years
- Notes regarding significant accounting policies

Current Audit File

These file contains information relating to the audit of the current period. Data in this file can include the following:

- Financial statements and audit report
- Working trial balance and worksheets
- Adjusting journal entries and reclassification entries
- Audit programs
- Documentation of the consideration of internal control and the consideration of fraud risk factors
- Record of test of controls and substantive tests
- Record of audit exceptions and their resolutions
- Letters of attorneys, representation letter and
- Confirmation responses

LESSON ROUND UP

- **An audit plan** lays out the strategies to be followed to conduct an audit. It includes the nature, timing and extent of audit procedures to be performed.
- The auditor should consider the following matters while laying out an audit plan:
  (a) Terms of engagement and any statutory responsibilities.
  (b) Nature and timing of report or other communications.
  (c) Accounting policies followed by the enterprise and change in those policies.
  (d) Effect of new accounting or auditing requirements.
  (e) Identification of significant audit areas.
  (f) Setting of materiality levels for audit purposes.
  (g) Degree of reliance expected to be placed on accounting system and internal control.
  (h) Nature and extent of audit evidence.
- **An Audit Programme** is a set of instructions which are to be followed for proper execution of audit. The audit programme contains the measures that are generally employed to determine what, and how much evidence must be collected and evaluated. It also lays down the responsibilities of the whole audit team for carrying out different tasks.
- **Advantages of Audit Programme-** It ensures that all important areas are covered during audit; it distributes the work among the assistants as per their competence; it provides instructions to staff and reduces scope for misunderstanding; it fixes the responsibility for the work done; it helps in assessing the progress of work; it serves as evidence against charge of negligence; it serves the purpose of audit record which may be useful for future reference.
- **Disadvantages of Audit Programme-** Losses its flexibility; It kills the competency of taking initiative of capable persons; it is mechanical; Not suitable for small audits; new problems arises may be over looked in the audit Programme.

– **Remedial Actions-** Programme should be flexible, staff should be encouraged to draw attention to locate any defects, The staff should be encouraged to explore fully unusual transaction,

– **Audit Working Papers are** the documents prepared or obtained by the auditors and retained by him in connection with the audit. Working papers include all the evidence gathered by auditor.

– **Audit Evidence** is information that is collected and used to provide a factual basis for developing observations and conclusion against audit objectives. Evidence provides ground for believing that a particular thing is true or not by providing persuasive support for a fact or a point in question. Audit should have sufficient appropriate evidence to support the contents of the audit report. To make evidence appropriate, the information must be relevant, reliable and valid. The quantity of evidence is sufficient if its weight is adequate to provide persuasive support for the contents of the audit report.

– **Techniques of Obtaining Evidence:** Inspection, Observation, Enquiry, Confirmation, Computation, Analytical review procedures, Independent execution.

GLOSSARY

Standard of Auditing (SAs)	SAs are standard on auditing issued by the Institute of Chartered Accountants of India. They are the guidelines to conduct an audit.
Documentary Evidence	Evidence in the form of written papers or documents.
Testimonial Evidence	Something that recommends a person or thing as worthy or desirable.
Audit Risk	Audit risk is the risk of the auditor providing an inappropriate opinion on the financial statements, particularly when those financial statements contain a material misstatement.
Analytical Review	Any process by which a person or company looks at an account or financial statement and attempts to identify any irregularities. This may involve comparing financial and non-financial information. An analytical review is less thorough than an audit.

SELF-TEST QUESTIONS

1. What is audit plan? What are factors to be considered while preparing an audit plan?
2. Write short notes on :
   (a) Permanent Audit File
   (b) Current Audit File
3. What is Audit Programme and how does it helps in performing an audit?
4. Describe briefly the various techniques that an auditor applies to collect evidence?

SUGGESTED READINGS

1. Fundamentals of Auditing – By Kamal Gupta
2. Auditing: principles and practice - By Ravinder Kumar, Virender Sharma
3. An Insight into Auditing- By Dr. B. K. Basu

Lesson 16
Audit and Auditors under Companies Act 2013 – Basic Provisions

LESSON OUTLINE

- Appointment of Auditors
- Appointment of Auditors of Government Companies
- Mandatory Rotation of Auditors
- Eligibility or Qualification of the Auditor
- Disqualifications of the Auditor
- Remuneration of the Auditors
- Powers and Duties of Auditors
- Auditor's Report
- Auditor not to render Certain Services
- Branch Audit
- Secretarial Audit
- Audit Report
- Contents of Auditor's Report
- Forming an Audit Opinion
- Types of Opinion
- LESSON ROUND UP
- SELF TEST QUESTIONS

LEARNING OBJECTIVES

These days the focus of the government is on self regulation by the business community. Society also wants less intervention of the government in the functioning of the business. Therefore various laws and legislation provide for the appointment of independent auditor. The appointment of auditor, his rights, duties and functions are governed by the legislations under which he is appointed. The emphasis of all these regulation is that the auditor should be independent. In this chapter we have highlighted the provisions of Companies Act, 2013 relating to the auditor and his reports.

In this lesson you will learn who is an auditor, how auditor can be appointed, what are the qualification, rights and duties of the auditor, meaning of auditors report and how and when auditors will qualify his opinion.

APPOINTMENT OF AUDITORS

The Board of Directors of a company shall appoint an individual or firm as the first auditor of a company, other than a Government company, within thirty days from the date of registration of the company. The appointment of first auditor shall be ratified by members at the first annual general meeting. The auditor so appointed shall hold the office from the conclusion of that meeting till the conclusion of sixth annual general meeting and thereafter till the conclusion of every sixth meeting. The appointment of auditors shall be ratified by members at every annual general meeting.

In the case of failure of the Board to appoint the first auditor, it shall inform the members of the company, who shall within ninety days at an extraordinary general meeting appoint such auditor and such auditor shall hold office till the conclusion of the first annual general meeting.

Any casual vacancy (except as a result of the resignation of an auditor) in the office of an auditor of a company, other than a Government company, shall be filled by the Board of Directors within thirty days. If casual vacancy is as a result of the resignation of an auditor, the Board of Directors shall fill the vacancy within thirty days but such appointment shall also be approved by the company at a general meeting convened within three months of the recommendation of the Board and he shall hold the office till the conclusion of the next annual general meeting.

A retiring auditor may be re-appointed at an annual general meeting, if—

(a) he is not disqualified for re-appointment;

(b) he has not given the company a notice in writing of his unwillingness to be re-appointed; and

(c) a special resolution has not been passed at that meeting appointing some other auditor or providing expressly that he shall not be re-appointed.

If at any annual general meeting, no auditor is appointed or re-appointed, the existing auditor shall continue to be the auditor of the company.

Appointment of Auditors of Government Companies

Government companies means any company owned or controlled, directly or indirectly, by the Central Government, or by any State Government or Governments, or partly by the Central Government and partly by one or more State Governments.

The Comptroller and Auditor-General of India shall appoint the first auditor of the Government Company within sixty days from the date of registration of the company. In case the Comptroller and Auditor-General of India does not appoint such auditor within the said period, the Board of Directors of the company shall appoint such auditor within the next thirty days; and in the case of failure of the Board to appoint such auditor within the next thirty days, it shall inform the members of the company who shall appoint such auditor within the sixty days at an extraordinary general meeting, who shall hold office till the conclusion of the first annual general meeting.

The Comptroller and Auditor-General of India in respect of a financial year shall appoint an auditor within a period of one hundred and eighty days from the commencement of the financial year, who shall hold office till the conclusion of the annual general meeting.

Any casual vacancy in the office of an auditor of a Government company shall be filled by the Comptroller and Auditor-General of India within thirty days. In case of failure of the Comptroller and Auditor-General of India to fill the vacancy within the said period, the Board of Directors shall fill the vacancy within next thirty days.

Mandatory Rotation of Auditors

The Companies Act, 2013 has introduced the system of rotation of auditors which is applicable to-

- all listed companies;
- all unlisted public companies having paid up share capital of rupees 10 crore or more;
- all private limited companies having paid up share capital of rupees 20 crore or more;
- all companies having paid up share capital of below threshold limit mentioned above, but having public borrowings from financial institutions, banks or public deposits of rupees 50 crore or more.

The concept of rotation of auditors shall not apply to one person companies and small companies.

All the companies mentioned above shall not appoint or re-appoint an individual as an auditor of the company for more than 1 term of 5 consecutive years. An individual auditor, who has completed his term of 5 consecutive years, shall not be eligible for re-appointment as auditor in the same company for 5 years from the date of completion.

All the companies mentioned above shall not appoint or re-appoint an audit firm as an auditor of the company for more than 2 terms of 5 consecutive years. An audit firm which has completed its 2 terms of 5 consecutive years shall not be eligible for re-appointment as auditor in the same company for 5 years from the completion of such terms. If any firm/LLP which has one or more partners who are also partners in the outgoing audit firm/LLP cannot be appointed as auditors during the 5 year period. In other words, if two or more audit firms have common partner(s), and one of these firms has completed its 2 terms of 5 consecutive years, none of such audit firms shall be eligible for re-appointment as auditor in the same company for 5 years.

Eligibility or Qualifications of the Auditor

- A person shall be eligible for appointment as an auditor of a company only if he is a chartered accountant.
- A firm whereof majority of partners practising in India are chartered accountants may be appointed by its firm name to be auditor of a company.
- If a limited liability partnership firm is appointed as an auditor of a company, only the partners who are chartered accountants shall be authorised to act and sign on behalf of the firm.

Disqualifications of the Auditor

The following persons shall not be eligible for appointment as an auditor of a company-

(i) a body corporate other than a limited liability partnership

(ii) an officer or employee of the company

(iii) a person who is a partner, or who is in the employment, of an officer or employee of the company

(iv) a person who, or his relative or partner and holding any security of or interest in the company or its subsidiary, or of its holding or associate company or a subsidiary of such holding company not exceeding Rs. 1 lakh.

(v) a person who, or his relative or partner is indebted to the company, or its subsidiary, or its holding or associate company or a subsidiary of such holding company not exceeding Rs. 5 lakh.

(vi) a person who, or his relative or partner has given a guarantee or provided any security in connection with the indebtedness of any third person to the company, or its subsidiary, or its holding or associate company or a subsidiary of such holding company, not exceeding Rs. 1 lakh.

(vii) a person or a firm who, whether directly or indirectly, has business relationship with the company, or its subsidiary, or its holding or associate company or subsidiary of such holding company or associate company

(viii) a person whose relative is a director or is in the employment of the company as a director or key managerial personnel;

(ix) a person who is in full time employment elsewhere or a person or a partner of a firm holding appointment as its auditor, if such persons or partner is at the date of such appointment or reappointment holding appointment as auditor of more than **twenty companies;**

(x) a person who has been convicted by a court of an offence involving fraud and a period of ten years has not elapsed from the date of such conviction;

(xi) any person whose subsidiary or associate company or any other form of entity, is engaged as on the date of appointment in consulting and specialised services as provided in section 144.

If any person appointed as an auditor of a company incurs any of the disqualifications mentioned above after his appointment, he shall vacate his office as such auditor and such vacation shall be deemed to be a casual vacancy in the office of the auditor.

Remuneration of the auditors

The remuneration of the auditor of a company shall be fixed in its general meeting. The Board may fix remuneration of the first auditor appointed by it. The remuneration shall be in addition to the fee payable to an auditor, include the expenses, if any, incurred by the auditor in connection with the audit of the company and any facility extended to him. The remuneration fixed does not include any remuneration paid to him for any other service rendered by him at the request of the company.

Powers and Duties of auditors

1. Every auditor of a company shall have a right of access at all times to the books of account and vouchers of the company, whether kept at the registered office of the company or at any other place.
2. The auditor shall be entitled to require from the officers of the company such information and explanation as he may consider necessary for the performance of his duties as auditor and amongst other matters inquire into the following matters, namely:—

   (a) whether loans and advances made by the company on the basis of security have been properly secured and whether the terms on which they have been made are prejudicial to the interests of the company or its members;

   (b) whether transactions of the company which are represented merely by book entries are prejudicial to the interests of the company;

   (c) where the company not being an investment company or a banking company, whether so much of the assets of the company as consist of shares, debentures and other securities have been sold at a price less than that at which they were purchased by the company;

   (d) whether loans and advances made by the company have been shown as deposits;

   (e) whether personal expenses have been charged to revenue account;

   (f) where it is stated in the books and documents of the company that any shares have been allotted for cash, whether cash has actually been received in respect of such allotment, and if no cash has actually been so received, whether the position as stated in the account books and the balance sheet is correct, regular and not misleading:

3. The auditor of a company which is a holding company shall also have the right of access to the records of all its subsidiaries in so far as it relates to the consolidation of its financial statements with that of its subsidiaries.
4. The auditor has right to receive notices of any general meeting and he shall attend either by himself or through his authorised representative, who shall also be qualified to be an auditor, any general meeting and shall have right to be heard at such meeting on any part of the business which concerns him as the auditor.

Auditor's Report

The auditor shall make a report to the members of the company on the accounts and financial statements examined by him after taking into account the provisions of the Companies Act, the accounting standards and auditing standards. The report shall be laid before the company in general meeting.

1. The auditor shall state in his report that to the best of his information and knowledge, the accounts and financial statements give a true and fair view of the state of the company's affairs as at the end of its financial year and profit or loss and cash flow for the year. The auditor shall comply with the auditing standards and sign the auditor's report of the company. The auditor's report shall also state following –
   (a) whether he has sought and obtained all the information and explanations which to the best of his knowledge and belief were necessary for the purpose of his audit and if not, the details thereof and the effect of such information on the financial statements;
   (b) whether, in his opinion, proper books of account as required by law have been kept by the company so far as appears from his examination of those books and proper returns adequate for the purposes of his audit have been received from branches not visited by him;
   (c) whether the report on the accounts of any branch office of the company audited by a person other than the company's auditor has been sent to him under and the manner in which he has dealt with it in preparing his report;
   (d) whether the company's balance sheet and profit and loss account dealt with in the report are in agreement with the books of account and returns;
   (e) whether, in his opinion, the financial statements comply with the accounting standards;
   (f) the observations or comments of the auditors on financial transactions or matters which have any adverse effect on the functioning of the company;
   (g) whether any director is disqualified from being appointed as a director
   (h) any qualification, reservation or adverse remark relating to the maintenance of accounts and other matters connected therewith;
2. If any of the matters required to be included in the audit report is answered in the negative or with a qualification, the report shall also state the reasons for the same.
3. The qualifications, observations or comments on financial transactions or matters, which have any adverse effect on the functioning of the company mentioned in the auditor's report shall be read before the company by the auditor in general meeting and shall be open to inspection by any member of the company.
4. As per the Companies (Auditor's Report) Order, 2015, an auditor should include a statement on the following matters in the auditor's report on the account of companies covered under this order-
   (i) Fixed assets

(ii) Inventory

(iii) Granting of loans to certain parties

(iv) Internal control system

(v) Acceptance of deposits

(vi) Maintenance of cost records

(vii) Deposit of statutory dues

(viii) Accumulated Losses and Cash Losses

(ix) Default in repayment of dues

(x) Guarantee for loans taken by others from bank or financial institutions

(xi) Application of term loans

(xii) Fraud Reporting

Auditor not to render certain services

An auditor appointed by the company will provide only such other services as are approved by the Board of Directors or the audit committee. The auditor is prohibited to provide any of the following services whether directly or indirectly to the company or its holding company or subsidiary company-

(i) accounting and book keeping services;

(ii) internal audit;

(iii) design and implementation of any financial information system;

(iv) actuarial services;

(v) investment advisory services;

(vi) investment banking services;

(vii) rendering of outsourced financial services;

(viii) management services; and

(ix) any other kind of services as may be prescribed.

Branch Audit

If any company has a branch office, the accounts of that office shall be audited either by the auditor of the company or by any other person qualified for appointment as an auditor of the company or appointed as auditor under the Act.

If the branch office is situated in a country outside India, the accounts of the branch office shall be audited either by the company's auditor or by an accountant or by any other person duly qualified to act as an auditor of the accounts of the branch office in accordance with the laws of that country.

The duties and powers of the company's auditor with reference to the audit of the branch shall be same. The branch auditor shall prepare a report on the accounts of the branch examined by him and send it to the auditor of the company who shall deal with it in his report in such manner as he considers necessary.

Secretarial Audit

Secretarial Audit is an audit to check compliance of various legislations including the Companies Act and other corporate and economic laws applicable to the company. The Secretarial Auditor expresses an opinion as to whether there exist adequate systems and processes in the company commensurate with the size and operations of the company to monitor and ensure compliance with applicable laws, rules, regulations and guidelines.

Secretarial Audit helps to detect the instances of non-compliance and facilitates taking corrective measures. It audits the adherence of good corporate practices by the company. It is therefore an independent and objective assurance intended to add value and improve operations of the Company. It helps to accomplish the organisation's objectives by bringing a systematic, disciplined approach to evaluate and improve effectiveness of risk management, control, and governance processes. Secretarial Audit thus provides necessary comfort to the management, regulators and the stakeholders, as to the statutory compliance, good governance and the existence of proper and adequate systems and processes.

As per Companies Act, 2013 and the Companies (Appointment and Remuneration of Managerial Personnel) Rules, 2014, the following companies are required to obtain Secretarial Audit Report:

- Every listed company;
- Every public company having a paid-up share capital of fifty crore rupees or more; or
- Every public company having a turnover of two hundred fifty crore rupees or more.

Companies which are not covered above may obtain Secretarial Audit Report voluntarily as it provides an independent assurance of the compliances in the company.

Eligibility of Secretarial auditor - Only a member of the Institute of Company Secretaries of India holding certificate of practice (company secretary in practice) can conduct Secretarial Audit and furnish the Secretarial Audit Report to the company.

The Secretarial Auditor needs to examine and report on the compliance of the following five specific laws:

(i) The Companies Act, 2013 (the Act) and the rules made thereunder;

(ii) The Securities Contracts (Regulation) Act, 1956 (SCRA) and the rules made thereunder;

(iii) The Depositories Act, 1996 and the Regulations and Bye-laws framed thereunder;

(iv) Foreign Exchange Management Act, 1999 and the rules and regulations made thereunder

(v) The following Regulations and Guidelines prescribed under the Securities and Exchange Board of India Act, 1992 (SEBI Act):-

- The Securities and Exchange Board of India (Substantial Acquisition of Shares and Takeovers) Regulations, 2011;
- The Securities and Exchange Board of India (Prohibition of Insider Trading) Regulations, 1992;
- The Securities and Exchange Board of India (Issue of Capital and Disclosure Requirements) Regulations, 2009;
- The Securities and Exchange Board of India (Employee Stock Option Scheme and Employee Stock Purchase Scheme) Guidelines, 1999;
- The Securities and Exchange Board of India (Issue and Listing of Debt Securities) Regulations, 2008;
- The Securities and Exchange Board of India (Registrars to an Issue and Share Transfer Agents) Regulations, 1993 regarding the Companies Act and dealing with client;
- The Securities and Exchange Board of India (Delisting of Equity Shares) Regulations, 2009; and
- The Securities and Exchange Board of India (Buyback of Securities) Regulations, 1998;

(vi) Any other laws as may be applicable specifically to the company.

The Secretarial Audit Report should be signed by the Secretarial Auditor who has been engaged by the company to conduct the Secretarial Audit and in case of a firm of Company Secretaries, by the partner under whose supervision the Secretarial Audit was conducted.

Audit Report

The auditor's report is a formal opinion, issued by either an internal auditor or an independent external auditor as a result of an internal or external audit or evaluation performed on an organisation. The auditor should review and assess whether the financial statements have been prepared in accordance with an acceptable financial reporting framework applicable to the entity under audit. It is also necessary to consider whether the financial statements comply with the relevant statutory requirements and then the audit report is prepared. The report is subsequently provided to the stakeholders such as shareholders, creditors, financial institutions, banks, government, or the general public at large as an assurance service so that the user can make decisions based on the results of the audit. Therefore, the auditor's report should contain a clear written expression of opinion on the financial statements taken as a whole.

Contents of an Auditor's Report

The auditor's report shall be in writing. The auditor's report should include a minimum of the following elements:

(a) A title;

(b) An addressee

(c) An introductory paragraph that identifies the financial statements audited;

(d) A description of the responsibility of management for the preparation of the financial statements;

(e) A description of the auditor's responsibility to express an opinion on the financial statements and the scope of the audit

(f) An opinion paragraph containing an expression of opinion on the financial statements and a reference to the applicable financial reporting framework used to prepare the financial statements

(g) The auditor's signature;

(h) The date of the auditor's report; and

(i) The place of signature.

Forming an Audit Opinion

Audits are conducted to express a true and fair view of a company's financial statements. Therefore in the audit report, the auditor's opinion is expressed on the basis of the information reviewed and analyzed during the verification of financial statements.

The auditor shall form an opinion on whether the financial statements are prepared, in all material respects, in accordance with the applicable financial reporting framework. In order to form that opinion, the auditor shall conclude as to whether the auditor has obtained reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error.

The auditor shall evaluate whether the financial statements are prepared, in all material respects, in accordance with the requirements of the applicable financial reporting framework. This evaluation shall include consideration of the qualitative aspects of the entity's accounting practices, including indicators of possible bias in management's judgments.

In particular, the auditor shall evaluate whether:

(a) The financial statements adequately disclose the significant accounting policies selected and applied;

(b) The accounting policies selected and applied are consistent with the applicable financial reporting framework and are appropriate;

(c) The accounting estimates made by management are reasonable;

(d) The information presented in the financial statements is relevant, reliable, comparable and understandable;

(e) The financial statements provide adequate disclosures to enable the intended users to understand the effect of material transactions and events on the information conveyed in the financial statements; and

(f) The terminology used in the financial statements, including the title of each financial statement, is appropriate

The opinion paragraph of the auditor's report should clearly indicate the financial reporting framework used to prepare the financial statements and state the auditor's opinion as to whether the financial statements give a true and fair view in accordance with that financial reporting framework and, where appropriate, whether the financial statements comply with the statutory requirements.

Types of opinion

The auditor may express one of the following four opinions:

- Unqualified Opinion
- Qualified Opinion
- Disclaimer of Opinion
- Adverse Opinion

Unqualified Opinion

An unqualified opinion is expressed when the auditor concludes that the financial statements give a true and fair view in accordance with the financial reporting framework used for the preparation and presentation of the financial statements. An unqualified opinion indicates, implicitly, that any changes in the accounting principles or in the method of their application, and the effects thereof, have been properly determined and disclosed in the financial statements. An unqualified opinion also indicates that-

(a) the financial statements have been prepared using the generally accepted accounting principles, which have been consistently applied;

(b) the financial statements comply with relevant statutory requirements and regulations; and

(c) there is adequate disclosure of all material matters relevant to the proper presentation of the financial information, subject to statutory requirements, where applicable.

The following is an illustration of an auditor's report expressing an unqualified opinion.

AUDITOR'S REPORT

(Appropriate Addressee)

We have audited the attached Balance Sheet of ...... (Name of the entity) as at 31st March 2XXX and also the Profit and Loss Account for the year ended on that date annexed thereto. These financial statements are the responsibility of the entity's management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with auditing standards generally accepted in India. Those Standards require that we plan and perform the audit to obtain reasonable assurance whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion and to the best of our information and according to the explanations given to us, the financial statements give a true and fair view in conformity with the accounting principles generally accepted in India:

(a) In the case of the Balance Sheet, of the state of affairs of..... (Name of the entity) as at 31st March 2XXX; and

(b) In the case of the Profit and Loss Account, of the profit/loss for the year ended on that date.

Modified Report

An auditor's report is considered to be modified when it includes:

(a) Matters That Do Not Affect the Auditor's Opinion

- emphasis of matter

(b) Matters That Do Affect the Auditor's Opinion

- qualified opinion
- disclaimer of opinion
- adverse opinion

(a) Matters That Do Not Affect the Auditor's Opinion

In certain circumstances, an auditor's report may be modified by adding an emphasis of matter paragraph to highlight a matter affecting the financial statements. The auditor considers modifying the auditor's report by adding a paragraph if there is a significant uncertainty (other than going concern problem), the resolution of which is dependent upon future events and which may affect the financial statements. The addition of such an emphasis of matter paragraph does not affect the auditor's opinion. It would ordinarily refer to the fact that the auditor's opinion is not qualified in this respect.

(b) Matters That Do Affect the Auditor's Opinion

An auditor may not be able to express an unqualified opinion when either of the following circumstances exists and, in the auditor's judgment, the effect of the matter is or may be material to the financial statements:

- there is a limitation on the scope of the auditor's work; or
- there is a disagreement with management regarding the acceptability of the accounting policies selected, the method of their application or the adequacy of financial statement disclosures.

The circumstances described in (a) could lead to a qualified opinion or a disclaimer of opinion. The circumstances described in (b) could lead to a qualified opinion or an adverse opinion.

Qualified Opinion

A qualified opinion is expressed when the auditor concludes that an unqualified opinion cannot be expressed, but that the effect of any disagreement with management is not so material and pervasive as to require an adverse opinion, or the limitation of scope is not so material and pervasive as to require a disclaimer of opinion. A qualified opinion should be expressed as being "subject to'" or "except for" the effects of the matter to which the qualification relates.

Disclaimer of Opinion

A disclaimer of opinion is expressed when the possible effect of a limitation on scope is so material and pervasive that the auditor has not been able to obtain sufficient appropriate audit evidence and is, therefore, unable to express an opinion on the financial statements.

Adverse Opinion

An adverse opinion is expressed when the effect of a disagreement is so material and pervasive to the financial statements that the auditor concludes that a qualification of the report is not adequate to disclose the misleading or incomplete nature of the financial statements.

At the end of the audit report, it is signed by the auditor. The audit report is the medium of communication of the auditor's expert views on the financial statements and it has a significant bearing on the credibility of such statements. By expressing views in the report, the auditor takes upon himself a great responsibility because a large number of people are likely to put reliance on the financial statements. Therefore, he is necessarily to be careful, clear and objective in the matter of preparation of the report. A good audit report should clearly express an opinion as to whether the financial statements of the company present the financial information truly and fairly in conformity with accounting principles and legal requirements.

LESSON ROUND UP

– The Board of Directors of a company shall appoint an individual or firm as the first auditor of a company, other than a Government company, within thirty days from the date of registration of the company.

– Government companies means any company owned or controlled, directly or indirectly, by the Central Government, or by any State Government or Governments, or partly by the Central Government and partly by one or more State Governments. The Comptroller and Auditor-General of India shall appoint the first auditor of the Government Company within sixty days from the date of registration of the company.

– The remuneration of the auditor of a company shall be fixed in its general meeting. The Board may fix remuneration of the first auditor appointed by it.

– Every auditor of a company shall have a right of access at all times to the books of account and vouchers of the company, whether kept at the registered office of the company or at any other place.

– The auditor shall make a report to the members of the company on the accounts and financial statements examined by him after taking into account the provisions of the Companies Act, the accounting standards and auditing standards. The report shall be laid before the company in general meeting.

– If any company has a branch office, the accounts of that office shall be audited either by the auditor of the company or by any other person qualified for appointment as an auditor of the company or appointed as auditor under the Act.

– Secretarial Audit is an audit to check compliance of various legislations including the Companies Act and other corporate and economic laws applicable to the company. The Secretarial Auditor expresses an opinion as to whether there exist adequate systems and processes in the company commensurate with the size and operations of the company to monitor and ensure compliance with applicable laws, rules, regulations and guidelines.

- The auditor's report is a formal opinion, issued by either an internal auditor or an independent external auditor as a result of an internal or external audit or evaluation performed on an organisation.
- Audits are conducted to express a true and fair view of a company's financial statements. Therefore in the audit report, the auditor's opinion is expressed on the basis of the information reviewed and analyzed during the verification of financial statements.
- An unqualified opinion is expressed when the auditor concludes that the financial statements give a true and fair view in accordance with the financial reporting framework used for the preparation and presentation of the financial statements.

SELF-TEST QUESTIONS

1. Who can be appointed as the auditor of a company?
2. How the first auditor of the company is appointed?
3. What is a casual vacancy? What are the rules regarding appointment for the casual vacancy on account of resignation?
4. What are the powers of the company auditor?
5. Can a company restrict the rights of its statutory auditor?

SUGGESTED READINGS

1. Fundamentals of Auditing – By Kamal Gupta
2. Auditing: principles and practice - By Ravinder Kumar, Virender Sharma
3. An Insight into Auditing- By Dr. B. K. Basu

FOUNDATION PROGRAMME

FUNDAMENTALS OF ACCOUNTING AND AUDITING

PRACTICE TEST PAPER

(This Test Paper is for practice and self study only and not to be sent to the Instititute)

Time Allowed : 2 Hours *Maximum Marks : 100*

[*Attempt all questions. Each question carries 1 Mark. There is no negative mark for incorrect answers.*]

PART A

1. Accounting standards are:
   (a) written policy documents issued by expert accounting body
   (b) set of broad accounting policies to be followed by an entity.
   (c) set in the form of general principles.
   (d) All of the above.
2. X and Y are partners with capitals of ₹10,000 and ₹20,000 respectively and sharing profits equally. They admit Z as their third partner with one-fourth profits of the firm on the payment of ₹12,000. The amount of hidden goodwill is:
   (a) ₹ 6,000.
   (b) ₹ 10,000.
   (c) ₹ 8,000.
   (d) None of the above.
3. Which account is the odd one out?
   (a) Office Furniture & Equipment.
   (b) Freehold Land and Buildings.
   (c) Stock of raw materials.
   (d) Plant and Machinery.
4. Purchase book records:
   (a) All cash purchases only.
   (b) All credit purchases only.
   (c) Credit purchases of goods in trade only.
   (d) Both cash and credit purchases.
5. Trial balance is a statement which shows the total of the ________or the ________balances of all the accounts.
   (a) Opening, Closing

Students are advised to read instruction on Computer based examinations available on ICSI website www.icsi.edu

(b) Current, Future.

(c) Debit, Credit.

(d) Cash, bank

6. Contra entries are passed only when

   (a) Double column cash book is prepared

   (b) Three-column cash book is prepared

   (c) Simple cash book is prepared

   (d) None of the above

7. Mr. Anand buys goods of ₹2,50,000 paying cash ₹2,00,000. What is the amount of expense as per the accrual concept?

   (a) ₹ 2,50,000.

   (b) ₹ 2,00,000.

   (c) ₹ 50,000.

   (d) Nil.

8. Profit or loss on revaluation of assets and liabilities at the time of admission of partner, is shared among the partners in _______ ratio.

   (a) Old Profit Sharing.

   (b) New Profit Sharing.

   (c) Capital.

   (d) Equal.

9. Which types of error do not affect matching of trial balance, except

   (a) Compensating errors.

   (b) Errors of complete omission.

   (c) Errors of partial omission.

   (d) Errors of principle.

10. Errors are ________ mistakes.

    (a) Intentional.

    (b) Unintentional.

    (c) Undetected.

    (d) None of the three.

11. Which of the following is an example of capital expenditure?

    (a) Drawings Account

    (b) Outstanding Expenses Account

    (c) Machinery Account

    (d) Debtors Account

12. Interest on capital will be paid to the partners if provided for in the agreement but only from________
    (a) Profits.
    (b) Reserves.
    (c) Accumulated Profits.
    (d) Goodwill.
13. Present liability of uncertain amount, which can be measured reliably by using a substantial degree of estimation, is termed as ________
    (a) Provision
    (b) Liability
    (c) Contingent liability
    (d) Reserve
14. If a purchase return of ₹94 has been wrongly posted to the debit of the sales return account, but had been correctly entered in the suppliers account, the total of the trial balance would show
    (a) the credit side to be ₹94 more than debit side.
    (b) the debit side to be ₹94 more than credit side.
    (c) the credit side to be ₹188 more than debit side.
    (d) the debit side to be ₹188 more than credit side.
15. X and Y are partners with the capital ₹1,50,000 and ₹1,40,000 respectively. They share profits and losses equally. Z is admitted on bringing ₹1,50,000 as capital only and nothing was brought against goodwill. Goodwill in Balance sheet of ₹20,000 is revalued as ₹35,000. What will be value of goodwill in the books after the admission of Z?
    (a) ₹55,000.
    (b) ₹35,000.
    (c) ₹20,000.
    (d) ₹15,000
16. The profits of last three years are ₹43,000; ₹38,000 and ₹45,000. Find out the goodwill if it is valued at two years purchase of average profits.
    (a) ₹42,000.
    (b) ₹84,000.
    (c) ₹1,26,000.
    (d) ₹36,000.
17. If capital employed by a partnership firm is ₹1,00,000 and its average profit is ₹20,000 normal rate of return is 15%, then find goodwill if it is valued on the basis of one year purchase of super profits.
    (a) ₹30,000
    (b) ₹5,000
    (c) ₹1,33,333
    (d) ₹33,333

18. Total capital employed by a partnership firm is ₹1,00,000 and its average profit is ₹25,000. Normal rate of return is 20% in similar firms working under similar conditions. The firms earns super profit of:
    (a) ₹3,000
    (b) ₹5,000
    (c) ₹4,000
    (d) ₹2,000
19. In the absence of any provision in the partnership agreement, profits and losses are shared
    (a) In the ratio of capitals.
    (b) Equally.
    (c) In the ratio of loans given by them to the partnership firm.
    (d) None of the above.
20. A company forfeited 2,000 shares of ₹10 each (which were issued at par) held by Mr. X for non-payment of first & final call money of ₹4 per share. The called-up value per share was ₹9. On forfeiture, the amount debited to share capital will be
    (a) ₹10,000
    (b) ₹8,000
    (c) ₹20,000
    (d) ₹18,000
21. Abacus Ltd. issued shares of ₹10 each at a discount of 10%. Mr. Mahesh purchased 30 shares and paid ₹2 on application but did not pay the allotment money of ₹3. The company forfeited his entire shares, the forfeiture account will be credited by
    (a) ₹90
    (b) ₹81
    (c) ₹60
    (d) ₹54
22. A company cannot issue redeemable preference shares for a period exceeding
    (a) 6 years
    (b) 7 years
    (c) 8 years
    (d) 20 years
23. ₹200 paid as wages for erecting a machine should be debited to
    (a) Repair account.
    (b) Machine account.
    (c) Capital account.
    (d) Furniture account

24. If sales are ₹2,000 and the rate of gross profit on cost of goods sold is 25%, then the cost of goods sold will be
    (a) ₹2,000.
    (b) ₹1,500.
    (c) ₹1,600.
    (d) None of the above.
25. If cost of goods sold is ₹80,700, Opening stock ₹5,800 and Closing stock ₹6,000. Then the amount of purchase will be
    (a) ₹80,500
    (b) ₹74,900
    (c) ₹74,700
    (d) ₹80,900.
26. Under the straight line method of depreciation, the amount of yearly depreciation _____________
    (a) Remains the same
    (b) Fluctuates
    (c) Increases year after year
    (d) Decreases year after year.
27. A Bank Reconciliation Statement is prepared to know the causes for the difference between:
    (a) the balances as per cash column of Cash Book and the Pass Book.
    (b) the balance as per bank column of Cash Book and the Pass Book.
    (c) the balance as per bank column of Cash Book and balances as per cash column of Cash Book
    (d) None of the above.
28. In case of redemption of preference shares out of distributable profits, an amount equal to the nominal value of preferences shares redeemed must be transferred to the
    (a) Development rebate reserve
    (b) Investment allowance reserve
    (c) Capital redemption reserve
    (d) Premium on redemption of preference shares
29. When preparing a Bank Reconciliation Statement, if you start with a debit balance as per the Cash Book, cheques issued but not presented within the period should be:
    (a) Added
    (b) Deducted
    (c) Not required to be adjusted
    (d) None of the above.

30. The assumption underlying the fixed instalment method of depreciation is that of ________ of the asset over different years of its useful life.
    (a) Increasing Usage
    (b) Equal Usage
    (c) Decreasing Usage
    (d) None of the above
31. Original cost = ₹1,26,000. Salvage value = ₹6,000. Useful Life = 6 years. Annual depreciation under Stragiht Line Method will be
    (a) ₹21,000
    (b) ₹20,000
    (c) ₹15,000
    (d) ₹14,000
32. Preference shares amounting to ₹1,00,000 are redeemed at a premium of 5% by issue of shares amounting to ₹50,000 at a premium of 10%. The amount to be transferred to capital redemption reserve account will be
    (a) ₹55,000.
    (b) ₹50,000.
    (c) ₹45,000.
    (d) ₹57,500.
33. Brave Ltd. issued 60,000 shares of ₹10 each at a discount of ₹1 per share. The application money was ₹2, allotment money was ₹4, and first call was of ₹1. The amount of final call will be
    (a) ₹3
    (b) ₹2
    (c) ₹1
    (d) ₹4
34. Discount on issue of debentures is shown as _________on the liabilities side of balance sheet:
    (a) Surplus
    (b) Negitive Surplus
    (c) Non-current liability
    (d) None of the above
35. Which of the following expenses are debited in trading account?
    (a) Surplus
    (b) Negative Surplus
    (c) Non-current liability
    (d) Wages

36. As per the accounting equation
    (a) Capital + Liabilities = Assets
    (b) Capital + Assets = Liabilities
    (c) Liabilities + Assets = Capital
    (d) Assets = Liabilities – Capital
37. In Double Entry System of Book-keeping every business transaction affects:
    (a) Two accounts with equal but opposite effect.
    (a) Two sides of the same account.
    (b) The same account on two different dates.
    (c) All of the above.
38. __________ is an intangible real account.
    (a) Land
    (b) Building
    (c) Goodwill
    (d) Cash
39. Journal entry for outstanding salary to clerk ₹6,000 will be
    (a) Dr. Salary a/c and Cr. Cash a/c ₹6,000.
    (b) Dr. Outstanding salary a/c and Cr. Salary a/c ₹6,000.
    (c) Dr. Salary a/c and Cr. Outstanding salary a/c ₹6,000
    (d) Dr. Cash a/c and Cr. salary a/c ₹6,000
40. What is the order in which the accounting transactions and events are recorded in the books?
    (a) Journal, Subsidiary books, Ledger and Trial Balance.
    (b) Ledger, Journal, Ledger, and Trial Balance.
    (c) Subsidiary books, Ledger and Trial Balance and Journal.
    (d) Profit and loss account, Ledger, Balance sheet, Journal.
41. The two amount columns in double column cash book are
    (a) Cash and bank
    (b) Cash and discount
    (c) Bank and discount
    (d) None of the above
42. The error caused because of the failure to differentiate between capital and revenue expenditures and capital and revenue receipts is
    (a) compensatory errors
    (b) errors of commission

(c) errors of omission

(d) errors of principle

43. ₹5,00,000 spent on advertising to introduce a new line of product is______.

(a) Capital expenditure.

(b) Revenue expenditure.

(c) Deferred revenue expenditure.

(d) None of the above.

44. When a trial balance does not agree, the difference can be transferred to ____________

(a) Nominal account

(b) Personal account

(c) Real account

(d) Suspense account

45. Bank pass book is also known as ________

(a) Bank book.

(b) Bank account.

(c) Bank column.

(d) Bank statement.

46. Machinery costing ₹20,00,000 was purchased on 1.4.2013. The installation charges amounting ₹5,00,000 were incurred. The depreciation at 10% per annum on straight line method for the year ended 31st March, 2013 will be

(a) ₹2,50,000

(b) ₹2,00,000

(c) ₹50,000

(d) ₹1,50,000

47. Debit balance as per Cash Book of Yeti Enterprises as on 31.3.2013 is ₹20,000.Cheques deposited but not cleared amounts to ₹2,000 and Cheques issued but not presented of ₹4,000. Balance as per pass book should be

(a) 22,000.

(b) 18,000.

(c) 20,000.

(d) 24,000

48. In the books of Deepak Ltd. the machinery account shows a debit balance of ₹60,000 as on April 1, 2011. The machinery was sold on September 30, 2011 for ₹30,000. The company charges depreciation @ 20% p.a. on diminishing balance method. Profit / Loss on sale will be

(a) ₹13,200 Profit

(b) ₹13,200 loss

(c) ₹6,800 profit

(d) ₹6,800 loss

49. The balance sheet of Mr. Kapoor consists of Capital ₹7,00,000; Machinery ₹5,00,000 and cash ₹2,00,000. If he spends ₹5,000 to buy a cycle for personal use, the balance of capital account will be

(a) ₹7,00,000

(b) ₹6,95,000

(c) ₹7,05,000

(d) ₹1,95,000

50. Withdrawal of money by the proprietor is not an expense but a reduction of__________.

(a) Capital

(b) Liability

(c) Asset

(d) None of the above

51. If the rate of gross profit is 25% on cost of goods sold and the sales are ₹5,00,000, the amount of gross profit will be __________.

(a) ₹1,00,000

(b) ₹1,50,000

(c) ₹1,25,000

(d) ₹1,20,000

52. Internally generated goodwill is-

(a) shown in Trading account.

(b) shown in Profit and loss account.

(c) shown in Balance sheet.

(d) not recorded in the books.

53. If outstanding wages appears in the trial balance it is shown in __________

(a) Balance sheet only

(b) Both in balance sheet and profit and loss account

(c) Profit and loss account

(d) Trading account

54. Which of the financial statement represents the accounting equation?

(a) Manufacturing account

(b) Cash flow statement

(c) Balance sheet

(d) Profit and loss account

55. Capital expenses are recorded in the ________
    (a) Balance sheet.
    (b) Profit and loss account.
    (c) Trading account.
    (d) Manufacturing account.
56. Cost of floating by a company is an example of:
    (a) Wasting assets
    (b) Intangible assets
    (c) Fictitious assets
    (d) Liquid assets.
57. A & B are partners sharing profits and losses in the ratio 5:3 respectively. On admission of C, new profit sharing ratio between A, B and C is 7:5:4 respectively. Find the sacrificing ratio as between A and B.
    (a) 3:1
    (b) 4:7
    (c) 5:4
    (d) 2:1
58. Ram and Shyam are partners sharing profits and losses in the ratio of 3:2 respectively having the capital of ₹180,000 and ₹150,000 respectively. They are entitled to 10% p.a. interest on capital before distributing the profits. During the year firm earned ₹7,800 after allowing interest on capital. Profits apportioned among Ram and Shyam are:
    (a) ₹4,680 and ₹3,120.
    (b) ₹4,800 and ₹3,000.
    (c) ₹5,000 and ₹2,800.
    (d) ₹6,000 and ₹1,800
59. At the time of death of a partner, firm gets ________ from the insurance company against the Joint Life Policy taken jointly for all the partners.
    (a) Policy Amount.
    (b) Surrender Value.
    (c) Policy Value for the dead partner and Surrender Value for the rest.
    (d) Surrender Value for all the partners.
60. Preference shares amounting to ₹1,00,000 are redeemed at a premium of 5% from the profits of the company. The amount to be transferred to capital redemption reserve account will be
    (a) ₹1,05,000.
    (b) ₹1,00,000.
    (c) ₹95,000.
    (d) ₹90,000.

61. In the absence of any provision in the partnership agreement, the partners have right to receive interest on loan at
    (a) 12% p.a
    (b) 6 % p.a
    (c) 20% p.a
    (d) Nil
62. Total capital employed by a partnership firm is ₹1,00,000 and its average profit is ₹25,000. Normal rate of return is 20% in similar firms working under similar conditions. The firms earns super profit of:
    (a) ₹3,000
    (b) ₹5,000
    (c) ₹4,000
    (d) ₹2,000
63. A, B and C are equal partners. D is admitted to the firm for one-fourth share. D brings ₹20,000 capital and ₹5,000 for goodwill. The value of goodwill of the firm is
    (a) ₹10,000
    (b) ₹40,000.
    (c) ₹20,000.
    (d) ₹50,000
64. A company issued 5,000 10% Debentures of ₹100 each at 10% discount. All the debentures were subscribed and allotted by crediting 10% Debentures account with
    (a) ₹10,00,000.
    (b) ₹12,00,000.
    (c) ₹5,00,000.
    (d) ₹4,50,000.
65. Bajaj Ltd. issued 5,000 equity shares of ₹10 each payable as ₹2 on application, ₹3 on allotment, ₹2 on first call and the balance in the final call. The amount to be debited to bank account at the time of receipt of first call money will be
    (a) ₹30,000
    (b) ₹10,000
    (c) ₹40,000
    (d) ₹50,000.
66. Mr. Verma holding 1000 equity shares of ₹10/- each issued at a discount of 10% could not pay final call of ₹3.50 and his shares were forfeited. In the books of the company, shares forfeited account will be credited by
    (a) ₹2,500.
    (b) ₹5,500.
    (c) ₹3,500.
    (d) ₹2,000.

67. Making provision for bad debts in respect of doubtful debts is based on the convention of _______________

    (a) Consistency
    (b) Disclosure
    (c) Conservatism
    (d) Materiality

68. Preference shares can be redeemed only if they are

    (a) Partly paid up
    (b) Fully paid up
    (c) Both of the above
    (d) None of the above

69. If sales revenues are ₹4,00,000; cost of goods sold is ₹3,10,000, the gross profit is

    (a) ₹90,000.
    (b) ₹4,00,000.
    (c) ₹3,10,000.
    (d) ₹7,10,000

70. If Average Stock = ₹24,000. Closing stock is ₹6,000 more than opening stock then the value of closing stock will be

    (a) ₹24,000
    (b) ₹48,000
    (c) ₹20,500
    (d) ₹27,000.

PART B

71. Which of the following is not corroborative evidence?

    (a) Minutes of meetings;
    (b) Confirmations from debtors;
    (c) Information gathered by auditor through observation;
    (d) Worksheet supporting consolidated financial statements.

72. In case the directors fail to appoint first auditor(s), the shareholders shall appoint them at…………by passing a resolution:

    (a) A general meeting
    (b) First annual general meeting
    (c) Statutory meeting
    (d) Annual general meeting.

73. Balance sheet audit does not include:

    (a) Vouching of income expense accounts related to assets and liabilities;
    (b) Examination of adjusting and closing entries;

(c) Verification of assets and liabilities;

(d) Routine checks

74. Which of the following statements is, generally, correct about the reliability of audit evidence:

(a) To be reliable, evidence should be conclusive rather than persuasive;

(b) Effective internal control system provides reliable audit evidence;

(c) Evidence obtained from outside sources routed through the client;

(d) All are correct.

75. Which of the following statement is true regarding an auditor's working papers:

(a) They document the level of independence maintained by the auditor.

(b) They should be considered as the principal support for the auditor's report

(c) They should not contain details regarding weaknesses in the internal control system.

(d) They help the auditor to monitor the effectiveness of the audit firm's quality control procedures.

76. Cost Audit is related to:

(a) Cost accounting records;

(b) Compliance

(c) Financial statements

(d) Balance and Profit & Loss Account

77. The current file of the auditor's working papers, generally, should include:

(a) A flowchart of the internal controls

(b) Organization charts

(c) A copy of financial statements

(d) Copies of bond and debentures

78. When an independent auditor relies on the work of an internal auditor, he or she should:

(a) Examine the scope of internal auditor's work

(b) Examine the system of supervising, review and documentation of internal auditor's work.

(c) Adequacy of related audit programme

(d) All of the above

79. Appropriateness of evidence depends on the following:

(a) Information must be reliable

(b) Information must be affordable

(c) Information must be relevant

(d) Information must be valid.

80. One of the following is not an advantage of maintaining working papers:

(a) Working papers helps in proper planning and performance of audit

(b) It provides as evidence of the audit performed to support the auditor's opinion

(c) Seniors can supervise the audit work performed by juniors by examining the working papers.

(d) Working papers acts as morale check on client staff.

81. Which of the following is not the objective of internal audit:
    (a) To keep proper control over business activities;
    (b) To evaluate accounting system
    (c) To report to the owners and outsiders
    (d) To evaluate the internal check system
82. Primary responsibility for the adequacy of financial statement disclosures rest with the:
    (a) Auditor
    (b) Management
    (c) Auditor's staff
    (d) Central Government
83. Who can be appointed as an auditor of the company:
    (a) Body corporate
    (b) A person who has indebted for more than Rs.1,000
    (c) An officer of the company
    (d) A partner of a firm
84. Secretarial audit is also termed as:
    (a) Financial audit
    (b) Compliance audit
    (c) Operational audit
    (d) Tax audit
85. For Tax Audit the specified limit given under Income Tax Act, 1961 for a person carrying on business shall be:
    (a) ₹40,00,000
    (b) ₹15,00,000
    (c) ₹60,00,000
    (d) ₹50,00,000
86. Cost Audit is compulsory for:
    (a) Specified entities
    (b) Specified industries
    (c) All Companies
    (d) All manufacturing companies.
87. ______________________ of the Companies Act, 2013 contains provisions regarding the appointment of the auditor.
    (a) Section 140
    (b) Section 141
    (c) Section 139

(d) Section 142

88. The quality of auditor to be free from influence is being defined by which term:
    (a) Self-Control
    (b) Objective
    (c) Independence
    (d) Unbiased.

89. Auditor has to obtain___________ audit evidence:
    (a) Adequate
    (b) Correct
    (c) Relevant
    (d) Sufficient and appropriate.

90. Which of the following statement is not true:
    (a) A partnership firm can be appointed as a statutory auditor of a limited company.
    (b) Appointment may be made in the name of the firm.
    (c) Majority of the partners should be practicing in India.
    (d) All partners should be Chartered Accountants.

91. If a casual vacancy in the office of auditor arises by his resignation it should only be filled by the company in a _______________
    (a) Board's meeting
    (b) Extraordinary general meeting
    (c) General meeting
    (d) Annual general meeting.

92. ___________ refers to the method and means adopted by the auditor for collection and evaluation of audit evidence in different audit situation:
    (a) Audit evidence
    (b) Audit tools
    (c) Audit planning
    (d) Audit technique.

93. The objective of an audit of financial statement is to enable an auditor to__________ on financial statements.
    (a) Completion of Audit
    (b) Express on opinion
    (c) Check the transactions
    (d) Check fraud.

94. A Company Secretary in Practice has been authorized under Section 2(2)(c)(v) of the Company Secretaries Act, 1980 to conduct :

(a) VAT Audit

(b) Secretarial Audit

(c) Cost Audit

(d) Bank Audit

95. The auditor of a Government Company is appointed by the ______________.

(a) Comptroller and Auditor General of India.

(b) The shareholder in a general meeting.

(c) The shareholder at an annual general meeting.

(d) The board of directors.

96. Who appoints internal auditor:

(a) Management

(b) Shareholders

(c) Government

(d) Stock Exchange

97. Due to lack of audit evidence, auditor issues a:

(a) Qualified opinion

(b) Unqualified opinion

(c) Adverse opinion

(d) Disclaimer of opinion

98. Which types of audit is conducted by the internal audit staff:

(a) Cost Audit

(b) Secretarial Audit

(c) Internal Audit

(d) Tax Audit

99. Who will be responsible for errors in report if external audit relies on the work of internal auditor:

(a) External auditor

(b) Internal auditor

(c) Management

(d) Shareholders

100. Weakness in internal control system ________________ the risk of fraud and errors:

(a) Increases

(b) Decreases

(c) Does not effect

(d) Eliminates

ANSWERS

Part A

1. (d)
2. (d)
3. (c)
4. (c)
5. (c)
6. (b)
7. (a)
8. (a)
9. (c)
10. (b)
11. (c)
12. (a)
13. (c)
14. (d)
15. (b)
16. (b)
17. (b)
18. (b)
19. (b)
20. (d)
21. (c)
22. (d)
23. (b)
24. (c)
25. (d)
26. (a)
27. (b)
28. (c)
29. (a)
30. (b)
31. (b)
32. (b)
33. (b)
34. (b)
35. (c)
36. (a)
37. (a)
38. (c)
39. (c)
40. (a)
41. (b)
42. (d)
43. (c)
44. (d)
45. (d)
46. (a)
47. (a)
48. (b)
49. (b)
50. (a)
51. (a)
52. (d)
53. (a)
54. (c)
55. (a)
56. (c)
57. (a)
58. (a)
59. (a)
60. (b)
61. (b)
62. (b)
63. (c)
64. (c)
65. (b)
66. (b)
67. (c)
68. (b)
69. (a)
70. (d)

Part B

71. (d)
72. (a)
73. (c)
74. (d)
75. (b)
76. (a)
77. (c)
78. (d)
79. (c)
80. (d)
81. (c)
82. (b)
83. (d)
84. (b)
85. (c)
86. (d)
87. (c)
88. (c)
89. (d)
90. (d)
91. (c)
92. (d)
93. (b)
94. (b)
95. (a)
96. (a)
97. (d)
98. (c)
99. (a)
100. (a)