

Financial Accounting

COURSE CODE: SGB24CM101MC

Bachelor of Commerce (Honours)

Major Course



FOUR YEAR UG PROGRAMME
SELF LEARNING MATERIAL

SREENARAYANAGURU OPEN UNIVERSITY

The State University for Education, Training and Research in Blended Format, Kerala



Vision

To increase access of potential learners of all categories to higher education, research and training, and ensure equity through delivery of high quality processes and outcomes fostering inclusive educational empowerment for social advancement.

Mission

To be benchmarked as a model for conservation and dissemination of knowledge and skill on blended and virtual mode in education, training and research for normal, continuing, and adult learners.

Pathway

Access and Quality define Equity.

Financial Accounting

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Semester - I

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MESSAGE FROM VICE CHANCELLOR

Dear Learner,

It is with great pleasure that I welcome you to the Four Year BCom Programme offered by Sreenarayanaguru Open University.

Established in September 2020, our university aims to provide high-quality higher education through open and distance learning. Our guiding principle, 'access and quality define equity', shapes our approach to education. We are committed to maintaining the highest standards in our academic offerings.

Our university proudly bears the name of Sreenarayanaguru, a prominent Renaissance thinker of modern India. His philosophy of social reform and educational empowerment serves as a constant reminder of our dedication to excellence in all our academic pursuits.

The Four Year BCom Programme covers all relevant areas aligned with modern business practices and economic principles. We have incorporated the latest trends in commercial studies to ensure a comprehensive and up-to-date curriculum. Moreover, the programme encompasses flexible options for learners to choose from a range of Ability Enhancement Courses, Multi-disciplinary Courses, Value Added Courses, and Skill Enhancement Courses, complemented by discipline-oriented Advanced and Additional Advanced Courses.

Our teaching methodology combines three key elements: Self Learning Material, Classroom Counselling, and Virtual modes. This blended approach aims to provide a rich and engaging learning experience, overcoming the limitations often associated with distance education. We are confident that this programme will enhance your understanding of commercial principles and practices, preparing you for various career paths and further academic pursuits.

Our learner support services are always available to address any concerns you may have during your time with us. We encourage you to reach out with any questions or feedback regarding the programme.

We wish you success in your academic journey with Sreenarayanaguru Open University.

Best regards,



Dr. Jagathy Raj V.P.
Vice Chancellor
Sreenarayanaguru Open University

01-09-2024



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Introduction

Unit 1

Introduction to Accounting

Learning Outcomes

After completing this unit, the learner will be able to:

- ◇ differentiate between book keeping and accounting
- ◇ gain insights on the concept of accounting
- ◇ identify the advantages and disadvantages of accounting
- ◇ understand on the concept of Generally Accepted Accounting Principles

Prerequisites

In a bustling city, a fair was taking place, attracting a large crowd. Mr. Raj and Mr. Kiran decided to set up a stall selling handcrafted jewellery. They purchased eight different designs, with 100 pieces each, from a local artisan and brought them to the fair. Sales were brisk, but amidst the flurry of activity, they forgot to keep track of their transactions. At the end of the day, when they counted the cash they had collected, they were left puzzled: What was the cost of each item they bought? How many pieces were sold? How many were left unsold? What expenses did they incur? And how much profit did they make?

This confusing situation could have been avoided if they had systematically recorded all their purchases, sales, and expenses. By doing so, they could have easily determined the purchase price of each item, the number of units sold, the unsold stock, the total expenses, and the profit they earned. As businesses grow and the volume of transactions increases, it becomes increasingly difficult for owners to remember every detail. This is where accounting becomes crucial. Accounting provides the tools to calculate and understand a business's profit or loss. It follows

specific rules and standards to ensure that financial information is accurate and reliable.

Keywords

Book keeping, Accounting, Accounting concepts, Accounting conventions, GAAP

Discussion

1.1.1 Accounting- Meaning and Definition

Accounting is the language used to communicate the financial information of business to its stakeholders like owners, creditors, employees, government and society. Accounting came into force to support human memory by recording business transactions. We can consider accounting as an information system because it receives, processes, and converts financial data into useful information.

According to American Institute of Certified Public Accounts (AICPA), “Accounting is the art of recording, classifying and summarizing in a significant manner and in terms of money, transactions and events which are, in part at least, of a financial character, and interpreting the result thereof.”

1.1.2 Process of Accounting

The process of accounting is as follows:

i. Recording

Recording business transactions is the first and most basic function of accounting. This is done in a book called the "Journal." Business transactions are classified into two types:

- i. External transactions: These involve the exchange of something valuable between two or more entities. Examples include purchasing raw materials from suppliers and selling goods to customers.
- ii. Internal transactions: These refer to events that occur within the enterprise, such as transferring materials from the stores department to the production department or providing stationery items to different departments.

ii. Classifying

The recorded transactions are classified based on their nature. Similar transactions are grouped together in a book called the "Ledger."

iii. Summarizing

The classified data is presented in a way that is understandable and useful to various users of accounting information, such as management, owners, creditors, and bankers. This process involves preparing an income statement to show the profit or loss of the business for a specific period and a position statement to show the assets and liabilities of the business on a specific date.

iv. Analysis and interpretation

The summarized financial data are analysed and interpreted so that users can make meaningful judgements about the financial position and operational results of the business.

v. Communication

After meaningful analysis and interpretation, accounting information needs to be communicated properly to the appropriate individuals. This is done by preparing and distributing accounting reports, such as accounting ratios, graphs, diagrams, etc.. Accounting is often referred to as the language of business because of this communication aspect.

Book keeping

Business owners are highly concerned about the growth and progress of their businesses. However, it becomes challenging for them to remember all the transactions associated with their business. Therefore, it is crucial to maintain proper records of these transactions. This is where book keeping comes in. Book keeping involves systematically recording business transactions in a set of books. It is a clerical task that serves as the foundation for accounting. The main purpose of book keeping is to create permanent records of business transactions, providing a reliable basis for financial analysis.

"Book keeping is the process of analysing, classifying and recording transactions in accordance with a preconceived plan".

- Kohler

The first three steps of accounting, namely recording, classifying, and summarizing business transactions, are referred to as book keeping.

1.1.3 Scope of Accounting

The main branches of accounting are financial accounting, management accounting, and cost accounting.

i. Financial accounting

Financial accounting involves the preparation and presentation of financial statements, such as Balance Sheets, Income Statements, and Cash Flow Statements. Its primary focus is to provide external stakeholders, such as investors, creditors, and regulators, with accurate and reliable information about the financial performance and position of an organisation. Financial accounting follows either Generally Accepted Accounting Principles (GAAP) or International Financial Reporting Standards (IFRS) to ensure consistency and comparability in financial reporting.

ii. Management accounting

Management accounting provides information to internal stakeholders, primarily management, to support decision making and operational control. It involves activities such as budgeting, cost analysis, variance analysis, and performance measurement. The goal of management accounting is to help managers plan, evaluate, and monitor the financial aspects of their organisation. Unlike financial accounting, which focuses on historical data, management accounting often includes forward looking information and is more flexible in adapting to the specific needs of management.

iii. Cost accounting

Cost accounting focuses on analysing, recording, and controlling costs associated with the production of goods or services. It involves classifying and allocating costs to different cost centres, such as departments or products, to determine their profitability and efficiency. Cost accountants track costs related to direct materials, direct labour, overhead, and other cost elements. This information is used by managers to make decisions about pricing, budgeting, and cost control. Cost accounting provides insights into the cost structure of a company, allowing management to optimise resources and improve cost effectiveness.

1.1.4 Characteristics of an Account

- ◇ Systematic and comprehensive: Accounting follows a structured approach and covers all financial transactions and events in an organised manner.

- ◇ Quantitative and monetary: Accounting records and measures financial information using monetary units to facilitate meaningful comparison and analysis.
- ◇ Historical in nature: Accounting primarily deals with past transactions and events, providing a historical perspective of an organisation's financial performance.
- ◇ Objective and reliable: Accounting aims to provide accurate and unbiased information based on verifiable evidence and Generally Accepted Accounting Principles.
- ◇ Relevant and timely: Accounting information should be pertinent to decision making and should be available in a timely manner to support effective planning and control.
- ◇ Legal and regulatory compliance: Accounting must adhere to legal requirements and regulatory frameworks to ensure transparency and accountability in financial reporting.
- ◇ Confidential and secure: Accounting information should be treated as confidential, ensuring that it is accessible only to authorised individuals and protected from unauthorised disclosure or manipulation.

1.1.5 Advantages of Accounting

- ◇ Decision making tool: Accounting serves as a valuable tool for decision making by providing relevant financial information. For instance, a company can analyse its financial statements to determine the profitability of different product lines and make informed decisions about resource allocation and pricing strategies.
- ◇ Overcoming memory limitations: By recording business transactions, accounting helps overcome the limitations of human memory. The books of accounts provide a reliable record of financial information, ensuring that important data is accessible at all times. For example, a company can refer to its sales records to track customer payments and outstanding balances.
- ◇ Comparing profit over time: Accounting allows for the comparison of profits across different years, enabling businesses to assess their progress and make informed decisions. For instance, by analysing the financial statements of previous years, a company can evaluate its growth rate and identify areas where it may need to make strategic changes.
- ◇ Tax compliance: Accounting records provide accurate information about the amount of tax levied on sales (Goods and Service Tax - GST) and the profit of the business (corporate tax). This facilitates compliance with tax regulations. For example, a company can refer to its accounting records to calculate the correct amount of GST payable and ensure timely and accurate tax reporting.
- ◇ Business valuation: Accounting enables the determination of the value of assets, liabilities, and the purchase price of a business. This information is crucial

in cases where a business is sold or undergoing a merger or acquisition. For instance, potential buyers can review the financial statements of a business to assess its financial position and make informed decisions regarding its value.

- ◇ Legal validation: In the event of a dispute, accounting records can be presented as evidence in court to support and validate the arguments of a business. For example, if there is a disagreement over financial transactions or contractual obligations, presenting the account books can help clarify and resolve the dispute.

1.1.6 Limitations/Disadvantages of Accounting

- ◇ Accounting is a post-mortem analysis: What happened in the business is examined through accounting; that is, the amount spent on a particular item of expenditure and the income of a particular source is recorded. But no information for controlling expenditure or increasing an income is mentioned.
- ◇ Only monetary transactions come under the purview of accounting: Non-monetary transactions like the sincerity and hardwork of employees, efficiency of management, etc. do not have a place in accounting.
- ◇ It does not consider the price level changes: As per the rule of accounting, fixed assets are to be shown on the asset side of the Balance Sheet at cost less depreciation. Therefore, it never shows the current market value of the asset. Hence the Balance Sheet will not show a true and fair view of the state of affairs of the business.
- ◇ Based on estimation: Accounting is based on estimation also. For example, there are different methods for providing depreciation. A particular method can be chosen by an accountant normally unless otherwise there are some legal restrictions. In no case, the amount of depreciation charged and debited to the Profit and Loss Account is the exact amount because the exact life of an asset, its estimated scrap value, etc. cannot be predicted in advance. Accounting is based on certain principles and concepts.

1.1.7 Users of Accounting Information

The users of accounting information are categorised into two:

- ◇ External users: Those parties such as creditors, government, banks, etc. show a keen interest in knowing the financial position of the company. They make use of the published financial statements of the company since they do not have access to the records of the company.
- ◇ Internal users: Those parties which are internal to the organisation and make use of the accounting information for planning, decision making, controlling, etc. They include the top level, middle level and bottom level management which make use of the reports of the company to obtain accounting information.

1.1.8 Generally Accepted Accounting Principles (GAAP)

The financial accounts prepared by various business undertakings have similar pattern and uniformity because they follow certain guidelines or practices which are generally accepted. These guidelines or practices complied with the preparation of financial accounts are known as accounting principles and standards. Accounting Standards are the authoritative base for the preparation and presentation of the financial statement of the concern. Let us examine these in detail in the coming section.

GAAP means Generally Accepted Accounting Principles. It involves standards, rules, and conventions that are helpful for the preparation and presentation of financial statements of companies. GAAP is introduced by Financial Accounting Standards Board (FASB).

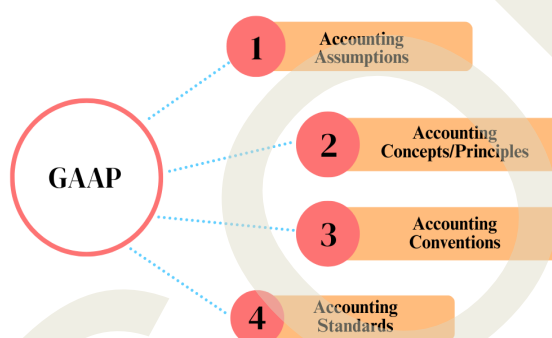


Figure 1.1.1
Generally Accepted Accounting Principles

1.1.8.1 Accounting Assumptions

These are a set of assumptions related to business and accounting transactions that are helpful for recording transactions.

i. Business entity concept

A business has a separate existence apart from the entity of the proprietor. From the point of view of accounting, the owner of a business is treated as a stranger. The only relationship between the owner and business is that the business has borrowed some money from a businessman, which may be technically called capital or share capital. The business is projected and transactions are recorded from the point of view of the business and not from the point of view of the owner. He is treated just like a creditor. This concept is also called the separate entity concept.

ii. Money measurement concept

Business transactions, measured in terms of money, can only be recorded in the books of accounts. Therefore, non-monetary transactions, such as sincerity of workers, quality of goods manufactured, reputation, the efficiency of manager, etc. cannot be recorded in the books of accounts. For example, the health of the owner of the business, the quality of products of the firm, and the qualifications of employees cannot be expressed in terms of money and, therefore, are not recorded in the books of account.

On the basis of this concept, only those transactions are recorded in accounts that can be expressed in terms of money. Money is a common denominator. With the help of money, diverse items can be added together. The total value of assets, such as raw materials, machinery, land and buildings, furniture and fixtures, etc. can be measured in terms of money. Thus, the money measurement concept helps to make accounting records homogeneous, relevant, simple, and understandable.

iii. Going concern concept

This concept states that a business has an indefinite life, as a result of which, the fixed assets of a business are not meant for resale in the immediate future, but used in the business for a long period. Therefore, there is no question of considering the current market value of fixed assets. Hence fixed assets are shown on the asset side of the Balance Sheet at cost less depreciation. It is never shown in its current market value. This concept is called the going concern concept. A firm is said to be a going concern when there is neither the intention nor the necessity to wind up its affairs. In the absence of this assumption, no outside parties would enter into long term contracts with the firm for supplying funds and goods. This assumption also justifies the distinction between fixed assets and current assets. The going concern concept also implies that the existing liabilities will be paid at maturity. Unsold stock of goods is taken to the next year.

iv. Accounting period concept

A business has an indefinite life; therefore, the exact profit or loss can be calculated only after its life, which is not possible and useful. The life of a business is divided into accounting periods that depends upon the nature of the business. Usually, a business calculates profit or loss once in every year. The segment or time interval is called the accounting period. This concept is called the accounting period concept. Under tax laws, the accounting period starts on 1 April and ends on 31 March next year.



1.1.8.2 Accounting Concepts/Principles

i. Dual aspect concept

Double-entry book keeping is based on this concept. In every business transaction, there are two aspects; receiving and giving aspect. In order to make a complete record of business transactions, both receiving and giving aspects must be recorded. From this concept, the accounting equation, $\text{Asset} = \text{Capital} + \text{Liabilities}$ is raised. According to this principle, every business transaction has a double (dual) effect on the business. This double effect can be recognised only by recording both aspects of every transaction. There are two aspects for every transaction represented in the form of an account. If one account is debited, another account must be credited, and vice-versa. The system of recording transactions on this principle is known as the 'Double-Entry System'. It is due to this principle that the two sides of the Balance Sheet are always equal.

ii. Cost concept

As per the cost concept, a business transaction should be recorded in the books of accounts at its cost price. It will be the base for all the subsequent accounting and therefore, this concept is closely related to the going concern concept.

iii. Revenue realisation concept

This concept discusses the time when the revenue is realised. The period of time of realisation of income is very significant for calculating the profit. As per this concept, the revenue is realised by a concern when the goods or services are actually delivered to the customers. It is immaterial whether the revenue is received in cash or not.

Cash basis and accrual basis are two different methods of accounting used to record and report financial transactions in a business. The main difference between the two lies in the timing of recognising revenues and expenses. In cash basis accounting, transactions are recorded only when cash is received or paid. Revenue is recognised when cash is received, and expenses are recorded when cash is paid. In accrual basis accounting, transactions are recorded when they occur, regardless of the timing of cash flow. Revenues are recognised when they are earned, and expenses are recorded when they are incurred, regardless of when the cash is received or paid.

iv. Matching concept

Matching concept states the matching of incomes with expenses of a particular accounting period. According to this principle, the cost of a particular period should

be charged from the revenue of the same period only. Only such matching of cost and revenue can reveal the true profit and loss for a period. Revenue must be ascertained first for a period and then the cost of that period should be charged to it. When cost is associated with a particular product or service, revenue earned from that product or service should be matched to its cost. This principle provides guidelines as to how the expenses are to be matched with revenue. It requires that in determining the net profit, all costs which are applicable to revenue of that period should be charged against that revenue.

v. Verifiable object concept

For recording transactions in the accounting books, there must have some solid proof of documents, such as invoices, bills, vouchers, cash memos, etc. supporting the transactions, which serve the purpose of evaluating the authenticity of transactions. This concept is called the verifiable object concept.

vi. Principles of timeliness

This principle states that accounting information through financial statements must be delivered to the users in the right time. Delayed information has no use and is considered as denied information.

1.1.8.3 Accounting Conventions

Accounting conventions are the customs and traditions used in accounting that give guidelines for the preparation of accounting statements and reports. These are the general rules and regulations used in accounting practices which are modified from time to time in accordance with the changing needs of the business.

i. Convention of full disclosure

This principle states that all relevant information must be shown in the financial statement and communicated to the stakeholders in some specific mode so as to give maximum information. Adequate information in the financial statement makes more validity to the users.

ii. Convention of materiality

This principle is a contradiction to the principle of full disclosure. According to this principle, only those facts which are material and significant need to be shown in the accounting statement and report. According to this principle, items having an

insignificant effect or irrelevant to the user need not be disclosed.

iii. Convention of conservatism

This principle makes the financial statement more reliable and accurate. It is stated that all anticipated losses should be considered, but all anticipated income should be fully neglected for calculating profit.

iv. Convention of consistency

This principle implies that a particular accounting method once adopted by a firm should not be changed from time to time to facilitate the comparison of accounting information between two periods. For example, if different depreciation methods are adopted in different accounting years, comparison of profit is very difficult and as a result, it will not be useful for the end users. It does not mean that a particular method of accounting should never be changed.

Recap

- ◇ Accounting - Record, classify, analyse, interpret and ascertain the result.
- ◇ GAAP - Standardised accounting rules.
- ◇ Cost principle - Original acquisition cost recorded.
- ◇ Matching principle - Match expenses with related revenues.
- ◇ Conservatism principle - Caution in recognising gains/losses.
- ◇ Materiality principle - Significance determines financial statement disclosure.
- ◇ Going concern concept - Assume business continuity for reporting.
- ◇ Consistency principle - Uniformity in accounting methods.
- ◇ Revenue recognition principle - Record revenue when earned.
- ◇ Entity concept - Separate entity from owners.
- ◇ Full disclosure principle - Disclose all relevant financial information.
- ◇ Historical cost principle - Record assets at original cost.

Objective Questions

1. What does GAAP stand for in accounting?
2. Which accounting principle recognises revenue when it is earned and expenses when they are incurred?
3. What is the main objective of the cost principle in accounting?
4. Which principle requires that expenses should be matched with the related revenues in the same accounting period?
5. What is the significance of the materiality principle in financial reporting?
6. Which concept assumes that a business will continue its operations for the foreseeable future?

7. What does the entity concept in accounting emphasise?
8. What is the concept which states that only monetary transactions can be recorded in accounting?

Answers

1. Generally Accepted Accounting Principles.
2. Accrual basis.
3. To record assets at their original acquisition cost.
4. Matching principle.
5. It determines the disclosure of financial information based on its significance or impact.
6. Going concern concept.
7. It separates the financial affairs of a business from the personal affairs of its owners
8. Money measurement concepts.

Self-Assessment Questions

1. Explain accounting assumptions.
2. What is the relevance of GAAP in accounting?
3. What are the uses of accounting?
4. What is the importance of accounting in business?
5. What is the role of financial statements in accounting?
6. How does the accrual basis of accounting differ from the cash basis?

7. How does the concept of materiality affect financial reporting?
8. How do accounting assumptions impact financial statements?

Assignments

1. Imagine you are a financial analyst of a company. Analyse a real-world case study and apply the principles of accrual accounting to assess the company's financial performance, including revenue recognition, expense matching, and the impact of materiality. Provide recommendations for improving financial reporting based on your analysis.
2. Choose a specific accounting principle (e.g., conservatism, cost principle, matching principle) and explain its significance in financial reporting. Discuss how the application of this principle affects the quality and reliability of financial information for decision making.
3. Discuss the concept of double-entry book keeping and explain how it helps to maintain the accuracy of financial records.
4. Investigate the role of accounting information in managerial decision making process. Provide examples of how accounting data can be used to support strategic planning and control.
5. Evaluate the importance of Generally Accepted Accounting Principles (GAAP) in financial reporting. Explain how GAAP ensures consistency, comparability, and transparency in financial statements. Provide examples of how GAAP is applied in practice.

Suggested Readings

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Unit 2

Accounting Standards

Learning Outcomes

After learning this unit, the learners will be able to:

- ◇ understand the meaning of Accounting Standards
- ◇ gain insights on the importance of Accounting Standards
- ◇ describe the limitation of Accounting Standards
- ◇ identify various standard-setting bodies in India and the standard setting procedures

Prerequisites

Imagine a scenario where a manufacturing company, TechCorp, has multiple divisions operating in different regions. Each division follows varying accounting practices, resulting in inconsistent financial statements. This lack of standardisation creates challenges in accurately assessing the company's overall financial performance and making informed decisions. By studying Accounting Standards under GAAP (Generally Accepted Accounting Principles), individuals can comprehend the prescribed rules and guidelines for financial reporting. Implementing Accounting Standards ensures uniformity in TechCorp's financial statements, enabling reliable consolidation and facilitating effective decision making by providing consistent and comparable financial information. Ultimately, a thorough understanding of GAAP empowers individuals to establish financial reporting practices that enhance transparency, credibility, and the overall financial management of the company.

Keywords

Accounting Standards, Standard Setting Bodies, Accounting Standards Board, Ind AS

Discussion

1.2.1 Introduction to Accounting Standards

Accounting Standards are the rules, regulations, and guidelines based on the methods and principles of accounting practices. The main object of Accounting Standards is to facilitate inter and intra-firm comparison and uniformity in financial reporting in the national and global levels.

There are certain universally accepted accounting policies and practices to maintain the accounting policies to be followed in the preparation of financial statements throughout the world. This principle is formulated for following universally accepted accounting practices. These standardised accounting policies and practices are called Accounting Standards.

According to T P Ghosh, “Accounting Standards are the policy documents issued by the recognised expert accountancy body relating to various aspects of measurement, treatment, and disclosure of accounting transactions and events.”

1.2.2 Objectives of Accounting Standards

The core concept behind Accounting Standards revolves around achieving uniformity in accounting policies and practices across different businesses. This aims to standardise the varied accounting practices used for different aspects of accounting. The main objectives of Accounting Standards are as follows:

- i. Eliminating the lack of comparability among financial statements, thereby enhancing the reliability of financial reporting.
- ii. Establishing a set of standardised accounting policies, valuation norms, and disclosure requirements.

By reducing the range of accounting options within reasonable limits, Accounting Standards ensure that the financial statements of different companies can be compared effectively.

1.2.3 Importance/Advantages of Accounting Standards

- ◇ To give information relating to the area in which the Accounting Standard is to be developed.
- ◇ To standardise and simplify accounting policies and practices.
- ◇ To interpret the Accounting Standard.
- ◇ To examine the extent of adoption of international Accounting Standards at the time of formulating Accounting Standard.
- ◇ To simplify the accounting practices.

1.2.4 Limitations of Accounting Standards

Accounting Standards are used as the prominence of accounting principles. There are certain limitations to Accounting Standards. The Accounting Standard regulatory bodies frequently update the standards to overcome these limitations. Some of the limitations are:

- ◇ **Subjectivity:** Accounting Standards involve judgement and interpretation, which can introduce subjectivity into the financial reporting process. Different accountants or companies may interpret standards differently, leading to inconsistencies in reporting.
- ◇ **Complexity:** Accounting Standards can be complex and technical, requiring significant expertise and knowledge to understand and apply correctly. This complexity can make it challenging for small businesses or non-accounting professionals to comply with the standards.
- ◇ **Lagging behind business practices:** Accounting Standards are typically developed and updated at a slower pace compared to the rapidly evolving business environment. As a result, the standards may not always reflect emerging business models, transactions, or economic realities accurately.
- ◇ **The difficulty in choosing alternatives given in the Accounting Standard:** There are different alternatives for treatment for some items like valuation of stock under LIFO, FIFO method, etc.. The Accounting Standards do not provide rules for the appropriate choice. Therefore, choosing between these alternatives is a threatening decision for the management.
- ◇ **Restricted scope:** Accounting Standards cannot supersede the laws or the statutes. They have to be framed within the limits of the laws prevailing at the time. That can limit their scope to offer the best policies for the situation.

1.2.5 Indian Accounting Standard

Indian Accounting Standards (Ind AS) are a set of Accounting Standards that are applicable to companies registered in India. These standards are based on the International Financial Reporting Standards (IFRS) issued by the International Accounting Standards Board (IASB).

The Ministry of Corporate Affairs (MCA) in India, in consultation with the National Advisory Committee on Accounting Standards (NACAS), adopted Ind AS to bring about convergence with the globally accepted Accounting Standards. The objective was to improve the transparency, comparability, and reliability of financial reporting in India.

Table 1.2.1

Indian Accounting Standards (Ind AS)

Accounting Standard	Title
Ind AS 1	Presentation of Financial Statements and Schedule III
Ind AS 2	Inventories
Ind AS 7	Statement of Cash Flows
Ind AS 8	Accounting Policies, Changes in Accounting Estimates and Errors
Ind AS 10	Events occurring after the Reporting Period
Ind AS 12	Income Taxes
Ind AS 16	Property, Plant and Equipment
Ind AS 19	Employee Benefits
Ind AS 20	Accounting for Government Grants and Disclosure of Government Assistance
Ind AS 21	The Effects of Changes in Foreign Exchange Rates
Ind AS 23	Borrowing Costs
Ind AS 24	Related Party Disclosures
Ind AS 27	Separate Financial Statements
Ind AS 28	Investments in Associates and Joint Ventures

Ind AS 29	Financial Reporting in the Hyperinflationary Economies
Ind AS 32	Financial Instruments – Presentation
Ind AS 33	Earnings Per Share
Ind AS 34	Interim Financial Reporting
Ind AS 36	Impairment of Assets
Ind AS 37	Provisions, Contingent Liabilities and Contingent Assets
Ind AS 38	Intangible Assets
Ind AS 40	Investment Property
Ind AS 41	Agriculture
Ind AS 101	First - Time Adoption of Indian Accounting Standards
Ind AS 102	Share - Based Payment
Ind AS 103	Business Combinations
Ind AS 104*	Insurance Contracts
Ind AS 105	Non-current Assets held for sale and discontinued operations
Ind AS 106	Exploration for and Evaluation of Mineral Resources
Ind AS 107	Financial Instruments: Disclosures
Ind AS 108	Operating Segments
Ind AS 109	Financial Instruments
Ind AS 110	Consolidated Financial Statements
Ind AS 111	Joint Arrangements
Ind AS 112	Disclosure of Interests in other Entities
Ind AS 113	Fair Value Measurement
Ind AS 114	Regulatory Deferral Accounts
Ind AS 115	Revenue from Contracts with Customers
Ind AS 116	Leases

* to be replaced by Ind AS 117 which is under formulation

1.2.6 Standard Setting Bodies in India

In India, the Accounting Standard setting bodies are responsible for developing and issuing Accounting Standards that govern the preparation and presentation of financial statements. The two primary bodies involved in Accounting Standard setting in India are:

- a) Accounting Standards Board (ASB): The ASB operates under the jurisdiction of the Institute of Chartered Accountants of India (ICAI), which is the regulatory

body for the accounting profession in India. The ASB is responsible for formulating Accounting Standards known as Indian Accounting Standards (Ind AS). These standards are in line with the International Financial Reporting Standards (IFRS) issued by the International Accounting Standards Board (IASB) and aim to improve the quality and comparability of financial reporting in India.

The Accounting Standard Board constituted a study group for studying the area and the subject where Accounting Standards are formulated. The ASB conducted meetings with representatives of various parties, such as the Government, industries, etc. for learning their ideas and views. The study groups of the ASB, presented draft proposing Accounting Standard to the ICAI and the general public. After gathering the opinion of members of ICAI and public, the ASB finalised the Accounting Standard and submitted to the council of ICAI and thereafter the council notified and published the Accounting Standard

b) National Advisory Committee on Accounting Standards (NACAS): NACAS is an advisory body constituted by the Ministry of Corporate Affairs (MCA) in India. Its primary role is to advise the Central Government on matters related to the formulation and implementation of accounting policies and standards. NACAS assists in the adoption of Indian Accounting Standards (Ind AS) and provides recommendations on any amendments or modifications to existing Accounting Standards.

These Accounting Standards setting bodies in India play a crucial role in establishing and maintaining high-quality Accounting Standards that ensure transparency, consistency, and comparability in financial reporting across various entities in the country.

1.2.7 Formulation of Accounting Standard

The procedure for framing Accounting Standards involves a systematic and collaborative approach to ensure the development of high quality standards that meet the needs of the accounting profession and stakeholders. The general steps involved in the procedure for framing Accounting Standards are as follows:

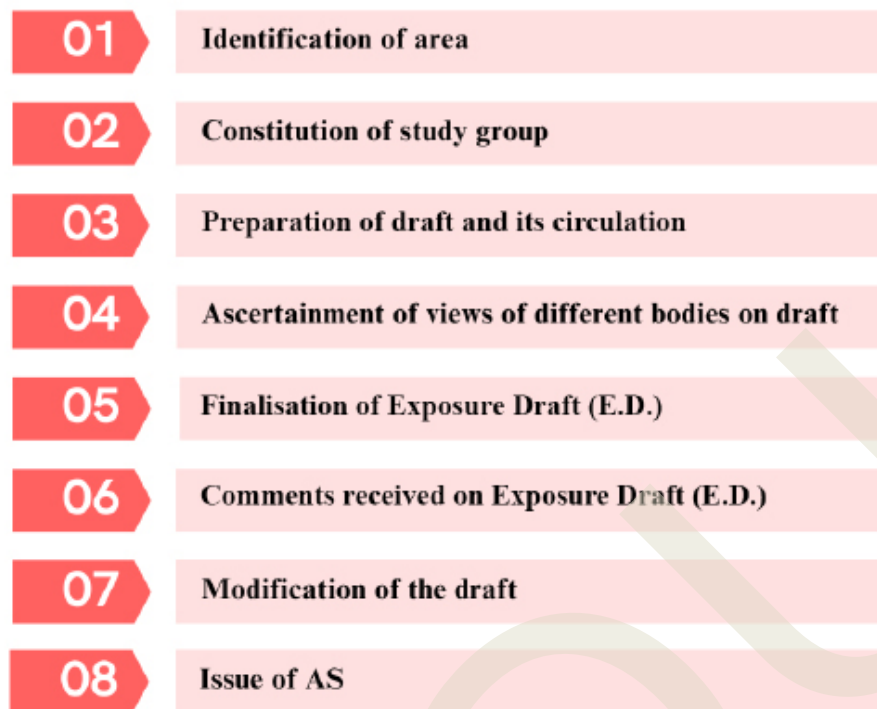


Figure 1.2.1
Formulation of Accounting Standards

Recap

- ◇ Accounting Standards- Universally accepted accounting policies and practices.
- ◇ Objective of AS- Achieve uniformity.
- ◇ Accounting Standards Board- Framing Accounting Standard in India.
- ◇ Ind AS- Applicable to companies registered in India.
- ◇ Ind AS- Improve transparency, comparability and reliability.
- ◇ Ind AS- Adopted by MCA.
- ◇ IFRS- Issued by IASB.
- ◇ Standard Setting Bodies in India - ASB, NACAS

Objective Questions

1. What are the objectives of Ind AS?
2. Identify the Board set up by ICAI for framing Accounting Standard in India.
3. In which year was the Accounting Standards Board constituted by the ICAI?
4. Which Indian Accounting Standard deals with the employee benefits?
5. Which Indian Accounting Standard deals with borrowing costs?
6. Which Indian Accounting Standard deals with income taxes?
7. Which Indian Accounting Standard deals with inventories?
8. Which Indian Accounting Standard deals with intangible asset?

Answers

1. Transparency, Comparability and reliability
2. Accounting Standards Board
3. 1977
4. Ind AS 19
5. Ind AS 23
6. Ind AS 12
7. Ind AS 2
8. Ind AS 38

Self Assessment Questions

1. Discuss the importance of Accounting Standards in financial reporting. How do they contribute to the comparability and reliability of financial statements?
2. What is the objective of the Indian Accounting Standards Board (IASB)?
3. How are Indian Accounting Standards (Ind AS) different from the previously used Accounting Standards (AS) in India?
4. Mention any three key advantages of adopting Indian Accounting Standards (Ind AS) for Indian companies?
5. What is the role of the Indian Accounting Standards Board (IASB) in the development and adoption of Ind AS?
6. How does the Indian Accounting Standards Board (IASB) ensure that Indian Accounting Standards (Ind AS) are aligned with International Financial Reporting Standards (IFRS)?
7. What are some of the major differences between Indian Accounting Standards (Ind AS) and International Financial Reporting Standards (IFRS)?
8. What is the process for the adoption and implementation of new Indian Accounting Standards (Ind AS) in India?

Assignments

1. Identify the Indian Accounting Standard of the following and explain how it is treated.
 - a. Earnings Per Share
 - b. Intangible assets
 - c. Consolidated financial statement
 - d. Business combination
 - e. Investment property



2. Discuss how Ind AS enhances financial reporting transparency and comparability.
3. Discuss the challenges faced and strategies used by the IASB in harmonising Indian accounting practices with global standards.
4. Investigate the process of adopting a new Indian Accounting Standard (Ind AS) in India. Explain the steps involved, including the consultation process, stakeholder engagement, and the role of the IASB.
5. Conduct a case study on a company in India that has recently transitioned from Accounting Standards (AS) to Indian Accounting Standards (Ind AS). Evaluate the impact of this transition on the company's financial statements and financial performance.
6. Select a recent amendment or new Indian Accounting Standard (Ind AS) introduced by the Indian Accounting Standards Board (IASB). Evaluate the reasons behind its implementation and analyse its impact on financial reporting and transparency in India.

Suggested Reading

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Unit 3

Accounting Process

Learning Outcomes

After completing this unit, the learners will be able to:

- ◇ familiarise with the various accounting terms
- ◇ prepare Journal and Ledger
- ◇ gain insights on the preparation of subdivisions of Journal
- ◇ check the arithmetical accuracy of books of accounts using Trial Balance

Prerequisites

Imagine you run a small business selling handmade crafts. Every day, you engage in various transactions such as purchasing materials, selling products, and paying expenses. To keep track of these financial activities, you maintain a set of essential accounting tools: the Journal, Ledger, and Trial Balance.

The Journal is where you record all business transactions in chronological order, providing a detailed account of each event. These transactions are then transferred to the Ledger, which organises them into individual accounts, allowing you to track balances and generate financial statements. Finally, the Trial Balance summarises the ledger account balances, ensuring that debits and credits are in balance and serving as an internal check for accuracy. By following this process, you can maintain accurate financial records to support decision making and analysis.

Keywords

Transactions, Account, Asset, Liabilities, Journal, Ledger, Trial Balance



1.3.1 Important Accounting Terms

i. Business transactions

Every day, there are numerous transactions in a business, which may be recorded in the books of accounts. For example, purchase of goods for cash, selling goods for cash, payment of wages, and receipt of cash from someone, etc. Transaction means the dealings of businessmen which have an impact on his business. It can be classified into two; cash transactions and credit transaction. If cash is paid at the time of the transaction, it is called a cash transaction. In a credit transaction, receiving and giving aspects do not take place simultaneously; either the receiving aspect or the giving aspect is postponed to a future date. Here, the name of the party is mentioned because the amount of the transaction is receivable or payable.

ii. Double-entry book keeping

In every transaction, there are two aspects; receiving aspects and giving aspects. Recognising as well as recording both these aspects in the books of accounts is called double-entry book keeping. It was introduced by an Italian mathematician named, Luca Pacioli in 1494. It is the scientific system of accounting. The underlining principle of double-entry book keeping is that for every debit, there is an equal and corresponding amount of credit.

iii. Entry

Entry means recording of transactions in the books of accounts.

iv. Debtor

In a business, credit transactions are very common. A debtor is a person who is indebted to another for some amount. That is a person who owes something of value to another. For example, Mr. A borrowed ₹1000 from Mr. B. Here, Mr. A is the debtor.

v. Creditor

A creditor is a person to whom something of value is due from another, In the above case, Mr. B is the creditor.

vi. Trade Debtors and Trade Creditors

In a business, it is common for goods to be sold and bought on credit. The customers who buy goods on credit are known as trade debtors, and the suppliers from whom goods are purchased on credit are called trade creditors.

vii. Account

Business transactions are numberless. The effect of transactions can be evaluated only if similar transactions are placed in a particular place. The technique used for this purpose is called Account. Account is the classified summary of all business transactions that have taken place during a particular period arranged in relation to a person, thing, expense or income. It is written in the form of 'T' having two equal sides; the left-hand side is called the debit side and the right-hand side is called credit side. Recording the effect of a transaction in the debit side of an account is called 'debiting' and recording the effect of a transaction on the credit side of an account is called 'crediting'.

In accounting, "Dr." stands for "debit," and "Cr." stands for "credit." These are abbreviations used to indicate the side of a ledger account where transactions are recorded.

Table 1.3.1

Form of Account

Name of the account

Dr.				Cr.			
Date	Particulars	J.F.	Amount	Date	Particulars	J.F.	Amount

Classification of Accounts

Accounts can be classified into three as per English approach. They are real account, personal account and nominal account.

a) Real account

Real accounts, usually referred to as permanent accounts, are the accounts with balances carried over from one accounting year to the next. In other words, the company's Balance Sheet's ending balance in one reporting year becomes the beginning balance of the following accounting year. Real accounts are accounts of properties, possessions, and things. Real accounts are types of accounts that deal with assets, such as machinery, cash, and furniture.

b) Personal account

Personal account are related to individuals or entities with which a business has financial transactions. They represent the people, organisations, or entities involved in those transactions. Personal accounts can be further divided as:

Natural personal accounts: These accounts represent specific individuals and are typically used for recording transactions with customers or suppliers. Examples include accounts of customers, suppliers, employees, and owners.

Example: If you sell goods to a customer on credit, the transaction would be recorded in a personal account called "Accounts Receivable" under the customer's name.

Artificial/Legal Entity Accounts: These accounts represent organisations or entities such as companies, banks, or government agencies. They are used to record transactions involving these entities.

Example: If your business takes out a loan from a bank, the transaction would be recorded in a personal account called "Bank Loan" under the name of the lending bank.

Representative personal accounts: These accounts include those accounts that represent natural or artificial persons such as outstanding expenses, accrued incomes etc.

c) Nominal account

Accounts which are neither personal nor real are called nominal accounts. These accounts are related to expenses, incomes, losses and gains. Nominal accounts are closed at the end of each accounting period to calculate the net income or net loss.

viii. Asset

An asset is an economic resource that is owned or controlled by a business or individual and is expected to provide future economic benefits.

Classification of Assets

Assets can be classified on the basis of physical form, permanency, and nature. On the basis of permanency, it can be classified into two; fixed assets and current assets. On the basis of physical form, it can be classified into two; tangible assets and intangible assets; on the basis of nature, it can be classified as wasting assets, liquid assets, and fictitious assets.

a) Fixed assets: These assets are purchased for the purpose of being used in the business for long term use. By using fixed assets, a business concern earns income. Example land, building, plant, machinery, etc..

b) Current assets: Current assets are those assets that can be easily converted into cash within a short period of time, say within one year. These assets are meant for subsequent conversion into cash. Example cash in hand, cash at bank, sundry debtors, stock, bills receivable etc..

c) Liquid asset: Liquid assets are assets either in the form of cash or which can be immediately converted into cash without much loss. Examples are cash in hand, cash at bank, marketable securities etc..

d) Tangible assets: Tangible assets are those assets that can be touched or have a physical form: one can see and feel, for example, building, stock, furniture, etc..

e) Intangible assets: Intangible assets are those assets having no physical form or existence but the possessor gets some right or privileges or advantages, for example, goodwill, trademark, patent rights, etc..

f) Wasting assets: These are a type of fixed assets, but the value becomes exhausted or reduced due to their usage or extraction. Examples of such assets are mines, oil wells, quarries, etc..

g) Fictitious assets: Fictitious assets are not assets in the real sense because no amount can be realised from these assets; by fulfilling the accounting principles and practices, these items are shown as assets on the asset side of the Balance Sheet, Examples, debit balance of Profit and Loss Account (loss), preliminary expenses, etc.



ix. Liabilities

Liability means the amount which a business is bound to pay either to the owners or outsiders. The amount payable by a business to outsiders is called external liability. Example: creditors, bills payable etc. The amount payable to the owner is called internal liability or internal equity or capital. On the basis of the nature and period of liability, it can be classified into current liabilities, fixed liabilities and contingent liabilities.

a) Current liability: Current liabilities are those liabilities which should be repaid within a period not exceeding one year. Examples are sundry creditors, bills payable, outstanding expenses, bank overdraft, etc.

b) Fixed liabilities: Fixed liabilities are otherwise called permanent liabilities, normally repayable beyond a period of one year. Such liabilities form part of a permanent source of finance and repayable at the time of closing down the business normally, except in the case of redeemable debentures and shares, term loans etc. Examples, are debentures, long term loans, etc.

c) Contingent liability: In simple words, contingent liability means a liability which may or may not arise in future upon the happening or non-happening of an uncertain event in future. Examples are a claim under suit, liability on account of discounted bill of exchange, etc.

x. Capital expenditure

Capital expenditure means expenditure incurred for purchasing a long term or fixed asset for permanent use in the business, and it also includes the amount spent for increasing the earning capacity of a fixed asset, for example, major repairs of a fixed asset. The benefit from such expenditure lasts for a long period of time. These assets are used in the business for earning income or revenue. Capital expenditures are non-recurring expenditures. Examples are land and building, plant and machinery, furniture, etc. These expenditures are shown on the asset side of the Balance Sheet.

xi. Revenue expenditure

Revenue expenditure means expenditure incurred for the day-to-day activities of the business, which are recurring in nature and the benefit from such expenditure is derived completely within that particular accounting year. Examples are salary, rent, wages, printing and stationery etc. Revenue expenditures are shown in the debit side of Trading or Profit and Loss Account.

xii. Deferred revenue expenditure

Deferred revenue expenditure means expenditure purely in the nature of revenue, but the benefit from such expenditure is extended beyond a period of one accounting year, for example, heavy amount of advertisement expenditure.

A signboard of a textile shop costs ₹50000 which has a life of 5 years. This revenue expenditure is not debited in the Profit and Loss Account completely in the year in which it is incurred. ₹10000 ($50000/5$) is debited to the Profit and Loss Account every year. After debiting the amount of ₹10000 each year in the Profit and Loss Account, the balance is shown in the asset side of the Balance Sheet. At the end of the 5th year, the expense is completely written off, and no amount is available to show in the Balance Sheet.

xiii. Capital receipts

Capital receipts mean the amount received mainly by way of raising capital, sale of a fixed asset or borrowing long term loans. Such receipts are not revenue income as they are not recurring in nature. Therefore, these receipts are not shown in the Profit and Loss Account but shown in the Balance Sheet.

xiv. Revenue receipts

Revenue receipt means recurring income mainly by way of sale of goods and services, indirect incomes like interest received, rent received, commission received, discount received, etc.. These incomes are recurring in nature and therefore credited to the Trading Account or Profit and Loss Account every year.

xv. Capital

Capital is the excess of assets over external liabilities. When a new business is started, capital is the total amount invested by the businessman in his business. Capital can be classified as:

a) Fixed capital

Fixed capital means that part of capital which is required for acquiring long term assets, such as land, building, plant, machinery, etc.. It is required for a long period of time; therefore, long term sources, such as issue of capital, long term loans, etc. may be considered.



b) Working capital

Working capital means that part of the capital required for the day-to-day activities of a business, such as the purchase of raw materials, payment of wages, etc.

xvi. Drawings

Drawings are the amount of cash or value of goods or assets taken by the businessman from his business for personal use.

1.3.2 Books of Accounts

The books of accounts of a company refer to the various registers or records where financial transactions are systematically recorded. These books play a crucial role in maintaining accurate and organised financial information for the company. Books of account consist of journal, ledger, Trial Balance, Cash Book etc..

1.3.3 Journal

The journal serves as the fundamental accounting record, where business transactions are initially documented. It is alternatively referred to as the books of original entry or daybook. Its name originates from the French term "jour," meaning a day, signifying its role as a book of daily records. In essence, the journal is an accounting book that chronologically records transactions in their original form, maintaining a day-to-day order.

Features

- i. Journal is a book of original entries.
- ii. Transactions are recorded in the journal as and when they occur, i.e., the record is chronological.
- iii. Journal is so ruled that all the transactions can be passed through it.
- iv. The process of recording transactions in the journal is called Journalising.

Table 1.3.2
Format of Journal
Journal

Date	Particulars	L.F.	Amount (Dr.)	Amount (Cr.)

A detailed explanation of the columns of the journal is given below:

Date

The first column of the journal is the date column. The year is entered first, and then it is followed by the month and date. Transactions are recorded in chronological order.

Particulars

This is the biggest column in the journal. The accounting element which is debited written in the first line and ends with 'Dr.'. Then the second accounting element is entered after leaving two or three letter spaces and starting with 'To'. The amount column is divided into debit and credit. The debit and credit amount are respectively recorded in the debit and credit amount columns. After recording the debit and credit accounting element, just below, a brief description of the transaction is given, which is called narration, within a bracket.

L.F. Column

The "L.F. column" in the journal refers to the "Ledger Folio" column. The Ledger Folio column is used to indicate the page number in the general ledger where the corresponding account is being posted. When a transaction is recorded in the journal, the account names are typically written in the "Account" column, and the respective ledger page numbers are noted in the "L.F." column. This helps to cross-reference and locate the specific ledger entries related to each transaction recorded in the journal.

Amount

The amount to be debited and credited to the accounts must be written in the debit and credit amount columns, respectively.

Journalising

Recording transactions in the journal is called Journalising. From the journal, posting is made to the respective ledger account.

Steps in Journalising

The first step in recording transactions in the books of accounts is Journalising. In order to journalise transactions, the following steps are involved:

- ◇ Identify the transactions
- ◇ Identify the two affected accounting element

- ◇ Classify the accounting element
- ◇ Apply the rules of debit and credit

a. Identify the transactions

The first step in the recording process is to identify the transaction; that is, whether the transaction is a cash or credit, or a barter transaction.

b. Identify the two accounting elements

How can we identify the accounting elements of cash transactions?

If the transaction is a cash transaction, one accounting element is a Cash Account. To know the second accounting element, ask a set of questions about the transaction. “For what purpose is the cash received or for what purpose is the cash paid?”. The answer will be the second accounting element. For example, selling goods for cash ₹500 is a cash transaction. Therefore, one accounting element is a Cash Account (A/c). For getting the second accounting element, ask the question to the transaction; for what purpose is the cash received or for what purpose is the cash paid? Here, cash is received for selling the goods. Therefore, the second accounting element is the Sales Account.

If no answer is obtained while asking the second question, ask another set of questions about the transaction. The question is “from whom the cash is received or to whom is the cash paid”? The answer will be the second accounting element. For example, paid Jacob ₹200 is a cash transaction. Therefore, one accounting element is a Cash Account. For getting the second accounting element, ask a set of questions about the transaction. “For what purpose is the cash received or for what purpose is the cash paid”? But no answer is obtained from this question. Therefore, ask the next set of questions to the transaction. “From whom the cash is received or to whom the cash is paid? Here, cash is paid to Jacob. Hence the second accounting element is Jacob’s Account.

How can we identify the accounting elements of credit transactions?

To know the two accounting elements of credit transactions, ask the following set of questions to the transaction. The answers will be the two accounting elements. “What is received or what is given and from whom the thing is received or to whom the thing is given”? For example, purchased furniture worth ₹555 from Sunil on credit is a credit transaction. For getting the accounting element, ask the question, “What is received or what is given and from whom the thing is received or to whom the thing

is given”? The answer to the question of what is received is furniture, and the answer to the question from whom the thing is received is Sunil. Therefore, the two affected accounting elements are the Furniture Account and Sunil’s Account.

How to identify the accounting elements of Barter transactions?

To know the two affected accounting elements of the Barter transaction, ask the following set of questions about the transaction. The answers will be the two accounting elements. “What is received or what is given and for what something is received or for what something is given”? For example, a table worth ₹1000 is exchanged for a chair of the same value. Here, the affected accounting elements are the Table Account and Chair Account.

c. Classify the accounting elements

Accounts are classified into real accounts, personal accounts, and nominal accounts as per the English approach. However, as per the American approach, accounts are classified into asset account, liability account, capital account, expenses and losses account, and incomes and gains account.

d. Apply the rules of debit and credit

English approach

Real account: Debit what comes in and credit what goes out.

Personal account: Debit the receiver and credit the giver.

Nominal account: Debit all expenses and losses and credit all incomes and gains.

American approach

Table 1.3.3
Rules for debit and credit

Items	Debit	Credit
Asset	Increase	Decrease
Expense	Increase	Decrease
Capital	Decrease	Increase
Liability	Decrease	Increase
Income/Revenue	Decrease	Increase

Some important rules for passing journal entry

i. Capital Account

It is the personal account of the proprietor. Capital may be contributed either in the form of cash, goods, or assets. In all times the proprietor is the giver, therefore, instead of crediting the proprietor's personal account, the Capital Account is credited, and Cash, Goods, or Asset Account is debited as the case may be.

ii. Drawings Account

Drawings is the amount of cash, goods, and asset taken by the proprietor from his business for his personal use. In all cases, the Drawings Account is debited and the Goods, Cash and Asset accounts are credited. At the end of the accounting period, the Drawings Account is transferred to the Capital Account.

iii. Goods

The term 'goods' is very important in accounting. It means the commodities or merchandise which is usually bought and sold by a businessman for his business. For example, a furniture dealer used to buy and sell furniture. Therefore, furniture is a goods for his business. But to a hotel, furniture is an asset.

When goods are purchased, goods come to the business, the Purchases Account is debited. Likewise, when purchased goods are returned, the Purchase Returns Account is credited. When goods are sold, goods go out. The Sales Account is credited. When sold goods are returned, the Sales Returns Account is debited.

When an asset is purchased, the Asset Account is debited and when it is sold, the Asset Account is credited. Likewise, when material like stationery is purchased, the Stationery Account is debited as it is an expense.

Illustration 1.3.1

From the following information, mention the type and the two affected accounting elements.

- | | |
|-------------------------------|--------|
| 1. Started business with cash | ₹10000 |
| 2. Purchased goods | ₹6000 |
| 3. Purchased furniture | ₹2000 |
| 4. Sold goods for cash | ₹5000 |
| 5. Paid salary | ₹1000 |



Solution

No.	Transactions	Type of transactions	Two affected accounts
1	Started business with cash ₹10000	Cash	Cash and Capital
2	Purchased goods ₹6000	Cash	Cash and Purchases
3	Purchased furniture ₹2000	Cash	Cash and Furniture
4	Sold goods for cash ₹5000	Cash	Cash and Sales
5	Paid salary ₹1000	Cash	Cash and Salary

Illustration 1.3.2

Identify the accounting element and types of accounts from the following transactions.

1. Purchased goods for cash ₹1000
2. Sold goods for cash ₹1200
3. Purchased machinery ₹900
4. Paid rent ₹200
5. Received commission ₹120
6. Paid to Mohan ₹250
7. Received from Anil ₹600

Solution

No.	Transactions	Accounting Elements	Types of Accounts
1	Purchased goods for cash ₹1000	Purchases A/c Cash A/c	Nominal Real
2	Sold goods for cash ₹1200	Sales A/c Cash A/c	Nominal Real
3	Purchased machinery for ₹900	Machinery A/c Cash A/c	Real Real
4	Paid rent ₹200	Rent A/c Cash A/c	Nominal Real



5	Received commission ₹120	Cash A/c Commission A/c	Real Nominal
6	Paid to Mohan ₹250	Mohan A/c Cash A/c	Personal Real
7	Received from Anil ₹600	Cash A/c Anil A/c	Real Personal

Illustration 1.3.3

From the following information, state the accounts to be debited and credited and mention the reason thereof.

1. Capital introduced ₹10000
2. Purchased furniture ₹5000
3. Purchased goods ₹4000
4. Paid advertisement expenses ₹500
5. Sold goods ₹2000
6. Paid wages ₹3000

Solution

No.	Transactions	Affected accounts	Types of account	To be debited or credited	Reason for debit or credit
1.	Capital introduced ₹10000	Capital A/c Cash A/c	Personal Real	Cr. Dr.	Cash comes to the business and the proprietor is the giver
2.	Purchased furniture ₹5000	Furniture A/c Cash A/c	Real Real	Dr. Cr.	Furniture comes in and cash goes out

3.	Purchased goods ₹4000	Purchases A/c Cash A/c	Nominal Real	Dr. Cr.	Purchases is an expense and cash goes out.
4.	Paid advertisement expenses ₹500	Advertisement A/c Cash A/c	Nominal Real	Dr. Cr.	Advertisement is an expense and cash goes out.
5.	Sold goods ₹2000	Sales A/c Cash A/c	Nominal Real	Cr. Dr.	Sales is an income and cash comes in
6.	Paid wages ₹3000	Wages A/c Cash A/c	Nominal Real	Dr. Cr.	Wages is an expense and cash goes out

Illustration 1.3.4

Mr. Sunil started a business on 1 January 2021 by introducing ₹50000 as his capital. The following are his transactions during January. Pass journal entries

Jan: 1	Purchased goods	₹5000
Jan: 2	Purchased furniture	₹6000
Jan: 4	Paid rent	₹1000
Jan: 7	Sold goods	₹7000
Jan: 8	Purchased goods from Mohan	₹3000
Jan: 9	Returned goods to Mohan	₹500
Jan: 10	Paid to Mohan	₹1500
Jan: 13	Sold goods to Kumar	₹4000
Jan: 15	Goods returned by Kumar	₹1000
Jan: 16	Received from Kumar	₹2000
Jan: 19	Paid rent	₹1200
Jan: 25	Drew for personal use	₹700
Jan: 31	Paid salaries	₹1500



Solution

Journal Entries in the books of Sunil

Date	Particulars	L.F.	Amount (Dr.)	Amount (Cr.)
2021 Jan 1	Cash A/c Dr. To Capital A/c (Capital introduced)		50000	50000
1	Purchases A/c Dr. To Cash A/c (Purchased Goods)		5000	5000
2	Furniture A/c Dr. To Cash A/c (Furniture purchased)		6000	6000
4	Rent A/c Dr. To Cash A/c (Rent Paid)		1000	1000
7	Cash A/c Dr. To Sales A/c (Goods sold for cash)		7000	7000
8	Purchases A/c Dr. To Mohan A/c (Purchased goods by Mohan)		3000	3000
9	Mohan A/c Dr. To Purchases Returns A/c (Mohan returned goods)		500	500
10	Mohan A/c Dr. To Cash A/c (Cash paid by Mohan)		1500	1500
13	Kumar A/c Dr. To Sales A/c (Sold to Kumar)		4000	4000

15	Sales returns A/c Dr. To Kumar A/c (Returned goods by Kumar)		1000	1000
16	Cash A/c Dr. To Kumar A/c (Cash received from Kumar)		2000	2000
19	Rent A/c Dr. To Cash A/c (Rent paid)		1200	1200
25	Drawings A/c Dr. To Cash A/c (Withdrew for personal use)		700	700
31	Salary A/c Dr. To Cash A/c (Salary paid)		1500	1500

Illustration 1.3.5

Journalise the following transactions for 2021,

- March 1. Paid wages ₹1200
3. Purchased Land ₹50000
5. Sold goods ₹20000
7. Paid to Lal ₹3000
10. Drew from Bank ₹30000

Solution

Date	Particulars	L.F.	Amount (Dr.)	Amount (Cr.)
2021 March 1	Wages A/c Dr. To Cash A/c (Wages paid)		1200	1200
3	Land A/c Dr. To Cash A/c (Land purchased)		50000	50000



5	Cash A/c To Sales A/c (Goods sold)	Dr.	20000	20000
7	Lal's A/c To Cash A/c (Cash received from Lal)	Dr.	3000	3000
10	Cash A/c To Bank A/c (Cash withdrawn from bank)	Dr.	30000	30000

Illustration 1.3.6

Mr. Bhargavan Das started a business on 1 March 2021 by introducing ₹30000 as his capital. The following are the remaining transaction during the month of March. You are required to pass journal entries.

2021 March	2	Plant purchased	₹25000
	3	Purchased goods from Joy	₹40000
	7	Sold goods	₹20000
	8	Purchased stationery	₹1000
	10	Paid to Joy	₹10000
	11	Returned goods to Joy	₹1000
	13	Sold plant	₹5000
	15	Purchased goods for cash	₹4000
	16	Paid electricity charges	₹500
	17	Furniture purchased	₹1400
	18	Sold goods to Ram	₹23000
	19	Goods returned by Ram	₹1200
	20	Received cash from Ram	₹20000
	24	Loans taken from bank	₹50000
	26	Paid rent	₹3000

27	Received commission	₹700
28	Paid interests on loan	₹400
31	Drew for personal use	₹1000

Solution

Journal entries in the books of Mr. Bhargavan Das

Date	Particulars	L.F.	Amount (Dr.)	Amount (Cr.)
2021 March 1	Cash A/c Dr. To Capital A/c (Capital introduced)		30000	30000
2	Plant A/c Dr. To Cash A/c (Purchased plant)		25000	25000
3	Purchase A/c Dr. To Joy A/c (Goods purchased on credit)		40000	40000
7	Cash A/c Dr. To Sales A/c (Goods sold for cash)		20000	20000
8	Stationery A/c Dr. To Cash A/c (Stationery purchased)		1000	1000
10	Joy A/c Dr. To Cash A/c (Cash paid to Joy)		10000	10000
11	Joy A/c Dr. To Purchases Returns A/c (Goods returned by Joy)		1000	1000
13	Cash A/c Dr. To Plant A/c (Plant purchased)		5000	5000

15	Purchase A/c Dr. To Cash A/c (Goods purchased)	4000	4000
16	Electricity Charges A/c Dr. To Cash A/c (Electricity charges paid)	500	500
17	Furniture A/c Dr. To Cash A/c (Furniture purchased)	1400	1400
18	Ram A/c Dr. To Sales A/c (Goods sold to Ram on credit)	23000	23000
19	Sales Returns A/c Dr. To Ram A/c (Goods returned by Ram received)	1200	1200
20	Cash A/c Dr. To Ram A/c (Cash received from Ram)	20000	20000
24	Cash A/c Dr. To Loan A/c (Loan taken)	50000	50000
26	Rent A/c Dr. To Cash A/c (Rent paid)	3000	3000
27	Cash A/c Dr. To Commission A/c (Commission received)	700	700
28	Interest A/c Dr. To Cash A/c (Interest paid)	400	400
31	Drawings A/c Dr. To Cash A/c (Cash taken for personal use)	1000	1000

Types of Journal Entry

There are two types of journal entry; simple journal entry and compound journal entry. If in a journal entry, there is only one debit item and one credit item, it is called a simple journal entry.

For example

Salary A/c	Dr.	400
	To Cash A/c	400

If in a journal entry, there is more than one debit item or more than one credit item or both, it is called a compound journal entry. For example, Mr. James started a business with cash of ₹10000, furniture of ₹5000, and building of ₹30000, on 1 January 2021. A journal entry can be passed for this transaction.

Cash A/c	Dr.	10000
Furniture A/c	Dr.	5000
Building A/c	Dr.	30000
	To Capital A/c	45000

Illustration 1.3.7

Pass journal entries in the books Mr. Goyal

2020 Jan 1	Started the business with	₹100000
2	Purchased building	₹40000
3	Purchased furniture	₹5000
5	Purchased goods	₹10000
6	Sold goods	₹8000
7	Paid cash to Ramus as a commission	₹500
8	Received interest from Roy	₹400
9	Sold part of the building	₹6000
10	Purchased a plant worth ₹50000 from Ms. Satwika and paid ₹10000 immediately	



Solution

Journal Entries in the books of Mr.Goyal

Date	Particulars	L.F.	Amount (Dr.)	Amount (Cr.)
2020 Jan 1	Cash A/c Dr. To Capital A/c (Capital introduced)		100000	100000
2	Building A/c Dr. To Cash A/c (Building purchased)		40000	40000
3	Furniture A/c Dr. To Cash A/c (Furniture purchased)		5000	5000
5	Purchases A/c Dr. To Cash A/c (Goods purchased)		10000	10000
6	Cash A/c Dr. To Sales A/c (Goods sold for cash)		8000	8000
7	Commission A/c Dr. To Cash A/c (Commission paid)		500	500
8	Cash A/c Dr. To Interest A/c (Interest received)		400	400
9	Cash A/c Dr. To Building A/c (Building sold)		6000	6000
10	Plant A/c Dr. To Cash A/c To Satwika A/c (Plant purchased of ₹50000 from Ms. Satwika and paid ₹10000 by cash and balance on credit)		50000	10000 40000

1.3.4 Ledger

In the ledger various accounts are drawn. Each page is used for recording separate account. The account is written in the form of “T” having two equal sides. The left-hand side is called the debit side and the right-hand side is called the credit side. A ledger is further classified as a personal ledger and an impersonal ledger. The personal ledger contains accounts of customers and suppliers. Personal ledger is classified into debtor’s ledger and creditor’s ledger. All accounts other than Debtors’ Account and Creditors’ Accounts are shown in the impersonal ledger or general ledger.

Table 1.3.4
Format of a Ledger
Name of the account

Dr.				Cr.			
Date	Particulars	J.F.	Amount	Date	Particulars	J.F.	Amount

How to record transactions into the ledger?

After journalising transactions, ledger accounts are opened. The process of recording the transaction from journal to ledger is called **posting**. If an account is debited in the journal, it means that the transaction is recorded on the debit side of that account and if an account is credited in the journal, the transaction is recorded on the credit side of that account. Posting can be illustrated with the help of the following example.

On 1 January 2021, Suresh started a business with cash of ₹20000. This transaction is recorded in the journal and ledger as follows.

Date	Particulars	L.F.	Amount (Dr.)	Amount (Cr.)
2021 Jan 1	Cash A/c Dr To Capital A/c (Business started with cash ₹20000)		20000	20000

The above journal entry can be posted to the ledger accounts by opening a Cash Account and Capital Account in the ledger. For recording the debit side of an account,

it begins with the abbreviation “To” and then records the credit accounting element and for recording the credit side of an account, begins with the abbreviation “By” and then records the debit accounting element.

Cash Account

Dr.				Cr.			
Date	Particulars	J.F.	Amount	Date	Particulars	J.F.	Amount
2021 Jan 1	To Capital A/c		20000				

Capital Account

Dr.				Cr.			
Date	Particulars	J.F.	Amount	Date	Particulars	J.F.	Amount
				2021 Jan 1	By Cash A/c		20000

Balancing of Account

After completing the posting, the balance of accounts is ascertained. The difference between the two sides of an account is called the balance of that account. When the debit amount total of an account is greater than its credit amount total, the account is said to have a debit balance and if the credit amount total of an account is greater than its debit amount total, the account is said to have a credit balance.

Personal accounts and real accounts are balanced. The debit balance of the personal account indicates that much of the amount is receivable and the credit balance shows that much of amount payable. A real account always shows a debit balance. It specifies that much value of the property is owned by the business. However, nominal accounts are not balanced but totalled. The total amount of each nominal account is transferred to the Trading and Profit and Loss Account at the end of the accounting period.

How to balance an account?

- Put a line in the amount column of the account, after leaving one line space, where more number of items is entered.
- Total the greater amount column and enter the amount in the opposite amount column of the account in the same line.
- Insert the difference on the shorter side so that the two sides of account become equal. The difference is the balance of the account and it is written as balance carried down (c/d).

- iv. The balance c/d is brought forward (b/d) to the opposite side of the account on the next day. If the brought forward amount comes on the debit side, the account is said to have debit balance and if it comes on the credit side, the account is said to have credit balance

1.3.5 Subdivisions of Journal

Transactions are recorded in the books of accounts without much delay. Due to a large number of transactions occurring daily, the big business journal is subdivided into purchases day book, purchases return book, sales day book, sales returns book, bills receivable book, bills payable book and Cash Book. Transactions relating to each book are separately recorded by different clerks to avoid delay in recording of transactions. From these various journals, posting is made to the ledger accounts.

1.3.5.1 Purchases Day Book

Purchases day book is a subdivision of the journal in which all credit purchases of goods are recorded. For example, in timber business, timber is goods. If it is purchased on credit, it will be recorded in this day book. This day book is prepared with the help of invoices issued by the supplier. Invoices contain the details of goods purchased, such as quantity, price, trade discount allowed, net amount payable, etc. Trade discount is the discount allowed for encouraging bulk purchases.

Table 1.3.5
Format of Purchases Day Book
Purchases Day Book

Date	Particulars	L.F.	Invoice No.	Amount

Illustration 1.3.8

From the following particulars prepare purchases day book of Ushas electrical, Kollam.

2021 Jan 1: Purchased from Bajaj Fans, 10 Fans@ ₹500 per Fan less 10% trade discount.

Jan 8 : Purchased 100 CFL lamps for cash from Jothy Lamps @ ₹10 per Lamp less 25% trade discount.



Jan 23: Purchased 20 Wall Fans from Usha Fans @ ₹400 per Fan less 20% trade discount.

Jan 29: Purchased from Royal Furniture Mart 5 Computer Chairs @ ₹800 per Chair less 20% trade discount.

Solution

Purchases Day Book

Date	Particulars	L.F.	Invoice No.	Amount
2020	Bajaj Fans			
Jan 1	10 Fans @ ₹500 per Fan	5000		
	Less Trade Discount 10%	(500)		4500
23	Usha Fans			
	20 wall Fans @ ₹ 400 per Fan	8000		
	Less 20% Trade discount	(1600)		6400

Working note

1. CFL lamp purchased for cash is recorded in the Cash Book and not in the purchases day book.
2. Computer chair purchased on credit is an asset and therefore not recorded in the purchases day book.
3. In the ledger account, the Bajaj Fan Account is credited with ₹4500, and Usha Fan Account is credited with ₹6400 as purchases.

1.3.5.2 Purchases Returns Book

Goods purchased may be returned due to poor quality, damage etc.. Purchases returns book is a subdivision of journal in which goods returned to suppliers are recorded. Whenever goods are returned or some allowance is claimed, it is intimated to the supplier by means of a statement which is called debit note. With the help of debit note, purchases returns book is prepared.

Table 1.3.6
Format of Purchases Returns Book
Purchases Returns Book

Date	Particulars	L.F.	Debit Note No.	Amount

Illustration 1.3.9

MSM Book house Kollam gives the following information. You are required to prepare a purchase returns book

2021 March 1: Returned 10 accounting text books @ ₹50 per book less trade discount of @25% to Jeevan Books, Karunagappally.

March 10: Returned 50 books of drama to Universal Books Kollam @ ₹100 per book less 10% trade discount.

Solution

Purchases Returns Book

Date	Particulars	L.F.	Debit Note No.	Amount
2020	Jeevan Books			
March 1	10 Books on accounting @ ₹50 per book 500			
	Less Trade Discount 25% (125)			375
10	Universal Books			
	50 Drama Books @ ₹100 per book 5000			4500
	Less trade discount 10% (500)			4875

1.3.5.3 Sales Day Book

Sales day book is a subdivision of journal in which all credit sales of goods are recorded. Therefore, cash sales of goods, ~~cash and~~ credit sales of assets are not recorded in this journal. While selling goods, an invoice is given to customers, which is called an outward invoice, showing the details of goods sold.

Table 1.3.7
Format of Sales Day Book
Sales Day Book

Date	Particulars	L.F.	Invoice No.	Amount

Illustration 1.3.10

The following are the details of credit sales of goods of Maruthi Udyog, Ltd. You are required to prepare sales day book.

2021 April 1	Sold 10 Swift Cars to Popular Motors, Kollam. The rate of a Car is ₹700000 less 10 % trade discount.
2021 April 5	Sold 5 Maruthi Alto cars @ ₹400000 per Car less 20% trade discount to Ashmiya Motors Mangalore
2021 April 9	Sold 3 Cars for cash to Atlas Motors @ ₹200000 per car less 30% discount.
2021 April 14	Sold 4 Maruthi 800 to Pallikkasserri motors @ ₹250000 less 20 % discount.

Solution

Sales Day Book

Date	Particulars	L.F.	Invoice No.	Amount
2021	Popular Motors Kollam			
April	10 Swift Cars @ ₹700000	7000000		
1	Less 10% Trade discount	(700000)		6300000
	Ashmiya Motors, Mangalore			
5	5 Maruthi Alto Cars @ ₹400000	2000000		
	Less 20% Trade discount	(400000)		1600000
	Pallikkasseri Motors			
	4 Maruthi 800 cars @ ₹250000	1000000		
14	Less 20% Trade discount	(200000)		800000
				8700000

Notes: Cash sales are not recorded in the sales day book

1.3.5.4 Sales Returns Book

Customers may occasionally return goods for various reasons, including defects in the products or claiming allowances. To keep track of these returns, a sales returns book is maintained, which is based on the credit notes issued to the customers. A credit note serves as a notification that the customer's account has been credited with the value of the returned goods or the granted allowances.

Table 1.3.8

Format of Sales Returns Book

Sales Returns Book

Date	Particulars	L.F.	Credit Note No.	Amount

Illustration 1.3.11

The following are the transactions of Indira Electricals, Karunagappally. You are required to prepare sales returns book.



- 2020 September 3: Joy and Co returned 3 Table Lamps @ ₹50 per Lamp less 10% trade discount.
- Sep 5: Jose Electricals 5 Table Fans @ ₹750 per Fan less 20% trade discount.
- Sep 20: Kairali Electrical 5 Heaters @ ₹200 per Heater less 5% discount

Solution

Sales Returns Book

Date	Particulars	L.F.	Credit Note No.	Amount
2020 Sep 3	Joy and Company 3 Table Lamps @ ₹50 per Fan Less trade discount	150 (15)		135
5	Jose Electricals 5 table Fans @ ₹750 per Fan Less trade discount 20%	3750 (750)		3000
20	Kairali Electricals 5 Heaters @ ₹200 per Heater Less trade discount 5%	1000 (50)		950
				4085

1.3.5.5 Bills Receivable Book

In the subdivision of the journal, the bills receivable book is a specialised ledger used to record and track all incoming bills or promissory notes that are due to be received by a company. It serves as a central repository for documenting the details of bills receivable, such as the date of issue, the amount, the due date, the name of the debtor, and any relevant remarks or comments. This book helps businesses keep a systematic record of their outstanding receivables and facilitates effective management of cash flow and collection efforts.

1.3.5.6 Bills Payable Book

The Bills Payable Book is a specialised book used to record all the bills or promissory notes that a business has accepted or received from its creditors. It is also known as the "Bills Payable Journal" or the "Bills Payable Register".



The Bills Payable Book and Bills Receivable Book are explained in detail in the forthcoming blocks.

1.3.5.7 Cash Book

Cash transactions are an integral part of any business, and they often occur in large volumes. To keep track of these transactions, a Cash Book is used as a subdivision of the journal. While the Cash Book is technically a journal, it is structured like a ledger account, serving the purpose of both a journal and a ledger. This eliminates the need to create a separate Cash Account in the ledger.

The Cash Book consists of two sides: the receipt side (left-hand side) and the payment side (right-hand side). Cash receipts are recorded on the debit side, while cash payments are recorded on the credit side. The closing balance of cash or cash in hand is determined by calculating the excess of receipts over payments.

There are different types of Cash Books available. The first is the simple or single-column Cash Book, which contains only one column for recording cash transactions. The second is the two-column Cash Book, which includes columns for cash and discount. The third is the three-column Cash Book, which has columns for cash, bank, and discount.

Simple Cash Book

A Simple Cash Book is also called single-column Cash Book. This Cash Book is kept by small concerns where usually transactions are made in cash and no cash discount is received or paid. Here, bank transactions if any, are also recorded in this Cash Book. The rules of recording bank transactions are discussed as follows.

- i. If a bank transaction increases the office cash balance, it should be recorded as a debit entry in the Cash Book. Conversely, if a bank transaction decreases the office cash balance, it should be recorded as a credit entry in the Cash Book
- ii. If a bank transaction does not affect the office cash balance, meaning it does not result in an increase or decrease in cash, it should be recorded on both the debit and credit sides of the simple Cash Book. The following transactions and journal entries gives more clarity in this area.
 - a. When payments are made by cheque, it is recorded as if cash is withdrawn from the bank and then payment is made.

Cash A/c Dr.

To Bank A/c

Parties' A/c Dr.

To Cash A/c

b. Direct deposit by the customers in the traders' account, it is recorded as if the amount is revived from customers directly and then deposited into the bank.

Cash A/c Dr.

To Customer's A/c

Bank A/c Dr.

To Cash A/c

c. Transactions such as payments made by the bank as per standing instructions, as well as interest and commissions charged by the bank, are recorded in the Cash Book as if cash were withdrawn from the bank and then used for the payment.

Cash A/c Dr.

To Bank A/c

Expense a/c Dr.

To Cash A/c

d. Amount such as interest, commission etc. collected by the bank and interest credited in the customer's account, etc.. These are recorded as if after receiving the income in cash and then remitted into the bank.

Cash A/c Dr.

To Income A/c

Bank A/c Dr.

To Cash A/c

While preparing single-column Cash Book, when the cheque is received, it is considered a receipt of cash. To ascertain the bank balance, the bank account is opened in the ledger account.

Table 1.3.9
Form of Simple Cash Book
Cash Book

Date	Particulars	L.F.	Amount	Date	Particulars	L.F.	Amount

Illustration 1.3.12

From the following prepare a single column Cash Book in the books of James.

2020 Jan 1	Cash balance	₹20000
2	Deposited into bank	₹5000
4	Cash received from Manu, a customer deposited into the bank	₹5000
5	Paid salaries	₹2000
7	Bought a typewriter	₹2500
8	Cash withdrawn from bank	₹1200
10	Stationary purchased	₹150
11	Sold goods for cash and deposited into bank	₹7500

Solution

Single Column Cash Book

Dr.				Cr.			
Date	Particulars	L.F.	Amount	Date	Particulars	L.F.	Amount
2020 Jan 1	To Balance b/d		20000	2020 Jan 2	By bank		5000
4	To Manu		5000	4	By bank		5000
8	To bank		1200	5	By Salary		2000
11	To sales		7500	7	By typewriter		2500
				10	By Stationary		150
				11	By Bank		7500
					By balance c/d		11550
			33700				33700

Two-Column Cash Book

Two column cashbook includes a cash column and a bank column. It is also called double column cash book. All cash transactions will be recorded in the cash column and bank transactions will be recorded in the bank column. But in two column cash books, some transactions are recorded in the debit and credit side simultaneously. Such entry is called contra entry. For example, when cash is deposited into bank, bank account is debited and cash account is credited, i.e., the transaction is recorded in the debit side of bank column, and credit side of cash column of two column cashbook. In the same way, when cash is taken from the bank for office use, cash account is debited and bank account is credited. The letter “C” is entered in the L.F. column for indicating it as a contra entry.

Table 1.3.10**Format of Cash Book with Cash and Bank column****Cash Book**

Dr.					Cr.				
Date	Particulars	L.F.	Bank	Cash	Date	Particulars	L.F.	Bank	Cash

Cash Book with Cash, Bank, and Discount Columns

This Cash Book is also called three-column Cash Books as there are three amount columns on both sides for recording discounts, cash, and bank transactions. Cash balance can be ascertained by balancing cash columns like a single-column or two-column Cash Books. The discount column is not balanced but totalled. The receipts side (debit side) is used to record all cash receipts, and deposits into the bank. Discount allowed is also recorded in the debit side. In the payments side (credit side), all payments in cash and cheque and discount earned are recorded. The discount column is not balanced but totalled and posted to the debit side of discount account (discount allowed) and credit side of discount account (discount earned) in the ledger account. The balance shown in the cash column is cash in hand whereas the difference of bank column may be either cash at bank or bank overdraft. Cash Book serves the purpose of a journal and ledger account at the same time, as mentioned earlier. Usually, a transaction is posted in a particular ledger account at one place, either in the debit side or credit side.

Rules of preparing three column Cash Books

- If cheque or cash is deposited into the bank, the Bank Account is debited and Cash Account is credited.
- If cheque received from parties are deposited on the same day, it will not affect the office cash balance, therefore, directly recorded on the bank column, in the debit side of three column Cash Book.
- If a transaction results an increase in the office cash balance, it should be recorded in the cash column, on the debit side.
- If a transaction decreases the office cash balance, it should be recorded in the cash column, on the credit side.
- If a transaction results an increase in the bank balance, it should be recorded in the bank column, on the debit side

- f. If a transaction results a decrease in the bank balance, it should be recorded in the bank column, on the credit side.

Table 1.3.11
Form of three column Cash Book
Cash Book

Dr.						Cr.					
Date	Particulars	L.F.	Dis count	Cash	Bank	Date	Particulars	L.F.	Dis count	Cash	Bank

Illustration 1.3.13

Prepare a three-column Cash Book from the information given below. Mr. Johnson started a business on 1 April 2021 by introducing ₹5000. Out of this amount, ₹1000 is deposited into bank and a sum of ₹300 is paid for the furniture 2021.

April 4	Cash purchases	₹400
April 5	Sold goods for cheque and paid into bank on the same day	₹300
April 7	Purchases goods and cheque issued	₹195
April 7	Received Cheque from Kuttan ₹49 and discount allowed to him	₹1
April 8	Endorsed cheques received from Kuttan to Manu	
April 11	Cash sales	₹1400
April 13	Sold goods for cheque	₹200
April 14	Paid into bank, cheque	₹200
April 18	Deposited into bank	₹300
April 20	Drew from bank for personal use	₹100
April 22	Drew from bank for office use	₹50
April 24	Paid to Mathukutty by cheque	₹405
	Discount received from him	₹5
April 24	Interest allowed by the bank	₹16
April 25	Bank charges debited in the pass book	₹14
April 26	Received from Jayakrishnan	₹40
	Discount allowed to him	₹1
April 26	Paid for the personal expenses of the proprietor	₹10

April 27	Paid salaries by cheque	₹100
April 30	Ajith remitted to the bank directly	₹25
April 30	Received from Nadarajan, cheque and the same is sent to the bank for collection	₹409
	Discount allowed to him	₹6

Solution

Cash Book

Dr.

Cr.

Date	Particulars	L.F.	Dis count	Cash	Bank	Date	Particulars	L.F.	Dis count	Cash	Bank
2021 April 1	Capital			5000		2021 April 1	Furniture			300	
1	Cash	C			1000	1	Bank	C		1000	
5	Sales				300	4	Purchases			400	
7	Kuttan		1	49		7	Purchases				195
11	Sales			1400		8	Manu			49	
13	Sales			200		14	Bank	C		200	
14	Cash	C			200	18	Bank	C		300	
18	Cash	C			300	20	Drawings				100
22	Bank	C		50		22	Cash	C			50
24	Interest				16	24	Mathukutty		5		405
26	Jayakrishnan		1	40		25	Bank charge				14
30	Ajith				25	26	Drawings			10	
30	Nadarajan		6		409	27	Salary				100
						30	Balance c/d			4480	1386
			8	6739	2250				5	6739	2250

1.3.6 Trial Balance

Once transactions are recorded in the journal, ledger accounts are prepared, real and personal accounts are balanced, while nominal accounts are totalled. To ensure the accuracy of the books of accounts, a Trial Balance is prepared. The Trial Balance serves as a summary of all business-related accounts and is presented in a tabular form with three columns: Particulars, debit balances, and credit balances.

In the particulars column, the names of the accounts are entered. The debit balance column records the amounts of accounts with debit balances, while the credit balance column records the amounts of accounts with credit balances. Under the double-entry



system of accounting, every transaction is recorded in two accounts simultaneously, with an equal amount on both the debit and credit sides. As a result, the total of debit amounts in the Trial Balance should be equal to the total of credit amounts. Thus, the Trial Balance should automatically tally.

However, it is important to note that even if the Trial Balance does tally, it does not guarantee the absence of errors. Some errors may not affect the agreement of the Trial Balance. The various types of accounting errors that affects the Trial Balance and that does not affect the Trial Balance are explained in the forthcoming section of the unit.

Hints of Preparing Trial Balance

These accounts show the following balances which should be entered in the respective debit and credit columns in the Trial Balance

Asset accounts	Debit Balance
Liability Accounts	Credit Balance
Expenses/losses Account	Debit Balance
Incomes/gains Accounts	Credit Balance
Purchase Accounts	Debit Balance
Purchase Returns Account	Credit Balance
Sales Account	Credit Balance
Sales Returns Account	Debit Balance
Capital Account	Credit Balance
Drawings Account	Debit Balance

Table 1.3.12

Format of Trial Balance

Trial Balance as on DD-MM-YY

Name of the Account	Amount (Dr.)	Amount(Cr.)
Cash	xxx	
Capital		xxx
Sundry creditors		xxx
Sundry debtors	xxx	
Wages	xxx	
Salary	xxx	
Land and Building	xxx	
Opening stock	xxx	
Purchases	xxx	
Drawings	xxx	

Printing and Stationary	XXX	
Purchase returns		XXX
Sales		XXX
Depreciation	XXX	
Repairs	XXX	
Interest paid	XXX	
Commission paid	XXX	
Dividend received		XXX
Total	XXXX	XXXX

Illustration 1.3.14

The following are the accounts balances of Mr. Murugan, as on 31 March 2021. You are required to prepare a Trial Balance.

Capital	₹40000
Cash	₹20000
Sundry Debtors	₹10000
Opening Stock	₹5000
Wages	₹3000
Carriages	₹2000
Sales	₹75000
Sales Returns	₹5000
Purchases	₹45000
Plant and Machinery	₹20000
Furniture and Fixtures	₹5000
Sundry Creditors	₹45000
Purchase Returns	₹5000
Drawings	₹3000
Depreciation	₹2000
Patent	₹10000



Goodwill	₹25000
Salary	₹3000
Printing and Stationary	₹2000
Advertisement	₹5000

Solution

Trial Balance of Mr. Murugan as on 31 March 2021

Name of Accounts	Amount (Dr.)	Amount (Cr.)
Capital		40000
Cash	20000	
Sundry Debtors	10000	
Opening Stock	5000	
Wages	3000	
Carriage	2000	
Sales		75000
Sales Returns	5000	
Purchases	45000	
Plant and Machinery	20000	
Furniture and Fixtures	5000	
Sundry Creditors		45000
Purchases Returns		5000
Drawings	3000	
Depreciation	2000	
Patent	10000	
Goodwill	25000	
Salary	3000	
Printing and Stationery	2000	
Advertisement	5000	
Total	165000	165000



1.3.7 Accounting Errors

Accounting is a meticulous process, but mistakes can sometimes sneak into the records. When books of accounts are maintained accurately using the double-entry system, every debit amount has a corresponding credit amount. As a result, the Trial Balance automatically balances. However, even if the Trial Balance balances, it does not guarantee the absence of errors, as certain errors may not impact the Trial Balance. These errors include errors of principle, compensating errors, errors of omission, and so on. Accounting errors refer to innocent or unknowing omissions and mistakes made during the preparation of books of accounts.

Classification of accounting errors

Accounting errors can be classified into two: clerical errors and errors of principles. Clerical errors are again classified into three; errors of omission, errors of commission, and compensating errors. Errors of omission is further classified as complete omission and partial omission.

A. Clerical errors

Clerical errors are errors occurred due to carelessness, negligence, etc. committed by the accounting staff. Such errors include errors of omission, errors of commission, and compensating errors.

- i. **Errors of omission:** Errors of omission occur when a transaction is either completely or partially left out from being recorded in the books of accounts. When a transaction is entirely omitted, it is known as a complete omission, and when it is partially omitted, it is referred to as a partial omission. The complete omission do not affect the Trial Balance agreement since both the debit and credit aspects of the transaction are omitted from recording. While a partial omission will affect the Trial Balance agreement since either debit or credit aspects of the transaction are omitted from recording.
- ii. **Errors of commission:** This type of errors may or may not affect the agreement of Trial Balance. This error arises due to wrong recording, wrong posting, wrong balancing, wrong carrying forward, etc. For example, goods purchased for cash ₹100 is recorded in the books of accounts as ₹500, payment to Ramesh wrongly recorded as Rajesh etc.
- iii. **Compensating errors:** If one error is compensated by another error, it is called compensating error. For example, ₹100 received from Hari credited to Sunil's Account. Instead of increasing the credit balance of Hari's Account, Sunil's Account credit balance is increased and therefore this error does not affect the agreement of Trial Balance.

B. Errors of principles

This type of error happens due to the ignorance of accounting principles and it does not affect the agreement of Trial Balance. For example, furniture worth ₹5000 purchased is debited to Purchase Account instead of debiting Furniture Account. Here the debit balance of Purchases Account is increased instead of increasing the debit balance of the Furniture Account and therefore it does not affect the agreement of Trial Balance.

Recap

- ◇ Journal - Business transactions are firstly recorded.
- ◇ Journalising - Recording of transactions in the journal.
- ◇ Real account - Debit what comes in and credit what goes out.
- ◇ Personal account - Debit the receiver and credit the giver.
- ◇ Nominal account - Debit all expenses and losses and credit all incomes and gains.
- ◇ Cash Book-Recording cash transactions
- ◇ Purchase day book- Credit purchase
- ◇ Sales day book- Credit sales
- ◇ Compound journal entry - More than one debit or credit.
- ◇ General ledger - All accounts other than debtors' and creditors' ledger.
- ◇ Errors of omission - Omit from recording.
- ◇ Errors of commission - Wrong recording.
- ◇ Errors of principle – Violation of accounting principle.
- ◇ Trial Balance - Arithmetical accuracy.

Objective Questions

1. What is the book of original entry known as?
2. When wages are paid for installing furniture, which account is credited and which account is debited?
3. Cash withdrawal from business by the proprietor should be credited to which account?
4. The process of transferring items from a journal to their respective ledger accounts is called:
5. What is the ledger column that links the entry with the journal called?
6. An error that violates the accounting principles is called:
7. What kind of errors rectify themselves with the compensating factors?
8. Which account/statement is used to check the arithmetical accuracy of books of accounts?

Answers

1. Journal
2. Cash, Furniture
3. Cash account
4. Posting
5. J.F. Column
6. Errors of principles
7. Compensating errors
8. Trial Balance

Self-Assessment Questions

1. What is a journal in accounting, and what is its purpose?
2. Explain the process of recording transactions in a journal.
3. What are the various types of accounts typically found in a ledger?
4. How are entries from the journal transferred to the ledger?
5. What is a Cash Book, and what purpose does it serve in accounting?
6. Differentiate between a single column Cash Book and a double column Cash Book.
7. Explain the process of recording cash and bank transactions in a Cash Book.
8. How is a Trial Balance prepared, and what information does it provide?
9. What does it mean if the Trial Balance is in balance? What if it is not in balance?

Assignments

1. Journalise the following transactions in the books of Mr. Midhun

	Amount
2021 January 1 Started business with cash	₹50000
2 Purchased goods for cash	₹30000
4 Purchased furniture for cash	₹5000
6 Paid rent to the landlord	₹1500
7 Sold goods for cash	₹25000
8 Paid carriage	₹500
11 Paid advertisement	₹1000
15 Sold goods to Ravi on credit	₹5000
18 Purchased stationery	₹1500
22 Goods returned by Ravi	₹700

25	Received cash from Ravi in full settlement	₹400
31	Paid salaries to staff	₹4000

2. Enter the following transactions in a single column Cash Book:

2019 April.1	Cash in hand	₹4100
2	Loan taken from Manju	₹5000
4	Cash Sales	₹6600
6	Received from Mohan	₹1200
8	Paid into bank	₹5000
10	Purchased postage	₹150
12	Paid for wages	₹750
14	Further capital introduced	₹5000
16	Spent for private use	₹800
18	Received interest on investment	₹400

(Answer: Cash Balance ₹15600)

3. Journalise the following transactions, and post them to their respective ledger.

	Amount
2022 Jan.1 P.K.Ghosh started business with cash	₹25000
Jan.1 Deposited cash into bank	₹15000
Jan.2 Purchased from Roy on credit	₹10000
Jan.4 Cash purchases	₹5000
Jan 5 Purchased furniture for cash	₹3000
Jan.7 Purchased stationery for cash	₹500
Jan.9 Sold goods to Dass Gupta	₹15000
Jan.10 Sold goods for cash	₹5000
Jan.12 Returned goods to Roy	₹800
Jan.14 Paid cheque to Roy in full settlement	₹9000

Jan.16	Dass Gupta returned goods	₹1000
Jan.18	Cheque received from Dass Gupta in full settlement	₹13500
Jan.20	Goods taken by Ghosh for personal use	₹500
Jan.30	Paid telephone charges	₹500
Jan.30	Paid wages	₹1000
Jan.30	Paid salaries	₹1500
Jan.30	Paid office rent	₹2000

4. The following balances were extracted from the books of a trader. Prepare a Trial Balance.

	Amount
Opening stock	₹5000
Purchases	₹75000
Creditors	₹7500
Capital	₹100000
Returns outward	₹5000
Carriage outward	₹5000
Interest received	₹10000
Provision for bad debts	₹5000
Wages	₹25000
Investments	₹25000
Loan	₹5000
Sales	₹100000
Debtors	₹15000
Drawings	₹7500

Returns inward	₹10000
Carriage inward	₹10000
Discount allowed	₹2500
Bad debts	₹2500
Trade expenses	₹10000
Goodwill	₹15000
Plant and Machinery	₹25000

(Answer: Trial Balance total ₹232500)

5. Prepare a Trial Balance for Mr. Ananthan and Co. as of 31st March 2021, using the following information.

	Amount
Capital	₹30000
Drawings	₹5000
Rent	₹4000
Interest paid	₹3000
Commission paid	₹2000
Loan	₹10000
Sales Returns	₹1000
Tools	₹4000
Trade debtors	₹5000
Electricity	₹500
Plant	₹4000
Stationary	₹1500
Sales	₹48000
Purchase returns	₹2000
Sundry creditors	₹10000

Purchases	₹15000
Building	₹13000
Cash	₹2000
Goodwill	₹40000

(Answer: Trial Balance Total ₹100000)

Suggested Readings

1. Maheswari, S. N. (2018). *Advanced Accounting*. Vikas Publishing House.
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BLOCK

Depreciation Accounts



Unit 1

Introduction to Depreciation Accounts

Learning Outcomes

After completing this unit, the learner will be able to:

- ◇ understand the concept of depreciation
- ◇ identify the causes of depreciation
- ◇ emphasise the need for providing depreciation
- ◇ be aware of the factors that affect depreciation

Prerequisites

Imagine a local bakery owned by Ms. Nisha. She invested in a state-of-the-art oven, a commercial mixer, and a delivery van to help grow her business. These assets were crucial in producing and delivering her delicious baked goods. However, as the years went by, Ms. Nisha noticed that the oven wasn't heating up as efficiently, the mixer was making unusual noises, and the delivery van required more frequent repairs. She realized that these assets weren't as valuable or effective as when she first bought them.

This gradual decline in the value and efficiency of her equipment puzzled her. She wondered, how can she account for this reduction in value over time? How does this affect her bakery's finances, and what should she do to ensure that she's setting aside enough money to replace these items when they can no longer be used?

This is where the concept of depreciation comes into play. Depreciation is an accounting method that allocates the cost of a tangible asset over its useful life. By systematically recording depreciation, Ms. Nisha can track the decreasing value of

her oven, mixer, and delivery van each year. This not only helps her understand the current value of her assets but also ensures that she is prepared to replace them when the time comes. Depreciation helps businesses like Ms. Nisha's bakery maintain accurate financial records and make informed decisions about future investments.

Keywords

Amortisation, Depletion, Fluctuation, Obsolescence

Discussion

2.1.1 Meaning

Depreciation is generally described as the decrease or the loss in value of fixed assets due to their constant use, expiry of time, obsolescence, diminution in quality and quantity, etc. Proper accounting of depreciation is highly necessary for the determination of true profit and loss, financial position, and for setting up necessary funds for the replacement of asset after the life span of the asset. In practice, different accounting policies are followed by different concerns for recording the value of depreciation. Accounting Standard 6 (AS 6) provides common policies for depreciation.

“Depreciation is the allocation of the depreciable amount of an asset over its estimated useful life. Depreciation for the accounting period is charged to income either directly or indirectly”

- *International Accounting Standard Committee*

“Depreciation is a measure of the wearing out, consumption or other loss of a 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 the depreciable amount in each accounting period during the expected useful life of the asset. Depreciation includes Amortisation of assets whose useful life is predetermined.”

- ***Institute of Chartered Accounts of India***

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“Depreciation is the shrinkage in the value of an asset at a given date as compared with its value on a previous date.”

- ***J.H. Burton***

“Depreciation is the permanent and continuing diminution in the quantity, quality or the value of an asset.”

- ***William Pickles***

In the international scenario, accountants have developed certain specific terms to denote the loss in value of a particular asset, other than depreciation. The following are such terms.

i. Obsolescence

Obsolescence refers to the process or state of becoming obsolete or outdated. It occurs when something, such as a product, technology, or idea, is no longer useful, effective, or relevant due to advances in technology, changing market demands, or the introduction of new and improved alternatives. Obsolescence can be either functional, meaning the item can no longer perform its intended function, or economic, where it is no longer economically viable to maintain or use the item.

ii. Depletion

Depletion typically refers to the gradual reduction or exhaustion of a wasting asset such as mines and quarries. It is commonly associated with non-renewable resources such as fossil fuels, minerals, or groundwater. Depletion occurs when these resources are extracted or consumed at a rate that exceeds their natural replenishment. As a result, the available reserves decline over time. Depletion can have significant environmental, economic, and social implications, as it affects the availability of vital resources and can lead to increased costs or the need for alternative solutions.

iii. Amortisation

Amortisation describes the process of incrementally expensing the cost of an intangible asset over the course of its useful economic life. It involves allocating the expense or repayment of the asset or liability over time rather than in a lump sum. Amortisation is commonly used for items such as patents, copyrights, and goodwill.

iv. Fluctuation

An increase or decrease in the value of a current asset is known as fluctuation. The increase may not be recorded in the books of account. But the decrease in the value of an asset shall be recorded in the books. Such a decrease in the value of an asset is treated as a loss (concept of conservatism - provides for all possible losses and there is no anticipation of incomes or gains)

Table 2.1.1
Difference between Depreciation and Fluctuation

Depreciation	Fluctuation
Depreciation refers to a decrease in value only.	Fluctuation may be either increase/decrease in value.
It is used in connection with fixed assets.	Fluctuation is used in connection with current assets.
Depreciation is permanent in nature.	It is temporary in most cases.
Depreciation is a gradual and continuous decrease in the value of an asset.	Fluctuation may not be a continuous and recurring process.
Depreciation is connected with book value.	Fluctuation refers to changes in market value.

2.1.2 Features of Depreciation

- i. **Cost allocation:** Depreciation allows businesses to allocate the cost of an asset over its useful life. Instead of recognising the full cost of the asset in a single accounting period, depreciation allows for the gradual recognition of the expense over multiple periods.
- ii. **Non-cash expense:** Depreciation is a non-cash expense, meaning it does not involve an actual outflow of cash. It represents the reduction in the value of an asset, even if the business has not spent any additional cash.
- iii. **Matching principle:** Depreciation aligns with the matching principle in accounting, which aims to match expenses with the revenues they generate. By depreciating an asset over its useful life, businesses can distribute the cost of the asset across the periods in which it contributes to generating revenue.
- iv. **Useful life:** Each asset has an estimated useful life, which represents the period over which it is expected to provide value to the business. Depreciation methods are based on this useful life and determine how the asset's value will be gradually reduced over time.

- v. **Salvage value:** Salvage value, also known as residual value or scrap value, is the estimated value of an asset at the end of its useful life. It represents the expected amount the business can recover from selling or disposing of the asset. Depreciation methods often take into account the salvage value when calculating the depreciation expense.
- vi. **Maintenance of an asset is not depreciation:** Repairs and maintenance to an asset is a revenue expense and do not amount to depreciation.

2.1.3 Causes of Depreciation

Depreciation of assets can occur due to various causes, which can be broadly categorised as follows:

- i. **Physical wear and tear:** The physical deterioration of an asset over time is one of the primary causes of depreciation. Regular usage, exposure to harsh conditions, and the passage of time can result in the degradation of the asset's physical condition, reducing its value.
- ii. **Technological obsolescence:** Advancements in technology can render certain assets outdated or less valuable. When new and improved versions of a particular asset or technology are introduced, the older versions may become less desirable or inefficient. This can lead to a decrease in the value of the existing assets.
- iii. **Functional obsolescence:** Functional obsolescence refers to a reduction in an asset's value due to changes in demand or preferences. It can occur when an asset no longer fulfils its intended purpose or becomes less effective in meeting the needs of the business or market. Changes in consumer preferences, industry trends, or regulations can contribute to functional obsolescence.
- iv. **Economic factors:** Economic conditions such as inflation, changes in market demand, or shifts in supply and demand dynamics can impact the value of assets. Fluctuations in the overall economy, industry-specific factors, or changes in the competitive landscape can lead to a decrease in the value of assets.
- v. **Legal and regulatory factors:** Changes in laws, regulations, or industry standards can affect the value of certain assets. For example, the introduction of new environmental regulations may require businesses to upgrade or replace existing assets, reducing their value.
- vi. **Time decay:** The passage of time itself can cause depreciation. Even without physical wear and tear or technological advancements, the mere ageing of an asset can result in a decrease in its value. This is particularly relevant for assets with limited useful lives or those that become less desirable as they get older.
- vii. **Accidents or damage:** Assets can also experience a sudden decline in value due to accidents, damage, or unforeseen events. For instance, a vehicle involved in a major collision may lose value due to the repair costs and the perception of reduced reliability.

- viii. Inadequate maintenance:** Insufficient or improper maintenance of assets can accelerate their depreciation. Regular maintenance, repairs, and upgrades are essential to preserve the value and extend the useful life of assets. Neglecting proper maintenance can result in faster depreciation and reduced asset value

2.1.4 Importance /Need for Providing Depreciation

It is mandatory to provide depreciation by all firms. The basic objectives are:

- i. To ascertain the true profit:** Depreciation is an operating expense of a physical asset that should be considered for the ascertainment of true profit earned during each year.
- ii. To ascertain the true value of an asset:** The Balance Sheet is prepared with the object of ascertaining the exact financial position of the firm. If no depreciation is provided the Balance Sheet will not disclose the exact financial position.
- iii. Provision of funds for the replacement of assets:** The asset is to be replaced after the expiry of the life span. Replacement of an asset requires sufficient funds. A suitable method of depreciation will help the firm to mobilise a sufficient amount of funds for the replacement of assets at the exact time.
- iv. Ascertaining the exact cost of production:** For ascertaining the exact cost of production, the exact amount of depreciation shall be charged to the cost of production. If not the cost of production will be understated and in turn will result in a lower selling price. Ultimately this will result in a loss of profit.
- v. Distribution of dividends out of capital:** If the proper amount of depreciation is not charged, this will result in paying a high dividend. The payment of a high dividend will lead to capital erosion and is detrimental.
- vi. For avoiding excess payment of income tax:** If the proper depreciation is not provided, the profit disclosed by the Profit and Loss Account will be more and the tax will be paid accordingly. The provision for depreciation will reduce the tax burden.

2.1.5 Factors Affecting Depreciation

The following are the various factors affecting depreciation:

- i. The original cost of the asset:** The original cost of the asset refers to the amount spent to acquire or construct the asset. It includes the purchase price, transportation costs, installation costs, and any other expenses directly attributable to bringing the asset into its working condition. The original cost serves as the basis for calculating depreciation.
- ii. Scrap value:** Scrap value, also known as residual value or salvage value, is the estimated value of an asset at the end of its useful life. It represents the expected amount that could be obtained from selling or disposing of the asset

after its useful life has ended. Scrap value is subtracted from the original cost to determine the depreciable amount, which is the amount that will be depreciated over the asset's useful life.

- iii. **Useful life:** Useful life refers to the estimated period during which an asset is expected to provide value to the business. It represents the time over which the asset is expected to be used, either physically or functionally, to generate revenue. The useful life is an important factor in calculating depreciation as it determines the period over which the depreciable amount will be allocated.
- iv. **Effect of Accounting Standard:** Different Accounting Standards, such as Generally Accepted Accounting Principles (GAAP) or International Financial Reporting Standards (IFRS), may prescribe specific rules and methods for calculating depreciation. These standards provide guidelines on how to determine the useful life, scrap value, and depreciation method to be used. Adhering to the applicable Accounting Standard ensures consistency and comparability of financial statements among different entities.
- v. **Chances of obsolescence:** Obsolescence refers to the risk that an asset may become outdated or less valuable due to technological advancements, changing market conditions, or evolving customer preferences. The chances of obsolescence are considered when estimating the useful life and scrap value of an asset. If there is a higher likelihood of obsolescence, the useful life may be shorter, and the scrap value may be lower, resulting in a higher rate of depreciation.
- vi. **Legal provisions:** Certain assets may be subject to legal provisions or regulations that affect their useful life or depreciation calculation. For example, tax laws may prescribe specific depreciation methods or useful life for certain types of assets. Legal provisions need to be considered to ensure compliance with applicable regulations and to accurately calculate the depreciable amount.

Considering these factors, the depreciable amount is determined by subtracting the estimated scrap value from the original cost and spreading this depreciable amount over the useful life of the asset using an appropriate depreciation method. The specific calculations and considerations may vary based on the accounting policies, applicable standards, and legal requirements of the business.

2.1.6 Accounting Treatment for Depreciation

For recording the amount of depreciation, the following entries are passed.

On purchase of an asset Asset A/c Dr. To Cash/bank A/c	XXXX	XXXX
For the amount of depreciation written off Depreciation A/c Dr. To Asset A/c	XXXX	XXXX
For charging depreciation to Profit and Loss Account Profit and Loss A/c Dr. To Depreciation A/c	XXXX	XXXX
For the sale of assets Bank A/c Dr. To Asset A/c	XXXX	XXXX
For the sale of asset at a loss Bank A/c Dr. Profit and Loss A/c Dr. To Asset A/c	XXXX XXXX	XXXX
For the sale of assets at a profit Bank A/c Dr. To Asset A/c To Profit and Loss A/c	XXXX	XXXX XXXX

Recap

- ◇ Amortisation - Writing off of an intangible asset.
- ◇ Depreciation - Shrinkage in the value of an asset.
- ◇ Depletion - Reduction in the value of assets due to permanent extraction.
- ◇ Fluctuation - Either increase or decrease in value.
- ◇ Obsolescence - Technological or functional obsolescence.
- ◇ Scrap value - Estimated end-of-life worth.

Objective Questions

1. What is the purpose of maintaining depreciation account?
2. What is the term that is used to describe a loss in value of an asset that arises out of new inventions?
3. What is the term which is used to denote the decrease in asset value brought about by permanent extraction?
4. Identify the term used for recording increase or decrease in the value of a current asset.
5. What term is used to describe the decline in the value of an asset due to becoming outdated or less useful?
6. Which term refers to the estimated worth of an asset at the end of its useful life?
7. What category of expense does depreciation fall under?
8. What is the term which is used to denote the process of writing off an intangible asset?

Answers

1. Prompt replacement of an asset
2. Obsolescence
3. Depletion
4. Fluctuation
5. Obsolescence
6. Scrap value
7. Non-cash expense
8. Amortisation

Self Assessment Questions

1. How does scrap value impact the calculation of depreciation?
2. Explain the concept of book value and its significance in asset valuation.
3. What are the main factors that affect the calculation of depreciation?
4. Name two factors that can contribute to obsolescence of an asset.
5. How does depreciation affect the financial statements of a business?
6. Define Amortisation and provide an example of an asset that is commonly amortised.
7. Explain the difference between Amortisation and depreciation.
8. Differentiate between depletion and depreciation.
9. Define fluctuation in the context of financial accounting.

Assignments

1. Identify three examples of assets that are prone to obsolescence. Explain the reasons behind their potential obsolescence.
2. Conduct a case study on a company of your choice and analyse the impact of depreciation on their financial statements. Discuss how depreciation affects the company's profitability and asset valuation.
3. Identify and discuss two Accounting Standards (GAAP or IFRS) that provide guidelines on the calculation and reporting of depreciation. Explain their key requirements and implications for businesses.
4. Select a specific type of asset (e.g., machinery, building) and discuss the factors that can contribute to its depreciation over time.

Suggested Reading

1. Maheswari, S. N. (2018). *Advanced Accounting*. Vikas Publishing House.
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Unit 2

Methods of Depreciations

Learning Outcomes

After completing this unit, the learner will be able to:

- ◇ calculate depreciation using fixed instalment method
- ◇ determine the value of depreciation using diminishing balance method
- ◇ differentiate fixed instalment method and diminishing balance method

Prerequisites

Depreciation is an essential accounting concept that enables businesses to allocate the cost of an asset over its useful life. By recognising the gradual decline in the value of an asset, depreciation ensures that the expenses associated with acquiring and using the asset are accurately reflected in a company's financial statements. There are several methods of calculating depreciation, each with its own advantages and considerations. In this unit, we will cover two common approaches: the fixed instalment method of depreciation and the diminishing balance methods of depreciation. These methods differ in their treatment of asset value over time and have distinct implications for financial reporting and decision making within organisations.

Keywords

Fixed instalment method, Diminishing balance method, Salvage value, Original cost



2.2.1 Fixed Instalment Method

Straight-line depreciation, also known as the fixed instalment method, is a straightforward approach to calculating depreciation. Under this method, the cost of an asset is evenly spread over its useful life, resulting in a constant depreciation expense in each accounting period. The formula for straight-line depreciation is:

$$\text{The annual amount of depreciation} = \frac{\text{Original cost of the asset} - \text{Scrap value}}{\text{Estimated useful life of the asset}}$$

In this formula, the cost of the asset is reduced by its estimated salvage value (the expected value at the end of its useful life), and the result is divided by the asset's useful life in terms of years. The straight-line method assumes a consistent decrease in value over time and is often employed for assets that have a predictable and uniform decline in value, such as buildings, office equipment, or vehicles.

By applying the fixed instalment method of depreciation, businesses can systematically allocate the cost of an asset over its useful life, accurately reflecting its declining value in their financial statements. This method provides simplicity and stability in expense recognition, making it easier for companies to plan and budget for the replacement or maintenance of assets.

Advantages

- i. ***Simplicity and ease of use:*** The straight-line method is straightforward and easy to understand. It involves a simple calculation where the cost of the asset is divided equally over its useful life. This simplicity makes it widely accessible and applicable for businesses of all sizes and industries.
- ii. ***Predictability and consistency:*** The straight-line method provides a consistent and predictable pattern of depreciation. Since the depreciation expense remains the same throughout the asset's useful life, it allows for easier financial planning and budgeting. This predictability aids in more accurate financial forecasting and decision making.
- iii. ***Equal allocation of costs:*** By evenly spreading the cost of the asset over its useful life, the straight-line method ensures that the expense is allocated fairly and consistently. This aligns with the matching principle in accounting, where expenses are matched with the revenues they generate.

Disadvantages

- i. **Unrealistic assumption:** The straight-line method assumes that the asset depreciates evenly over time. However, in reality, many assets may have different patterns of value decline. Some assets might experience higher depreciation in the early years, while others may have a more rapid decline in later years. The straight-line method does not account for these variations.
- ii. **Inaccurate reflection of asset value:** Due to its linear nature, the straight-line method may not accurately represent the asset's actual value at any given point in time. The asset may be worth significantly more or less than its recorded value on the Balance Sheet. This discrepancy can affect the financial reporting and decision making process.
- iii. **Tax implications:** Depending on the tax regulations in a particular jurisdiction, using the straight-line method may not provide the most advantageous tax benefits. Other depreciation methods, such as accelerated depreciation, may allow for larger deductions in the early years, resulting in reduced tax liabilities.
- iv. **Ignoring technological advancements:** In industries with rapid technological advancements, assets can quickly become outdated or obsolete. The straight-line method does not account for this factor and may result in overestimating the asset's useful life and undervaluing the need for asset replacement or upgrades.

Illustration 2.2.1

X Ltd purchased a machinery costing ₹80000 on 1 April 2011. It is expected to have a life span of 7 years, by the end of which it would get a scrap value of ₹10000. Prepare machinery account in the books of X Ltd for the first three years by providing depreciation under the fixed instalment method. Accounts are closed on 31 March every year.

Solution

$$\begin{aligned}\text{The annual amount of depreciation} &= \frac{\text{Original cost of the asset} - \text{Scrap value}}{\text{Estimated useful life of the asset}} \\ &= \frac{80000 - 10000}{7} \\ &= 10000\end{aligned}$$

Machinery Account

Date	Particulars	Amount	Date	Particulars	Amount
1-04-2011	To Bank	80000	31-03-2012	By Depreciation	10000
			31-03-2012	By Balance c/d	70000
		80000			80000
1-04-2012	To Balance b/d	70000	31-03-2013	By Depreciation	10000
			31-03-2013	By Balance c/d	60000
		70000			70000
1-04-2013	To Balance b/d	60000	31-03-2014	By Depreciation	10000
			31-03-2014	By Balance c/d	50000
		60000			60000
1-04-2014	Balance b/d	50000			

2.2.2 Diminishing Balance Method

This method is also known as the written down value method or reducing instalment method. Diminishing balance method is a depreciation approach that assumes that an asset's value declines more rapidly in the early years of its useful life and gradually slows down over time. This method reflects the recognition that many assets tend to be more productive and valuable in their initial years of use, but their efficiency and worth diminish as they age.

Under the diminishing balance method, a fixed percentage rate, often referred to as the depreciation rate or the depreciation factor, is applied to the asset's net book value (cost minus accumulated depreciation) at the beginning of each period. The depreciation expense is calculated as:

$$\text{Annual Depreciation} = \text{Depreciation Rate} \times \text{Net Book Value}$$

The diminishing balance method is often used for assets that are expected to have a higher rate of obsolescence or rapid technological advancements, such as computers, software, or electronic devices. This method recognises that these assets may lose their value more quickly than assets with a more consistent decline in worth. The diminishing balance method allows companies to allocate more significant depreciation expenses in the earlier years, reflecting the asset's higher productivity and generating tax advantages through accelerated deductions.

Advantages

- i. **Reflects asset's actual usage:** The diminishing balance method aligns with the concept that assets often experience a higher rate of depreciation in their early years due to heavy usage or technological advancements. This method better reflects the asset's actual decline in value over time, especially for assets that quickly become outdated or less efficient.
- ii. **Tax benefits:** The accelerated depreciation provided by the diminishing balance method can result in higher depreciation deductions in the earlier years. This can lead to increased tax benefits and reduced tax liabilities for businesses, providing more immediate cash flow advantages.
- iii. **Early expense recognition:** The diminishing balance method allows businesses to front-load depreciation expenses. This means that a larger portion of the asset's cost is expensed in the earlier years, which can provide a more accurate reflection of the asset's contribution to revenue generation during its more productive stages.

Disadvantages

- i. **Overstated asset value in later years:** As the diminishing balance method applies a higher depreciation rate in the early years, the asset's net book value may be overstated in the later years of its useful life. This can lead to an inflated representation of the asset's value on the Balance Sheet, potentially misrepresenting its true economic worth.
- ii. **Inconsistent expense recognition:** Unlike the straight-line method, where depreciation expense is evenly distributed, the diminishing balance method results in varying depreciation expenses each period. This can make financial analysis and year-over-year comparisons more challenging, as the depreciation expenses fluctuate based on the asset's net book value.
- iii. **Limited applicability:** The diminishing balance method may not be suitable for all types of assets. It is typically more appropriate for assets with a higher rate of obsolescence or assets which rapidly decline in value. Assets that have a more consistent or linear decline may be better served by other depreciation methods, such as straight-line depreciation.
- iv. **Value not reduced to zero:** The disadvantage of the diminishing balance method is that it does not reduce the asset's value to zero within its useful life. Unlike some other depreciation methods, such as the straight-line method, the diminishing balance method may not fully write off the asset's value by the end of its useful life.

2.2.3 Difference between Fixed instalment and Diminishing balance method

The two most important methods of charging depreciation are straight-line method. The following are the differences:

Table 3.2.1

Difference between Fixed instalment and Diminishing balance method

Basis	Fixed Instalment Method (Straight-Line)	Diminishing Balance Method (Declining Balance)
Calculation of depreciation	Equal amount allocated in each accounting period	Calculated based on a fixed percentage and declining balance
Depreciation expense pattern	Constant depreciation expense throughout the asset's useful life	Higher depreciation expense in the early years, gradually decreasing over time
Distribution of costs	Uniformly distributed to the Profit and Loss Account	More significant expenses recognised in the earlier years
Assumption	Assumes a constant rate of decline in asset value	Assumes a faster decline in asset value in the early years, gradually slowing down
Asset value reduction	Asset value reduces linearly over its useful life	Asset value may not be reduced to zero within its useful life
Applicability	Suitable for assets with consistent and predictable decline in value	Suitable for assets prone to rapid obsolescence or declining value
Accounting complexity	Relatively simple and straightforward calculations	Requires more complex calculations and monitoring of depreciation rates

Illustration 2.2.2

On 1 April 2016 Chand and Associates purchased machinery for ₹60000 and spent ₹10000 for installation. The machinery is to be depreciated at 20% per annum. Prepare the machinery account for the first two years, depreciating under:

- Diminishing Balance Method
- Fixed Instalment Method.

Accounts are closed on 31 March every year.



Solution

A. Diminishing Balance Method

Date	Particulars	Amount	Date	Particulars	Amount
1-04-2016	To Bank		31-03-2017	By Depreciation	14000
	(60000+10000)	70000	31-03-2017	By Balance c/d	56000
		70000			70000
1-04-2017	To Balance b/d	56000	31-03-2018	By Depreciation	11200
			31-03-2018	By Balance c/d	44800
		56000			56000
1-04-2018	To Balance b/d	44800			

B. Fixed Instalment Method

Date	Particulars	Amount	Date	Particulars	Amount
1-04-2016	To Bank	70000	31-03-2017	By Depreciation	14000
	(69000+10000)	-	31-03-2017	By Balance b/d	56000
		70000			70000
1-04-2017	To Balance b/d	56000	31-03-2018	By Depreciation	14000
			31-03-2018	By Balance c/d	42000
		56000			56000
1-04-2018	To Balance b/d	42000			

(When there are additions of assets)

Illustration 2.2.3

On 1 January 2007, a company bought plant and machinery costing ₹45000 and spent ₹5000 for installation charges. The company additionally purchased machinery on 1 July 2009 for the value of ₹20000. Depreciation is to be provided at 10% per annum. Prepare Plant and Machinery Account for four years under:

- Fixed instalment system
- Diminishing balance method

Accounts are closed on 31 December every year.



Solution

A. Fixed Instalment Method

Plant and Machinery Account

Date	Particulars	Amount	Date	Particulars	Amount
1-01-2007	To Bank (45000+5000)	50000	31-12-2007	By Depreciation	5000
			31-12-2007	By Balance c/d	45000
		50000			50000
1-01-2008	To Balance b/d	45000	31-12-2008	By Depreciation	5000
			31-12-2008	By Balance c/d	40000
		45000			45000
1-01-2009	To Balance b/d	40000	31-12-2009	By Depreciation (5000+1000)	6000
1-07-2009	To Bank	20000	31-12-2009	By Balance c/d	54000
		60000			60000
1-01-2010	To Balance b/d	54000	31-12-2010	By Depreciation	7000
			31-12-2010	By Balance c/d	47000
		54000			54000
1-01-2011	To Balance b/d	47000			

$$\text{Annual depreciation for plant and machinery} = 50000 \times \frac{10}{100}$$

$$= 5000$$

$$\text{Annual depreciation for furniture} = 20000 \times \frac{10}{100}$$

$$= 2000$$

$$\text{Depreciation for 6 months (01-07-2009 to 31-12-2009)} = 20000 \times \frac{10}{100} \times \frac{6}{12}$$

$$= 1000$$

B. Diminishing Balance Method

Plant and Machinery Account

Date	Particulars	Amount	Date	Particulars	Amount
1-01-2007	To Bank (45000+5000)	50000	31-12-2007	By Depreciation	5000
			31-12-2007	By Balance c/d	45000
		50000			50000
1-01-2008	To Balance b/d	45000	31-12-2008	By Depreciation	4500
			31-12-2008	By Balance c/d	40500
		45000			45000
1-01-2009	To Balance b/d	40500	31-12-2009	By Depreciation (4050+1000)	5050
1-07-2009	To Bank	20000	31-12-2009	By Balance c/d	55450
		60500			60500
1-01-2010	To Balance b/d	55450	31-12-2010	By Depreciation	5545
		55450	31-12-2010	By Balance c/d	49905
					55450
1-01-2011	To Balance b/d	49905			

(When there is a sale of the asset)

Illustration 2.2.4

On January 1 2007, Rainbow Ltd. purchased machinery worth ₹112000, with an additional ₹8000 paid for erection and carriage. On January 1 2008, additional machinery was purchased for ₹60000. On July 1 2009, new machinery was bought for ₹34000, with an additional ₹6000 spent on erection. On July 1 2010, the machinery purchased on July 1 2009, was sold for ₹33000. Depreciation is provided at a rate of 10% per annum. The accounts are closed on December 31 each year. Prepare necessary accounts, under fixed instalment method.



Solution

Machinery Account

Date	Particulars	Amount	Date	Particulars	Amount
1-01-2007	To Bank	120000	31-12-2007	By Depreciation	12000
			31-12-2007	By Balance c/d	108000
		120000			120000
1-01-2008	To Balance b/d	108000	31-12-2008	By Depreciation	18000
1-01-2008	To Bank	60000		(12000+6000)	
			31-12-2008	By Balance c/d	150000
		168000			168000
1-01-2009	To Balance b/d	150000	31-12-2009	By Depreciation	
1-07-2009	To Bank	40000		(12000 + 6000 + 2000)	20000
				By Balance c/d	170000
		190000			190000
1-01-2010	To Balance b/d	170000	01-07-2010	By Bank	33000
			01-07-2010	By Profit and Loss A/c	3000
			31-12-2010	By Depreciation	
				(12000+6000+2000)	20000
				By Balance c/d	114000
		170000			170000

Working note

Calculation of loss on sale of machinery

Cost of machinery sold	40000
Less depreciation for 6 months 01-07-2009 to 31-12-2009 $(40000 \times \frac{10}{100} \times \frac{6}{12})$	2000

Less depreciation for 6 months in 01-01-2010 to 31-06-2010	2000
$(40000 \times \frac{10}{100} \times \frac{6}{12})$	
	36000
Less sale price	33000
Loss on sale transferred to P&L A/c	3000

Illustration 2.2.5

On 1 January 2007, ABC Ltd. bought machinery worth ₹54000 and paid ₹6000 on installation charge. On 1 January 2008, an addition is made to the machinery for ₹30000. On 1 July 2009, a second-hand machinery is bought for ₹34000 and spent ₹6000 for erection. On 1 July 2010, the machinery bought on 1 July 2009 was sold for ₹33000. Depreciation provided 10% p.a. Accounts are closed on 31 December each year. Prepare necessary accounts, under diminishing balance method.

Solution

Machinery Account

Date	Particular	Amount	Date	Particulars	Amount
1-01-2007	To Bank	60000	31-03-2007	By Depreciation	6000
			31-03-2007	By Balance c/d	54000
		60000			60000
1-01-2008	To Balance b/d	54000	31-03-2008	By Depreciation	8400
1-01-2008	To Bank	30000	(5400+3000)		
			31-03-2008	By Balance c/d	75600
		84000			84000
1-01-2009	To Balance b/d	75600	31-03-2009	By Depreciation	9560
1-07-2009	To Bank	40000	(7560+2000)		
			31-03-2009	By Balance c/d	106040
		115600			115600



1-01-2010	To Balance b/d	106040	01-07-2010	By Bank	33000
			01-07-2010		
			31-03-2010	By Profit and Loss A/c	3100
			31-03-2010	By Depreciation	8704
			31-03-2010	By Balance c/d	61236
		106040			106040
1-01-2011	To Balance b/d	61236			

Calculation of depreciation for the year 2010

$(106040 - 38000) \times \frac{10}{100} =$	6804
$38000 \times \frac{10}{100} \times \frac{6}{12} =$	1900
Total	8704

Calculation of loss on sale of machinery

Cost of machinery sold	40,000
Less depreciation 2009 for 6 months at 10% p.a.	<u>2,000</u>
	38,000
Less depreciation in 2010 at 10% for 6 months	<u>1900</u>
	36100
Less Selling price	<u>33000</u>
Loss on sale	3100

Recap

- ◇ Fixed instalment method - Amount of depreciation is same every year
- ◇ Diminishing balance method - Amount of depreciation is reducing every year
- ◇ Diminishing balance method - Depreciation is calculated on book value

- ◇ Straight line method - Depreciation is calculated on original cost of the asset
- ◇ Diminishing balance method - Highly useful for those assets having more life
- ◇ Annual amount of depreciation under fixed instalment method -

$$= \frac{\text{Original cost of the asset} - \text{Scrap value}}{\text{Estimated useful life of the asset}}$$

Objective Questions

1. What is the other name for the fixed instalment method?
2. Which method of depreciation maintains a constant amount charged throughout the asset's life?
3. How the depreciation per year calculated using the straight-line method?
4. What is the alternative name for the Diminishing Balance Method?
5. What is the basis for calculating depreciation under the Diminishing Balance Method?
6. How would you define salvage value in relation to depreciation?
7. What method of depreciation evenly allocates the cost of an asset over its useful life?
8. Does the depreciation expense increase, decrease, or have no effect on the carrying value of the asset in the diminishing method?

Answers

1. Straight-line method or original cost method.
2. Fixed instalment method
3. Annual depreciation = $\frac{\text{Original cost of the asset} - \text{Scrap value}}{\text{Estimated useful life of the asset}}$

4. Written down value method or reducing installment method
5. Book value
6. Estimated disposal value
7. Straight-line method
8. Decrease

Self-Assessment Questions

1. Compare and contrast the straight-line method and the diminishing balance method of depreciation. Discuss their underlying principles and application scenarios.
2. Explain how the choice between the straight-line method and the diminishing balance method can impact financial statements and the reported profitability of a company.
3. Discuss the advantages and disadvantages of using the straight-line method in different industries or types of assets.
4. Consider a scenario where an asset has a high salvage value. Which method of depreciation, straight-line or diminishing balance, would be more appropriate in this situation and why?
5. Suppose a company acquires a new technology asset that is expected to become obsolete in a short period of time. Which method of depreciation, straight-line or diminishing balance, would be more suitable for reflecting the asset's decreasing value accurately? Justify your answer.
6. Discuss the advantages and disadvantages of using the diminishing balance method in different industries or types of assets.
7. What is the formula to compute the value of depreciation using straight-line method?
8. What are the two methods that can be followed for maintaining depreciation accounts? Explain each by stating its advantages and disadvantages.

Assignments

1. On 1 April 2020 JK and Associates purchased a machinery for ₹120000 and spent ₹20000 for erection. The machinery is to be depreciated at 10% per annum. Prepare the machinery account for the first two years, depreciating under Diminishing Balance Method. Accounts are closed on 31 March every year.

(Answer: 113400)

2. Show the machinery account for 5 years using, straight-line method and written down method, assuming an annual depreciation of 10%, based on the following information:

- i. On 1 April 2012, a firm purchased machinery worth ₹150000.
- ii. On 1 October 2015, the firm bought additional machinery worth ₹30000. with an additional expenditure of ₹3000 for erection.
- iii. The accounts are closed each year on March 31.

(Answers: Balance as on 31 March, 2017, ₹103050 (straight-line method)

and ₹116788.5 (written down method))

3. ABC Ltd. company acquired machinery for ₹16000 as on 01-01-2015, which has a useful life of 7 years and a residual value of ₹2000 at the end of its useful life. Use the straight-line method to prepare the Machinery account for a period of 3 years.

(Answer: Depreciation per year = ₹2000 value of machinery after 3 years = ₹10000)

4. Calculate the depreciation under the straight-line method and prepare the Machinery account for a period of 2 years using the following data for Mansoon Ltd:

- ◇ Cost of machinery - ₹250000
- ◇ Purchase date - 01-01-2018
- ◇ Useful life - 5 years
- ◇ Residual value - ₹5000

(Answer: Depreciation per year = ₹49000 value of machinery after 2 years = ₹152000)



5. On January 1 2019, XYZ Ltd. company purchased machinery for ₹100000. On July 1, 2020, an additional machinery was purchased for ₹50000. The company applies a depreciation rate of 10% per year. The accounts are closed on 31 December every year. Prepare the Machinery account for three year using diminishing balance method.

(Answer: ₹115650)

Suggested Readings

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Bills of Exchange

BLOCK



Unit 1

Introduction to Bills of Exchange

Learning Outcomes

After completing this unit, the learners will be able to:

- ◇ explain the concept of bills of exchange and meaning of different terms involved in the bills of exchange
- ◇ identify the parties involved in the bills of exchange
- ◇ familiarise with the various transactions relating to the bills of exchange
- ◇ record transactions relating to the bills of exchange

Prerequisites

There were two traders: Baiju from Kerala and Raja from West Bengal. Baiju had a shipment of spices that Raja wanted to buy for his store in Kolkata. However, there was a small problem. Raja didn't have the cash on hand to pay for the spices immediately, and Baiju didn't want to ship his goods without some guarantee of payment. Baiju drew up a document that stated: Raja promises to pay Baiju the sum of rs10,000 in three months." This document was signed by both Baiju and Raja, making it a legally binding agreement. This document is a bill of exchange; now holding this bill of exchange, he was assured that Raja would pay him after three months. In the meantime, Baiju could even use this bill to raise money. He could take the bill to his local bank and show them the document, and the bank might agree to give him some of the money immediately in exchange for the bill, keeping a small fee for themselves. The bank would then collect the full amount from Raja when the bill was due. Three months later, when Raja had sold the spices in his store and made a profit, he could pay rs 10,000 to the bank (or to Baiju directly if he hadn't discounted the bill). Baiju got his money; Raja got her spices. This illustrates how a bill of exchange works. It's a way for buyers and sellers to trade goods on credit while ensuring that the seller has some guarantee of payment in the future.

Keywords

Negotiable Instrument Act, Drawer, Drawee, Payee, Acceptance

Discussion

3.1.1 Bills of Exchange

The main aim of every business is to make maximum profit by increasing sales. In a competitive environment, a trader is forced to sell his goods on a credit basis, where the buyer promises to make the payment after an agreed credit period. In that case, the seller collects a document from the buyer, named a bill of exchange or a promissory note. Both of these instruments are legal under the Negotiable Instrument Act of 1881.

3.1.2 Meaning

A bill of exchange is a written acknowledgement of a debt given by one person to another. It is drawn on the debtor by the creditor. It directs the debtor to pay a definite amount on demand or after the expiry of the period stated therein. It is a legal document and is considered evidence of debt.

3.1.3 Definition

A bill of exchange has been defined under Section 5 of the Indian Negotiable Instrument Act, 1881 as “an instrument in writing containing an unconditional order signed by the maker, directing a certain person to pay a certain sum of money only to, or to the order of, a certain person or to the bearer of the instrument.”

3.1.4 Essentials of a Bill of Exchange

The following are the essentials of a bill of exchange:

- ◇ It should be in writing.
- ◇ It should contain an order by the seller to the purchaser to make the payment in future. A mere request by the seller to the purchaser to make the payment in future does not amount to a bill of exchange.
- ◇ The payment to be made must be certain and it should be in money alone.
- ◇ The purchaser upon whom the bill is drawn is known as “drawee” and he must be a certain person.

- ◇ The person to whom payment of the bill is to be made is known as “Payee”.
- ◇ The order contained in the bill should be unconditional.
- ◇ The maker of the bill or the seller is known as “drawer” and the bill must be signed by him.

Normally, the drawer and payee are the same person. Similarly, the drawee and the acceptor are the same person. For example, Lokesh Kumar sold goods worth ₹20000 to Vijay and drew a bill of exchange on him for the same amount payable in three months. Here, Lokesh Kumar is the drawer of the bill, and Vijay is the drawee. If the bill is retained by Lokesh Kumar for three months and the amount of ₹20000 is received by him on the due date, then Lokesh Kumar will be the payee. If Lokesh Kumar gives away this bill to his creditor Ruchi, then Ruchi will be the payee. If Lokesh Kumar gets this bill discounted to the bank, then the bank will become the payee. In this bill of exchange, Lokesh Kumar is the drawer, and Vijay is the drawee. Since Vijay has accepted the bill, he is the acceptor.

3.1.5 Important Points in Bill of Exchange

The following points should be considered in the preparation of bill of exchange:

- i. Parties to a bill of exchange
 - a) The drawer: He/she is the maker of the bill of exchange. A seller/creditor who is entitled to receive money from the debtor can draw a bill of exchange upon the buyer/debtor. The drawer after writing the bill of exchange has to sign it as the maker of the bill of exchange.
 - b) The drawee or the acceptor: The drawee is the debtor, and a bill is written by the drawer ordering the drawee to make a certain payment after a fixed period.
 - c) The payee: The payee is the person to whom payment of the bill is to be made on the maturity date. The drawer of the bill himself/herself will be the payee if he/she keeps the bill till the date of payment.
- ii. **Stamp:** The stamp is fixed on every bill of exchange except bills payable on demand. The value of the stamp affixed varies according to the amount of the bill.
- iii. **Amount:** The amount for which the bill is drawn is written twice, once in the figure and again in words, to avoid the possibility of alteration.
- iv. **Date:** The date of writing the bill must be given on the face of the bill because the period of the bill is to be counted from this date.

- v. **Term:** It is the period after which the payment of the bill becomes due.
- vi. **For value received:** The last words in the body of the bills of exchange, “value received,” indicate that the drawer is drawing the bill upon the drawee in consideration of the goods he has sold to the drawee on credit.
- vii. **Tenure of the bill:** The time period for the payment of the bill is known as the tenure of the bill.
- viii. **Days of grace:** Days of grace are three extra days added to the period of the bill. It is customary to add the days of grace.

Example: Suppose a bill is drawn on 5 March and is payable after three months. The three months will end on 5 June; adding three days, the due date will be 8 June. If the due date falls on a public holiday, the bill will be payable the preceding working day; a bill due on 26 January will be payable on 25 January. When the due date (last day of grace) is a bank holiday or Sunday and the second day of grace is also a holiday, the bill is payable the next (succeeding) business day. It may be noted that days of grace are not added in case of instruments payable on demand.

- i. **Date of maturity:** - The date which comes after adding three days to the due date of a bill is called the date of maturity.

3.1.6 Advantages of the Bills of Exchange

The bills of exchange as an instrument of credit is frequently used in business because of the following advantages:

- ◇ **Framework for relationship:** A bill of exchange represents a device which provides a framework for enabling the credit transaction between the seller/creditor and buyer/debtor on an agreed basis.
- ◇ **Certainty of terms and conditions:** The creditor knows the time when he will receive the money and also the debtor is fully aware of the date by which he has to pay the money
- ◇ **Convenient means of credit:** A bill of exchange enables the buyer to buy the goods on credit and pay after the period of credit.
- ◇ **Conclusive proof:** The bill of exchange is legal evidence of a credit transaction implying thereby that during the course of trade. The buyer has obtained credit from the seller of the goods; therefore, he is liable to pay the seller.
- ◇ **Easy transferability:** A debt can be settled by transferring a bill of exchange through endorsement and delivery.

3.1.7 Types of Bills of Exchange

Bill of exchange can be classified on the basis of time, objective and territory.

On the basis of time

i. Demand bill of exchange

It is a bill that has no fixed date for the payment. It is payable at the time when it is presented by the holder. Days of grace are not allowed on demand bill. Demand bill is also known as sight bill.

ii. Term bill of exchange

It is a bill which is drawn for a specific time period. This type of bill has either a fixed future date or a determinable future time.

◇ On the basis of objective

iii. Trade bill of exchange

A trade bill of exchange is drawn and accepted as a result of credit transaction. This type of bill is drawn by the creditor (Seller) and accepted by the debtor (Buyer).

iv. Accommodation bill of exchange

Accommodation bill is drawn and accepted without the sale and purchase of goods. The main purpose of such bill is to provide financial assistance to one or both parties. This bill does not come into existence due to any trading activity.

On the basis of territory

i. Inland bill of exchange

It is a bill that is drawn, accepted, and payable in one country and is called an inland bill of exchange. Actually, the drawer and drawee of this bill are residents of the same country.

ii. Foreign bill of exchange

A bill which is drawn in one country and accepted and payable in another country is called a foreign bill of exchange. Actually, the drawer and drawee of this bill are the residents of two different countries.

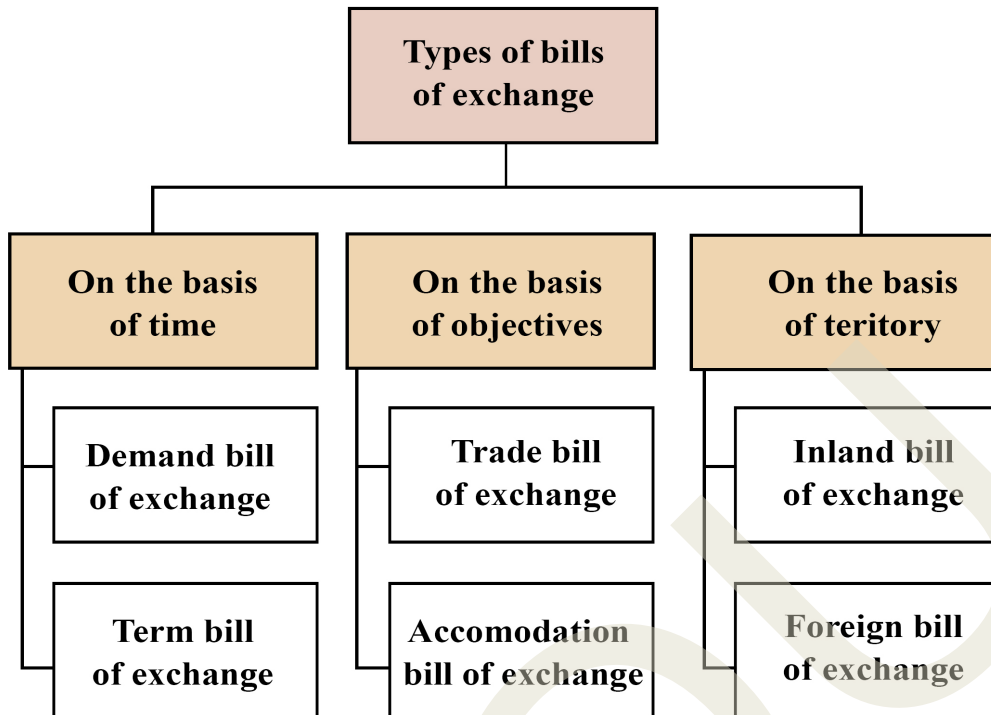


Figure 3.1.1
Types of bills of exchange

Recaps

- ◇ Bill of exchange – Credit tool in the business.
- ◇ Trade bill of exchange - Sale and purchase of goods on credit.
- ◇ Accommodation bill - Without sale and purchase of goods.
- ◇ Accommodation bill - Financial assistance to one or both parties.
- ◇ Draft - Bill of exchange before its acceptance.
- ◇ Foreign bill of exchange - Drawn and accepted in two different countries.
- ◇ Inland bill of exchange - Bill drawn, accepted, and payable in one country.
- ◇ Demand bill - Sight bill.

Objective Questions

1. For which circumstances are a trade bills drawn?
2. Identify the type of bill that is drawn and accepted without sale.
3. What is the term which is used to denote the time period in which a bill is required to be paid?
4. What is it called, when all the parties in a bill of exchange are from within a country?
5. Identify the type of bill, which is drawn in one country and accepted and payable in another country.
6. Who signs a negotiable instrument and orders the payment?
7. Who is the person or entity who receives the payment mentioned in a negotiable instrument?
8. To whom is the bill of exchange drawn and is responsible for making the payment?

Answers

1. Sale and purchase of goods
2. Accommodation bill
3. The tenure of the bill
4. Inland bill
5. Foreign Bill
6. Drawer
7. Payee
8. Drawee

Self-Assessment Questions

1. Who are the parties involved in a Bills of Exchange?
2. What are the advantages of using a Bill of Exchange in commercial transactions?
3. Name three types of Bills of Exchange.
4. Explain the process of drawing a Bill of Exchange.
5. How does a Bill of Exchange facilitate trade between parties?
6. What is the role of the drawer in a bill of exchange transaction?
7. Who is a drawee in a bill of exchange, and what is their responsibility?
8. How does discounting a bill of exchange work and what are the benefits?
9. Explain the concept of maturity date in relation to a bill of exchange.

Assignments

1. Write a short essay discussing the origins of bills of exchange and their importance in facilitating international trade.
2. Study the similarities and differences between bills of exchange and cheque including their characteristics, parties involved, legal frameworks, and practical applications.
3. Prepare a step-by-step guide explaining the process of creating and issuing a bill of exchange.
4. Analyse and compare the advantages and disadvantages of using bills of exchange as a method of payment compared to other financial instruments.
5. What is accommodation bill? How it is useful for a business for short term money requirements?

Suggested Readings

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Unit 2

Accounting Treatment of Bills of Exchange

Learning Outcomes

After completing this unit, the learner will be able to:

- ◇ differentiate honouring and dishonouring of bills
- ◇ familiarise with the concept of bill discounting
- ◇ gain insights on the accounting treatment required for discounting of bill
- ◇ explain the accounting procedure for bills sent for collection

Prerequisites

In the previous unit, we learnt about the "Tenure of the bill," which denotes the specific period during which a bill is valid. As the maturity date nears, the drawee is anticipated to render payment. Nevertheless, particular inquiries may arise:

- What transpires if the drawer urgently requires money prior to the bill's maturity date?
- How can the bill be securely preserved until its maturity date?
- What transpires if the drawee defaults in making the payment to the drawer on the maturity date?

In this unit, we shall examine the accounting treatments for bills of exchange under various circumstances, addressing these crucial questions to impart a clearer comprehension of bill management.

Keywords

Dishonouring of bill, Rebate, Noting, Discounting of bill, Endorsement of bill, Bill sent for collection

Discussion

3.2.1 Acceptance of a Bill

The mere fact that one person draws a bill upon another does not make the drawee liable for payment of the amount. The drawee (Debtor) must accept the liability before he/she can be made liable. It will become a valid bill of exchange only when the drawee accepts the bill. This is done by writing the word 'accepted' across the face of the bill together with his/her signature and date. This act is called 'the Acceptance of the Bill'.

Similarly, the drawee must accept the bill within 48 hours of its receipt from the maker of the instrument: otherwise, the bill will be considered as "Dishonoured by Non-acceptance"

After the drawee has accepted the bill, he is known as the acceptor. Now the bill has become a valid bill of exchange and is called the 'Acceptance'. A bill of exchange before its acceptance is called the 'Draft'. The bill is then returned to the drawer. As far as the drawer is concerned, it is a bill receivable, and to the acceptor, it is a bill payable.

3.2.2. Accounting Treatment

For the purpose of accounting, a bill of exchange is known by two names, viz., a) Bills receivable and b) Bills Payable. A bill in respect of which a trader has to receive money is called a bill receivable. A bill accepted by a trader and for which one has to pay money is called bills payable. The journal entries relating to the same bill of exchange will differ in various parties' books. So, it is essential to know the various journal entries to be recorded in the books of different parties.

A bill receivable can be treated in the following four ways by its holder:

- i. He may hold it till maturity and obtain the payment from the acceptor on the due date (Honouring of bills).
- ii. He may discount it with his banker for immediate cash. The banker will deduct

a small amount, known as discount, and the balance amount is paid to him (Discounting of bills).

- iii. He may transfer it to his creditors (Endorsement of bills)
- iv. He may send it to the bank for collection on the due date (Bills sent for collection).

The accounting treatment under the above four options is given below under the assumption that the acceptor duly honours the bill on maturity.

3.2.2.1. When the bill is retained by the holder till the date of maturity

In this case, the bill is honoured on maturity date. Honouring a bill refers to the act of fulfilling the financial obligation stated in the bill by making the payment within the specified time frame. Let us discuss the journal entries.

Journal entry in the books of the Drawer

Date	Particulars	L.F.	Amount (Dr.)	Amount (Cr.)
I	When the goods are sold on credit			
	Debtor's A/c Dr.		xxx	
	To Sales A/c			xxx
II	On receiving the bill after acceptance			
	Bills receivable A/c Dr.		xxx	
	To Debtor's A/c			xxx
III	On maturity of the bill (presented on the due date and payment received)			
	Cash A/c/ Bank A/c Dr.		xxx	
	To Bills receivable A/c			xxx

Journal entry in the books of the Drawee/ Acceptor

Date	Particulars	L.F.	Amount (Dr.)	Amount (Cr.)
I	When goods are purchased on credit.			
	Purchases A/c Dr. To Creditor's A/c		xxx	xxx
II	On accepting the bill and giving it to drawer.			
	Creditor's A/c Dr. To Bills payable A/c		xxx	xxx
III	On maturity of the bill (payment made on the due date)			
	Bills payable A/c Dr. To Cash/ Bank A/c		xxx	xxx

Illustration 3.2.1

Ragesh sold goods for ₹5000 on credit to Dileep on 15 March 2013 and drew a bill for the amount 2 months after date. Dileep duly accepted the bill and returned it to Ragesh. The bill was honoured at maturity. Show entries in the books of both the parties.

Solution

It involves the following steps:

- When goods are sold on credit, it requires a journal entry to record the sale of goods.
- When the seller draws bill, no entry is required. It will become a valid bill only when it is accepted.
- The bill is accepted and returned to seller of goods. On receiving the bill, the debt of Dileep is cancelled and in turn Ragesh got an asset (Bills receivable) worth ₹5000 from him. Hence a journal entry is necessary.
- Then the bill is honoured at maturity. That means on the due date Dileep will make the payment on receiving the bill from Ragesh. An entry is required when cash is paid to Ragesh. The transactions can be journalised as follows;

Journal entry entries in the books of Ragesh (Drawer)

Date	Particulars	L.F.	Amount (Dr.)	Amount (Cr.)
15-03-13	Dileep A/c Dr. To Sales A/c (Sold goods on credit)		5000	5000
15-03-13	Bills Receivable A/c Dr. To Dileep A/c (An acceptance received from Dileep)		5000	5000
18-05-13	Cash A/c Dr. To Bills receivable A/c (Cash received on the bill at maturity)		5000	5000

Journal entry entries in the books of Dileep (Drawee)

Date	Particulars	L.F.	Amount (Dr.)	Amount (Cr.)
15-03-13	Purchases A/c Dr. To Ragesh A/c (Purchased goods on credit)		5000	5000
15-03-13	Ragesh A/c Dr. To Bills Payable A/c (Accepted the bill drawn by Ragesh)		5000	5000
18-05-13	Bills payable A/c Dr. To Cash A/c (Cash paid on the bills payable at maturity)		5000	5000

3.2.2.2. When the bill is discounted

If the holder of a bill wants cash immediately before the maturity of the bill, he/she can sell it to the banker or some other person. The purchaser will deduct from the face value of the bill a certain amount called 'discount' and pays the balance to the holder of the bill. This is called "Discounting the bill". The purchaser deducts discount because he/she has to wait for the money till the bill becomes due. The discount is the interest charged for the amount advanced, calculated at a certain percentage on the face value for the unexpired period.

When the holder gets the bill discounted from the bank, the following journal entry is required to be passed in his book

Bank A/c	Dr.	xxx	
Discount A/c	Dr.	xxx	
	To Bills receivable A/c		xxx

Illustration 3.2.2

Rajan sold goods worth ₹5000 on credit to Reji on 1 January, 2014 and drew a bill for the amount on a date after 3 months. Reji duly accepted the bill and returned it to Rajan. On 4 January, Rajan discounted the bill with his bank at 12 per cent per annum. On the due date the bill is met. Give journal entries in the books of Rajan and Reji.

Solution

Journal entries in the books of the drawer (Rajan)

Date	Particulars	L.F.	Amount (Dr.)	Amount (Cr.)
01-01-14	Reji's A/c Dr. To Sales A/c (Sold goods on credit)		5000	5000
01-01-14	Bills receivable A/c Dr. To Reji's A/c (Received Reji's acceptance for three months)		5000	5000

04-01-14	Bank A/c	Dr.	4850	
	Discount A/c	Dr.	150	
	To Bills receivable A/c			5000
	(Reji's acceptance discounted with the bank @ 12% per annum)			

Calculation of discount

$$\text{Discount} = 5000 \times \frac{3}{12} \times \frac{12}{100} = ₹150$$

Journal entries in the books of Drawee (Reji)

Date	Particulars	L.F.	Amount (Dr.)	Amount (Cr.)
01-01-14	Purchases A/c Dr.		5000	
	To Rajan's A/c (Purchased goods on credit)			5000
01-01-14	Rajan's A/c Dr.		5000	
	To Bills payable A/c (Accepted the bill drawn by Rajan payable after three months)			5000
04-04-14	Bills payable A/c Dr.		5000	
	To Bank A/c (Met acceptance at maturity)			5000

3.2.2.3. When the bill is endorsed in favour of a creditor

Endorsement

A bill may be an order bill or a bearer bill. An order bill is payable to a certain person or order. In the case of a bearer bill, it is payable to the bearer of the instrument. The bearer bill can be transferred by mere delivery. If it is an order bill, it is transferable by endorsement and delivery.

An endorsement is a written order on the back of the instrument by the payee or the holder for transferring his/her right to another person. This is done by putting his/

her signature on the back of the instrument with or without the name of the person to whom it is endorsed. The person who makes the endorsement is called Endorser and the person in whose favour the endorsement is made is called the Endorsee.

Journal entries in the books of Drawer/Endorser

a. On endorsing the bill

Creditor's/Endorsee's A/c	Dr.
To Bills receivable A/c	

b. On maturity

No entry

Note: Since the bill has been transferred in favour of the creditor, the creditor becomes the owner and will receive the payment on maturity. Hence no entry will be passed in the books of person (endorser) endorsing the bill.

Journal entries in the books of endorsee

a) *On receiving the bill*

Bills receivable A/c	Dr.
To Debtor's A/c/Endorser's A/c	

b) *On Maturity*

Bank A/c	Dr.
To Bills receivable A/c	

Illustration 3.2.3

Ramesh sold goods worth ₹4000 to Thomas on credit on 15 March 2012 and draws a bill for the amount two months after the date. Thomas accepted the bill and returned it to Ramesh. Ramesh endorsed the bill to Dinesh, his creditor, on 19 March 2012. Thomas met his acceptance on maturity. Give entries in the books of Ramesh, Thomas and Dinesh.

Solution

Journal entries in the books of Drawer (Ramesh)

Date	Particulars	L.F.	Amount (Dr.)	Amount (Cr.)
15-03-12	Thomas A/c Dr. To Sales A/c (sold goods on credit)		4000	4000
15-03-12	Bills receivable A/c Dr. To Thomas A/c (Received Thomas's acceptance for two months)		4000	4000
19-03-12	Dinesh A/c Dr. To Bills receivable A/c (Thomas's acceptance endorsed in favour of Dinesh)		4000	4000

Journal entries in the books of Drawee (Thomas)

Date	Particulars	L.F.	Amount (Dr.)	Amount (Cr.)
15-03-12	Purchases A/c Dr. To Ramesh A/c (Purchased goods on credit)		4000	4000
15-03-12	Ramesh A/c Dr. To Bills payable A/c (Accepted bill drawn by Ramesh payable after two months)		4000	4000
18-05-12	Bills payable A/c Dr. To Bank A/c (Met acceptance at maturity)		4000	4000

Journal entries in the books of Endorsee (Dinesh)

Date	Particulars	L.F.	Amount (Dr.)	Amount (Cr.)
19-03-12	Bills receivable A/c Dr. To Ramesh A/c (Received a bill from Ramesh)		4000	4000
18-05-12	Bank A/c Dr. To Bills receivable A/c (Received cash on the bill on maturity)		4000	4000

3.2.2.4. Bills sent for collection

Often a party does not itself like to hold a bill till maturity and sends it to its bankers with instructions that it should be collected on the due date (The bill is not being discounted).

The entry to be made is

- On sending the bill for collection

Bills sent for collection A/c Dr.

To Bills receivable A/c

- On collection of the amount by the bank

Bank A/c Dr.

To Bills sent for collection A/c

- If the bill is dishonoured, the entry will be

The Acceptor (or the party from whom the bill was received) A/c Dr.

To Bills sent for collection A/c

At the time of the closing of the books, a balance in the Bills sent for collection account will represent an asset being the bills yet to be collected by the bank. It will be noticed that the acceptor's books are not affected by the holder sending the bill to his bank for collection.

Illustration 3.2.4

On 15 March 2013 Rajesh drew and Adarsh accepted a two months bill for ₹4500. On 16 March, Rajesh sent the bill to bank for collection. On the due date bank informed that the bill has been duly met. Pass journal entries in the books of Rajesh and Adarsh.

Solution

Journal entries in the books of Drawer (Rajesh)

Date	Particulars	L.F.	Amount (Dr.)	Amount (Cr.)
15-03-13	Adarsh A/c Dr. To Sales A/c (Sold goods on credit)		4500	4500
15-03-13	Bills receivable A/c Dr. To Adarsh A/c (Received Adarsh's acceptance for two months)		4500	4500
16-03-13	Bills sent for collection A/c Dr. To Bills receivable A/c (Sent the bill to bank for collection)		4500	4500
18-05-13	Bank A/c Dr. To Bills sent for collection A/c (The amount collected by the bank on the due date)		4500	4500

Journal entries in the books of Drawee/Acceptor (Adarsh)

Date	Particulars	L.F.	Amount (Dr.)	Amount (Cr.)
15-03-13	Purchases A/c Dr. To Rajesh A/c (Purchased goods on credit)		4500	4500

15-03-13	Rajesh A/c Dr. To Bills payable A/c (Accepted bill drawn by Ramesh payable after two months)	4500	4500
18-05-12	Bills payable A/c Dr. To Bank A/c (Met acceptance at maturity)	4500	4500

Illustration 3.2.5

Ajith sold goods for ₹20000 to Sujith on credit on January 1, 2020, Ajith drew a bill of exchange upon Sujith for the same amount for three months. Sujith accepted the bill and returned it to Ajith. Sujith met his acceptance on maturity. Record the necessary journal entries under the following circumstances.

- Ajith retained the bill till the date of its maturity.
- Ajith discounted the bill @12% p.a. from his bank
- Ajith endorsed the bill to his creditor Arya
- Ajith retained the bill and on March 31, 2020 then sent the bill for collection to its bank. On April 05, 2020 bank advice was received.

Solution

Journal entries in the book of Ajith

- Ajith retained the bill till the date of its maturity

Date	Particulars	L.F.	Amount (Dr.)	Amount (Cr.)
01-01-20	Sujith A/c Dr. To Sales A/c (Sold goods on credit)		20000	20000
01-01-20	Bills receivable A/c Dr. To Sujith A/c (Received Sujith's acceptance for two months)		20000	20000

04-04-20	Bank A/c Dr. To Bills receivable A/c (Sujith met his acceptance on maturity)		20000	20000
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ii. Ajith discounted the bill @12% p.a. from his bank

Date	Particulars	L.F.	Amount (Dr.)	Amount (Cr.)
01-01-20	Sujith A/c Dr. To Sales A/c (Sold goods on credit)		20000	20000
01-01-20	Bills receivable A/c Dr. To Adarsh A/c (Received Adarsh's acceptance for two months)		20000	20000
01-01-20	Bank A/c Dr. Discount A/c Dr. To Bills receivable A/c (Sent the bill to bank for collection)		19400 600	20000

iii. Ajith endorsed the bill to his creditor Arya

Date	Particulars	L.F.	Amount (Dr.)	Amount (Cr.)
01-01-20	Sujith A/c Dr. To Sales A/c (Sold goods on credit)		20000	20000
01-01-20	Bills receivable A/c Dr. To Sujith A/c (Received Sujith's acceptance for two months)		20000	20000
01-01-20	Arya A/c Dr. To Bills receivable A/c (Sujith acceptance endorsed in favour of Arya)		20000	20000

iv. When the bill was sent for collection by Ajith to the bank

Date	Particulars	L.F.	Amount (Dr.)	Amount (Cr.)
01-01-20	Sujith A/c Dr. To Sales A/c (Sold goods on credit)		20000	20000
01-01-20	Bills receivable A/c Dr. To Sujith A/c (Received Sujith's acceptance for two months)		20000	20000
31-03-20	Bills sent for collection A/c Dr. To Bills receivable A/c (Bills sent for collection)		20000	20000
05-04-20	Bank A/c Dr. To Bills sent for collection A/c (Bills sent for collection collected by the bank)		20000	20000

Journal entries in the book of Sujith

Date	Particulars	L.F.	Amount (Dr.)	Amount (Cr.)
01-01-20	Purchase A/c Dr. To Ajith A/c (Purchase goods on credit)		20000	20000
01-01-20	Ajith A/c Dr. To Bills payable A/c (Accepted bill drawn by Ajith payable after three months)		20000	20000
04-04-20	Bills payable A/c Dr. To Bank A/c (Met acceptance maturity)		20000	20000

3.2.3 Retirement of a Bill

When the drawee pays the bill before its due date, it is called Retirement of a Bill. The holders allow the drawee a rebate of a certain amount calculated at a certain rate per annum from the date of retirement to the date of maturity. Usually, the holder would be willing to allow a deduction in case of retirement because of the interest involved. Such a deduction is called rebate. For the acceptor, the rebate will be a gain and for the holder a loss. The entries to be made are accordingly.

In the books of the acceptor

Bills payable A/c	Dr. (The amount of the bill)	xxx	
To Cash (or Bank) A/c	(The actual amount paid)		xxx
To Rebate A/c	(The amount of the rebate earned)		xxx
(The acceptance met before the due date availed rebate)			

In the books of the holder

Cash (or Bank) A/c	Dr.	xxx	
Rebate A/c	Dr.	xxx	
To Bills receivable A/c			xxx
(The amount received before the due date and allowed rebate)			

3.2.4. Dishonour of a Bill

Dishonour of a bill means a situation when the acceptor of the bill refuses or is unable (say because of insolvency) to pay the amount. In such a case, the holder of the bill can recover the amount from the drawer or any of the previous endorsers. The holder of the bill may present the bill through a Notary Public and get the dishonour of the bill noted. It is to be noted that it is important but not legally necessary to present the bill through the Notary Public. Noting will consist of the following:

- The bill has been dishonoured.
- The date of the dishonour.
- The reason, if any, for the dishonour and
- The fee charged by the Notary Public, i.e., noting charges.

3.2.5. Noting

When the bill is dishonoured for non-payment, the holder usually gets it noted to establish the legality of dishonour. Noting is done by a 'Notary Public' who is an advocate appointed by the government. Noting is the act of recording the fact of dishonour. A fee is charged for providing this service, called "Noting charges". The amount of noting charges paid by the holder is eventually recovered from the acceptor by the drawer. In other words, it is an expense to be borne by the acceptor.

3.2.6. Protesting

The term 'Protest' may be defined as the formal certificate of dishonour issued by the Notary public to the holder of the bill. This certificate should contain the details of the bill, the fact of dishonour, the date and place of dishonour and the signature of the Notary public.

Recap

- ◇ Noting - Done by a Notary Public.
- ◇ Fee charged in noting - Noting charges.
- ◇ Dishonouring of bill – Non-payment by the acceptor.
- ◇ Retiring of bill - Payment of bill before maturity.
- ◇ Protesting - Document issued by Notary public.
- ◇ Endorsement - Transfer of bill.
- ◇ Bill sent for collection - Drawer sends the bill to the bank for collection.
- ◇ Bank - Payee for the bill sent for collection.

Objective Questions

1. Who performs the process of noting?
2. What is the fee charged for noting known as?
3. What is the term used to describe the situation when the acceptor of the bill refuses to pay the amount?
4. Identify the term for paying the bill in advance.
5. What is the amount which is deducted at the time of discounting the bill of exchange known as?
6. Who is the payee when the drawer sends the bill for collection?
7. When will the amount be credited to the bank account on the honouring of the bill?
8. What measure can be used by the drawer when he needs immediate finance?

Answers

1. Notary public
2. Noting charge
3. Dishonouring of bill
4. Retiring of bill
5. Discount
6. Bank
7. Maturity date
8. Discounting bill of exchange

Self-Assessment Questions

1. What is the significance of obtaining the acceptor's signature on a bill of exchange, and how does it affect the liability of the parties involved?
2. Explain retiring a bill, and discuss the accounting treatment associated with this method.
3. When a bill is honoured, what are the financial implications for the acceptor and the drawer, and how are these transactions recorded in the books?
4. Identify one consequence of dishonouring a bill of exchange and describe the subsequent legal recourse available to the holder.
5. What is the purpose of noting and protesting a dishonoured bill, and how does this process help protect the rights of the parties involved in the bill of exchange?
6. What are the key elements of a bill of exchange?
7. What is the role of acceptance in a bill of exchange?
8. How is the maturity date determined for a bill of exchange?

Assignments

1. On January 01, 2021, Midhun sold goods Rs.50000 to Sanjay. Half of the payment was made immediately and for the remaining half Midhun drew a bill of exchange upon Sanjay payable after 3 months. Sanjay accepted the bill and returned it to Midhun. On the due date, Midhun presented the bill to Sanjay and received the payment.

Journalise the above transaction in the books of Midhun and Sanjay.

2. On January 15, 2021, Kiran sold goods for Rs.60000 to Binu and drew upon him three bills of exchange of Rs.20000 each payable after one, two, three months respectively. The first bill was retained by Kiran till its maturity. The second bill was endorsed by him in favour of his creditor Rakhu and the

third bill was discounted by him immediately at the date of 6 percentage per annum. All the bills were met by Binu. Journalise the above transaction in the books of Kiran and Binu. Also prepare ledger account in the books of Kiran and Binu.

3. Neeraj purchased goods for Rs.50000 from Roshan on February 01, 2022. Roshan drew upon Neeraj a bill of exchange for the same amount payable after 2 months. On the due date Neeraj dishonoured his acceptance. Pass the journal entries in the books of Roshan and Neeraj in the following cases:
- When the bill was retained by Roshan with him till the date of its maturity.
 - When the bill was dishonoured by Roshan immediately with his bank at the rate of 6 percentage per annum.
 - When the bill was endorsed to his creditor Dhyan.
 - When the bill was send by Roshan to his bank for collection 20 days before its maturity
4. Vasundhara purchased goods Rs.30000 from Sivanandan on January 15, 2021 and accepted a bill of exchange drawn upon him by Sivanandan payable after two months. On the date of the maturity the bill was duly presented for payment. Vasundhara dishonoured the bill.

Record the necessary journal entry in the books of Sivanandan and Vasundhara when.

- The bill was retained by Sivanandan till the date of its maturity.
 - The bill was immediately discounted by Sivanandan with his bank @6% p.a.
 - The bill was endorsed by Sivanandhan in favour of his creditor Shafeeq.
 - Fifteen days before its maturity the bill was sent by Sivanandan to his bank for collection.
5. On January 1, 2022, Micheal sold goods to Rajesh on credit worth Rs. 27,000. I drew a bill for 4 months. Rajesh failed to meet his acceptance on the due date. Prepare a journal entry in the books of Micheal and Rajesh

under the following circumstances.

- i) Micheal retained the bill till the date of its maturity.
 - ii) Micheal discounted the bill on 3rd February 2022 @12 % p.a.
 - iii) The bill was sent for collection on 3rd March 2022.
 - iv) When the bill was endorsed to his creditor Nandhu.
6. Balamurali sold goods worth Rs 50,000 to Manu on February 1, 2022, for three months. Manu repaid the amount in advance on March 4th, 2022. Hence, Balamurali allowed a rebate of 13% p.a. Prepare journal entries in the books of Balamurali and Manu.
7. Ashok sold goods to Rejith on 30th October, 2020 for Rs.15000 and received three bills for Rs.3000, Rs.4000 and Rs.8000 at 1, 3 and 4 months respectively. He kept the first bill till maturity, endorsed the second bill in favour of his creditor Lekshmi and discounted the third bill on 3rd December 2020 at 6% p.a. the first and second bill were duly met on maturity but the third bill was dishonoured; the bank paying Rs.60 as noting charges. Give journal entries in the books of Ashok and Rejith.
8. Midhun purchased goods from Mahesh for Rs.35000 on 1st March 2022 and accepted a bill of exchange drawn by Mahesh for the same amount. The bill was payable after one month. On 25th march 2022 Mahesh sent the bill to his bank for collection. The bill was duly presented by the bank. Midhun dishonoured the bill and the bank paid Rs. 200 as noting charges. Record the necessary journal entries for the above transactions in the books of Midhun and Mahesh.

Suggested Readings

1. Maheswari, S. N. (2018). *Advanced Accounting*. Vikas Publishing House.
2. Paul, S. K. R. (2011). *Advanced Accounting*. New Central Book Agency (P) Ltd.
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BLOCK

Final Accounts of Sole Proprietor

Unit 1

Final Accounting

Learning Outcomes

After completing this unit, the learner will be able to:

- ◇ explain the role of final accounts in summarising a company's financial activities, performance, and position
- ◇ differentiate the items that are of capital nature and revenue nature
- ◇ gain insight on the various components of final accounts of sole proprietor
- ◇ distinguish between income and expense of direct nature and indirect nature

Prerequisites

Determining results is a critical factor contributing to an individual's success in life. Take, for instance, a student named Akshay, interested in assessing his academic progress through examinations. Consequently, he experiences considerable anxiety regarding his exam outcomes. Similarly, a business person harbours apprehensions about their business's performance. The precise evaluation of a business's results is only achievable upon its closure, a circumstance rarely attainable due to the indefinite lifespan of businesses. Consequently, business life is segmented into accounting periods to ascertain profit or loss during these intervals. The choice of the accounting period varies based on the nature of the business, whether it's daily, weekly, monthly, quarterly, semi-annually, or annually. For instance, a fishmonger calculates daily results, whereas most businesses typically assess their performance annually. Final accounts are compiled to determine the profit, loss, and financial status of the business, facilitating informed business decision-making.

Keywords

Trading Account, Profit and Loss Account, Balance Sheet, Gross Profit, Net Profit

Discussion

4.1.1 Final Accounts

Sole proprietorship business is a form of business where an individual invests his own capital and has the right to take decisions by himself/herself and to receive profit or bear loss of the business. A sole proprietor prepares final accounts for accurately depicting the financial performance of the business.

The preparation of final accounts, or financial statements, comes after the preparation of the Trial Balance. The final stage of the accounting cycle is the creation of final accounts. It supports the accomplishment of the main goal of accounting. The key goals of accounting include figuring out a company's profit and loss for every given accounting period as well as its financial standing on a given date.

Final accounts of sole proprietors are the accounts that are prepared by the sole proprietor to ascertain the profit (or loss) and financial position as on a particular date. Final accounts are also known as financial statements and are prepared from Trial Balance. It is through the financial statements that the parties who are interested in knowing the financial position of a firm such as government, creditors, customers, shareholders, investors and so forth obtain information.

Final accounts consist of Manufacturing Account, Trading Account, Profit and Loss Account and Balance Sheet. In case of trading concerns, it consists of only Trading Account, Profit and Loss Account and Balance Sheet. Most of the proprietorship businesses are in the nature of trading business, therefore final accounts consist of only the above three accounts. In case the business conducts any manufacturing activity, a Manufacturing Account is also prepared as a part of the Final Accounts for ascertaining the cost of goods manufactured and is transferred to the Trading Account. In order to ensure that the Trading Account, Profit and Loss Account and Balance Sheet provide a true and fair view of the state of affairs of the enterprise, it should be made sure that the Matching principle is correctly adhered.

Matching Concept

Matching concepts state the matching of income with expenses of a particular accounting period. The expenses incurred to generate revenue during an accounting year should be correlated in order to ascertain the true profit or loss of the enterprises and to determine the true financial position of the enterprise. If this principle is violated, the books of accounts of such enterprises would fail to provide a true and fair view of the state of affairs of the enterprise. The expenses and incomes can be classified on the basis of nature as: Capital and Revenue.

Capital and Revenue

Expenses and incomes of a business can be divided into two; capital expenditure and revenue expenditure, capital receipts and revenue receipts. There is another expenditure called deferred revenue expenditure. It is also popular in accounting. A detailed idea of the above terms is highly essential to preparing final accounts.

Capital Expenditure

Capital expenditure means expenditure incurred for purchasing a long term or fixed asset for permanent use in the business, and it also includes the amount spent for increasing the earning capacity of a fixed asset, for example, major repairs of a fixed asset. The benefit from such expenditure lasts for a long period of time. These assets are used in the business for earning income or revenue. Capital expenditures are non-recurring expenditures. Examples are land and building, plant and machinery, furniture, etc.. These expenditures are shown in the asset side of the Balance Sheet.

Revenue Expenditure

Revenue expenditure means expenditure incurred for the day-to-day activities of the business, which are recurring in nature and the benefit from such expenditure is derived completely within that particular accounting year. Examples are salary, rent, wages, printing and stationery, etc.. Revenue expenditures are shown in the debit side of trading or Profit and Loss Account.

Deferred Revenue Expenditure

Deferred revenue expenditure means expenditure purely in the nature of revenue, but the benefit from such expenditure is extended beyond a period of one accounting year, for example, huge amount of advertisement expenditure. A signboard of a textile



shop costs ₹50000 which has a life of 5 years. This revenue expenditure is not debited in the Profit and Loss Account completely in the year in which it is incurred. ₹10000 ($50000/5$) is debited to the Profit and Loss Account every year. After debiting the amount of ₹10000 in each year in the Profit and Loss Account, the balance is shown in the asset side of the Balance Sheet. At the end of the fifth year, the expense is completely written off, and no amount is available to be shown in the Balance Sheet.

Capital Receipts

Capital receipts mean the amount received mainly by way of raising capital, sale of a fixed asset or borrowing long term loans. Such receipts are not revenue income as they are not recurring in nature. Therefore, these receipts are not shown in the Profit and Loss Account but shown in the Balance Sheet.

Revenue Receipts

Revenue receipts mean recurring income mainly by way of sale of goods and services, indirect incomes like interest received, rent received, commission received, discount received, etc.. These incomes are recurring in nature and therefore credited to the Trading Account or Profit and Loss Account every year.

4.1.2 Components of Final Accounts

The three key components of the final accounts of a sole proprietor include the following:

- a. Trading Account
- b. Profit and Loss Account
- c. Balance Sheet

4.1.2.1 Trading Account

Trading Account is prepared to find out the trading profit or loss. The trading profit is called Gross Profit and trading loss is called Gross Loss. This account is a nominal account and therefore the rules of nominal account for debit and credit are applied for preparing this account. Trading Account is prepared for a particular period of time.

All expenses which relate to either purchase of raw material for manufacturing of goods (known as direct expenses) are recorded in Trading Account. It is debited with opening stock, net purchases (purchases less purchase returns), all expenses directly

related to purchase and manufacture of goods such as wages, carriage inwards, customs duty, clearing charges, cartage, freight, import duty, octroi, factory expenses, fuel, power, gas, royalty based on production, etc.. and credited with net sales and closing stock. Net sales mean sales minus sales returns. If the total amount on the credit side of this account is more than its debit side the difference is called Gross Profit and is transferred to the credit side of Profit and Loss Account. Similarly, if the total amount on the debit side is greater than its credit side the difference is called Gross Loss and is transferred to the debit side of Profit and Loss Account.

The equation related to Gross Profit is as follows:

Gross Profit (or Gross Loss) = Net sales- Cost of Goods sold

Cost of goods sold = Opening stock + Net purchases + Direct expenses- Closing stock

Advantages of Trading Account

- ◇ **Facilitate decision making:** Trading Account gives Gross Profit or Gross Loss of a particular period. Such information helps the sole proprietor in taking informed decisions.
- ◇ **Facilitate comparison:** The information of Gross Profit or Gross Loss obtained from Trading Account of a particular period can be compared with those of previous years. Comparison of closing stock of the current year with those of the previous year can also be made.
- ◇ **Helps in controlling expenses:** Trading Account gives details of the direct expenses incurred. Comparison of such expenses of the current year can be made with the previous years which help in controlling cost.

4.1.2.2 Profit and Loss Account

Trading Account is followed by Profit and Loss Account. It is prepared for determining the Net Profit or Net Loss made by the business during a particular accounting period. The result of Trading Account; either Gross Profit or Gross Loss is transferred to this account. It is a nominal account therefore all indirect expenses are debited and all indirect incomes are credited. All expenses connected with sales and establishment expenses, cost of financing, etc. are debited to this account. Indirect incomes such as income from investment and financing, discount received from creditors, commission received etc. are credited to this account. If the total amount on the credit side of this account is greater than total amount on the debit side, the difference is Net Profit, which increases the capital balance and therefore added to capital account in the liability side

of the Balance Sheet. Likewise, if the total amount on the debit side of this account is greater than its credit side, the difference is called Net Loss, which reduces the capital balance and therefore deducted from capital in the liability side of the Balance Sheet.

Advantages of Profit and Loss Account

- ◇ **Facilitate decision making:** The information on Profit and Loss Account gives Net Profit or Net Loss of a particular period helps the sole proprietor in decision making.
- ◇ **Analyse efficiency:** The information of Net Profit or Net Loss obtained from Profit and Loss Account of a particular period can be compared with those of previous years which helps in checking efficiency of the organization.
- ◇ **Helps in controlling expenses:** Profit and Loss Account gives details of the indirect expenses incurred. Comparison of such expenses of the current year can be made with the previous years which help in controlling cost which are unwanted and not reasonable.
- ◇ **Helps in preparation of Balance Sheet:** The information about the Net Profit (or loss) obtained from Profit and Loss Account is adjusted with capital while preparing the Balance Sheet.
- ◇ **Calculation of accounting ratios:** Facilitate calculation of accounting ratios such as net profit ratio, operating ratio etc. for managerial use.
- ◇ **Legal Compliance:** Assist in fulfilling legal requirements under GST Act, Income tax Act, etc..

4.1.2.3 Balance Sheet

We are familiar with the term Balance Sheet. Different people from different sections are invariably using this term frequently even though they are unaware of the exact technical meaning of the term. Balance Sheet is a statement of assets and liabilities of business organizations. The main objective of preparing Balance Sheet is to ascertain the financial position of the business at a particular point of time. It can be understood by comparing the assets and liabilities. Balance Sheet is prepared in a tabular form. It is prepared at the end of every accounting year which shows the value of assets and liabilities on a particular point of time. It has two equal sides: the right-hand side is called asset side and the left-hand side is called liability side. On the asset side various assets are shown and on the liability side capital and other liabilities are shown. Only the balances of personal and real accounts are shown in the Balance Sheet. At any time, the assets of a business must be equal to capital and liabilities. So, Balance Sheet should tally automatically.

Advantages of Balance Sheet

- ◇ **Ascertaining of financial position:** Balance Sheet is a statement which depicts the financial position of a concern as on a point of time and thereby analyse about the solvency of the organisation.
- ◇ **Value assets and liabilities:** The Balance Sheet shows the value of various assets such as land, machinery, closing stock etc. and the value of liabilities such as creditors, loans, bills payable etc. as on a point of time.
- ◇ **Provides information:** Balance Sheet provides information on the amount of capital at the end of the year. It also provides information for preparing Opening entries at the beginning of next year.

Thus, sole traders prepare Trading Account, Profit and Loss Account and Balance Sheet as part of their final accounts for determining the profit (or loss) incurred during the period and for ascertaining the financial position.

Recap

- ◇ Final accounts - Manufacturing Account, Trading Account, Profit and Loss Account and Balance Sheet.
- ◇ Matching principle - Matching of income with expenses.
- ◇ Capital expenditure - Expenditure incurred for purchasing a long term or fixed asset.
- ◇ Revenue expenditure - Expenditure incurred for the day-to-day activities.
- ◇ Deferred revenue expenditure - Revenue expenditure the benefit of which is extended.
- ◇ Capital receipts - Raising capital, sale of a fixed asset, borrowing long term loans.
- ◇ Revenue receipts - Income from sale of goods and services.
- ◇ Trading Account - Nominal account that gives Gross Profit or Gross Loss.
- ◇ Profit and Loss Account - Nominal account that gives Net Profit or Net Loss.
- ◇ Balance Sheet - Statement depicting the financial position.

Objective Questions

1. Which account is prepared by businesses that conduct manufacturing activity?
2. Which principle deals with the matching of income with expenses of a particular accounting period?
3. Which type of expenditure is incurred for purchasing a long term or fixed asset for permanent use in the business?
4. Which type of expenditure is incurred for the day-to-day activities of the business, which are recurring in nature and the benefit from such expenditure is derived completely within that particular accounting year?
5. Which type of expenditure is purely in the nature of revenue, but the benefit from such expenditure is extended beyond a period of one accounting year?
6. What term is used to denote the amount received mainly by way of raising capital, sale of a fixed asset or borrowing long term loans?
7. What term is used to denote the income recurring mainly by way of sale of goods and services?
8. What happens when credit side is greater than debit side in Trading Account?
9. What happens when debit side is greater than credit side in Profit and Loss Account?
10. Where will the Net Profit or Net Loss be transferred to?

Answers

1. Manufacturing Account
2. Matching principle
3. Capital expenditure

4. Revenue expenditure
5. Deferred revenue expenditure
6. Capital receipt
7. Revenue receipt
8. Business earns Gross Profit
9. Net Loss for business
10. Added or deducted with the capital in the Balance Sheet

Self Assessment Questions

1. What do you mean by final account of a sole proprietor?
2. Briefly explain the components of final accounts of a sole proprietor.
3. What is a Trading Account?
4. What is a Profit and Loss Account?
5. What is a Balance Sheet?
6. What are the items to be included in its debit side and credit side of a Trading Account?
7. What are the items to be included in its debit side and credit side of a Profit and Loss Account?
8. Explain matching principle in accounting.

Assignments

1. Classify the following expenses into direct and indirect expenses and mention in which account (Trading Account or Profit and Loss Account) the expenses are included?

- a. Carriage inwards
- b. Carriage outwards
- c. Gas, water, electricity
- d. Salary to salesmen
- e. Expenses for printing and stationery

2. Find out the cost of goods sold from the following information:

Opening stock	₹20000
Purchase	₹50000
Gas and Water	₹2000
Carriage inwards	₹1500
Interest on capital	₹200
Closing stock	₹40000

(Answer: ₹33500)

3. Find out Gross Profit or Gross Loss from the following information:

Opening stock	₹20000
Purchase	₹30000
Freight	₹2000
Carriage inwards	₹1500
Interest on drawings	₹1200
Closing stock	₹50000
Sales	₹120000

(Answer: Gross Profit- ₹116500)

4. Find out Gross Profit or Gross Loss from the following information:

Opening stock	₹50000
Purchase	₹40000
Carriage inwards	₹13500
Closing stock	₹40000
Sales	₹50000

(Answer: Gross Loss- ₹13500)

Suggested Readings

1. Maheswari, S. N. (2018). *Advanced Accounting*. Vikas Publishing House.
2. Paul, S. K. R. (2011). *Advanced Accounting*. New Central Book Agency (P) Ltd.
3. Jain, S. P., and Narang, K. L. (2019). *Advanced Accountancy*. Kalyani Publishers, New Delhi.
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Unit 2

Preparation of Final Accounts

Learning Outcomes

After completing this unit, the learners will be able to:

- ◇ familiarise with the preparation of Trading Account
- ◇ gain insights on the preparation of Profit and Loss Account
- ◇ be aware of the items to be included in Balance Sheet
- ◇ prepare Balance Sheet

Prerequisites

Sriram, the proprietor of a retail business dealing with tyres, has been successfully operating his company for one year. During this period, he has incurred a variety of expenses necessary for the smooth functioning of his business. These expenses can be categorised into direct expenses, directly associated with manufacturing operations (e.g., wages, carriage inwards), and indirect expenses, indirectly related to the business (e.g., general expenses, printing, and stationery). Alongside sales income (direct income), Sriram's business also generates income from sources unrelated to sales, known as indirect income (e.g., discount received, commission received). Sriram's primary objective is to achieve a desirable level of profitability through his business operations. To ensure accurate assessment, he recognises the importance of maintaining comprehensive records of all business-related expenses and revenues. By monitoring these records, Sriram can effectively determine whether his business is yielding a profit or incurring a loss.

To calculate the profit or loss of his business accurately, Sriram must prepare financial statements. They provide a detailed overview of the financial position and performance of the business. The financial statements include the Trading Account, which presents the direct expenses and incomes incurred during a specific period, the Profit and Loss Account, which presents the indirect expenses and incomes, and the Balance Sheet, which outlines the assets, liabilities, and capital of the business at a specific point in time. Through the preparation and analysis of these financial statements, Sriram can gain valuable insights into the financial health and profitability of his tyre retail business.

Keywords

Direct expense, Direct income, Indirect expense, Indirect income, Asset, Liability, Capital, Marshalling of Balance Sheet

Discussion

4.2.1 Preparation of Final Accounts

Final account is prepared from a Trial Balance. Trial Balance shows items of accounts of debit balances and credit balances. Normally an item given in the debit balance column of Trial Balance is either an expense or an asset. The expense is debited to Trading Account or Profit and Loss Account and the asset is shown on the asset side of the Balance Sheet. Likewise, item given in the credit column of Trial Balance is either an income or a liability. The income is credited to Trading Account or Profit and Loss Account and the liabilities are shown on the liability side of the Balance Sheet. In short, an item in the Trial Balance is considered only at one place in the preparation of final accounts; that is either in the Trading Account or in the Profit and Loss Account or in the Balance Sheet. The preparation of Trading Account, Profit and Loss Account, and Balance Sheet are discussed in detail below.

4.2.1.1 Preparation of Trading Account

For the preparation of Trading Account, all direct expenses and direct incomes are transferred to Trading Account. For this purpose, the following transfer entries are passed.



a. For transferring opening stock

Trading A/c Dr.

To Opening stock A/c

(Opening stock transferred to Trading Account)

b. For transferring purchase returns

Purchase returns A/c Dr.

To Purchases A/c

(Settlement of purchase returns)

c. For transferring net purchase

Trading A/c Dr.

To Purchases A/c

(Purchase account transferred to Trading Account)

d. For transferring sales returns

Sales A/c Dr.

To Sales returns A/c

(Settlement of sales return)

e. For transferring net sales

Sales A/c Dr.

To Trading A/c

(Sales account transferred to Trading Account)

f. For transferring Direct expenses

(Wages, carriages, customs duty, octroi, excise duty, import duty, freight, etc.)

Trading A/c Dr.

To Direct Expenses A/c (individual expenses)

(Direct expenses transferred to Trading Account)

g. For transferring Closing stock

Closing stock A/c Dr.

To Trading A/c

(Closing stock transferred to Trading Account)

h. For transferring Gross Profit

Trading A/c Dr.

To Profit and Loss A/c

(Gross Profit transferred to Profit and Loss Account)

i. For transferring Gross Loss

Profit and Loss A/c Dr.

To Trading A/c

(Gross Loss transferred to Profit and Loss Account)

Table 4.2.1

Format of Trading Account

Trading Accounts as on DD-MM-YY

Dr.		Cr.	
Particulars	Amount	Particulars	Amount
To Opening Stock	xxx	By Sales	xxxx
		less Sales Returns	(xxx)
To Purchases	xxxx		xxx
Less Purchase Returns	(xxx)	By Closing Stock	xxx
To Direct Expenses	xxx	By Gross Loss c/d	xxx
To Manufacturing Wages	xxx		
To Carriage/Carriage inwards	xxx		
To Factory Expenses	xxx		
To Gas/Electricity/Water/Fuel/ Power	xxx		
To Freight and Cartage	xxx		
To Customs/Excise/Import duty	xxx		
To Royalty based on products	xxx		
To Gross Profit c/d	xxx		
	xxxx		xxxx

Treatment of important items shown in the Trading Account

Treatment of some important items of Trading Account is explained in detail here below:

a. Opening stock

The last year's closing stock will be the opening stock of the current accounting year. This item is usually given in the debit column of Trial Balance and taken as the first item in the debit side of Trading Account. There will be no opening stock in case of a new business. For example, Kalyan silks have a stock of clothes worth ₹20 crores on 31-12-2020. This is the closing stock as on 31-12-2020. This item will be the opening stock of next accounting year, therefore, while preparing final accounts for the year

ended 31-12-2021, this item will appear as opening stock in the debit side of Trading Account.

b. Purchases

Purchases include both cash and credit purchases of goods which are for resale purposes. Purchases are a main item debited to the Trading Account. The net purchases (purchase – purchase returns) are considered.

GST is to be paid whenever there is a purchase of goods or services. When purchase of goods is made within the state, CGST and SGST are to be paid. In case purchase of goods is from another state, then IGST is to be paid. The term used for GST paid is 'Input GST'. While selling goods, GST (CGST and SGST or IGST) shall be collected from the customer. The term used for GST collected is called 'Output GST'. The net GST payable shall be Input GST minus Output GST. This mechanism of setting off Input GST against Output GST is known as 'Input Tax Credit' (ITC).

GST (CGST and SGST or IGST) paid on purchase is not debited to Purchase account because it is set off against GST (CGST and SGST or IGST) collected on sales. Hence it is not cost of goods purchased.

Separate account is maintained for each type Input GST (CGST, SGST, IGST) as well as Output GST (CGST, SGST, IGST). In case of Purchase returns, goods given as charity or samples, Input GST is credited, i.e., reversed.

GST which is paid when purchase is made is 'Input GST'. On Intra state purchases, Input CGST and Input SGST is levied. On Interstate purchase of goods, Input IGST is levied.

The journal entry for cash purchase shall be-

Purchase A/c	Dr.(Amount of purchases)
Input CGST A/c	Dr.(CGST for intra state)
Input SGST A/c	Dr. (SGST for intra state)
Input IGST A/c	Dr. (IGST for interstate)
To Cash A/c (Amount of purchases + GST)	
(Purchases made)	



c. Direct expenses

Direct expenses mean all expenses directly related to purchases or manufacturing.

Examples of such expenses are:

◇ **Manufacturing wages**

Wages paid to workers engaged in production or trading activity is debited to this account. Sometimes wages and salaries are clubbed. If it is given as wages and salaries, major part of the amount constitutes wages and the entire amount is treated as direct expenses and debited to the Trading Account. If it is stated as salaries and wages, the meaning is major part of the amount is salaries and the total amount is debited to Profit and Loss Account as indirect expenses.

◇ **Customs Duty/ Import Duty**

This duty is paid for importing goods from a foreign country. Since it is related to purchases of goods, it is debited to Trading Account.

◇ **Excise Duty**

Duties levied on the value of goods produced in our country. This is related to manufacturing and therefore debited to Trading Account.

◇ **Factory Expenses**

Factory expenses, such as factory rent, lighting, gas, electricity, water, fuel, consumable items like Greece, cotton waste, engine oil, etc. are also debited to Trading Account.

d. Sales

The major direct income of a concern is sales. From the gross sales, sales return is deducted and the net amount is shown as sales in the credit side of Trading Account as the first item.

The firm charge GST when goods are sold by them. This GST (CGST and SGST or IGST) collected on sale is termed as Output GST (CGST, SGST, IGST). When sale is made in cash, the following entry shall be made:

Cash A/c Dr. (Sale amount + GST)

 To Sales A/c (Amount of Sales)

 To Output CGST A/c (Amount of CGST on intra state sales)

 To Output SGST (Amount of SGST on intra state sales)

 or

 To Output IGST A/c (Amount of IGST on Interstate sales)

 (Sales made)

e. Closing Stock

Usually closing stock is given as a footnote of the Trial Balance because at the time of closing books of accounts, there may not be a closing stock account and therefore it is not usually given in the Trial Balance. The value of closing stock should be considered for calculating the Gross Profit or Gross Loss; hence it is credited to Trading Account.

This is done on the presumption that had it been sold in the accounting year, the sales amount value would have been increased to that extent.

Illustration 4.2.1

Prepare Trading Account from the following information as on 31 December 2020.

Sales	₹120000
Purchases	₹60000
Wages	₹5000
Opening stock	₹20000
Customs duty	₹4000
Carriages	₹1000
Closing stock	₹30000

Solution

Trading Account for the year ended 31st Dec 2020

Dr.		Cr.	
Particulars	Amount	Particulars	Amount
To Opening stock	20000	By Sales	120000
To Purchases	60000	By Closing Stock	30000
To Wages	5000		
To Carriages	1000		



To Customs duty	4000		
To Gross Profit c/d	60000		
	150000		150000

4.2.1.2 Preparation of Profit and Loss Account

For preparing Profit and Loss Account, all indirect expenses and all indirect incomes are transferred to the Profit and Loss Account. For this purpose, the following closing entries are passed.

a. For closing indirect expenses

Profit and Loss A/c Dr.

To Indirect expenses A/c (individual expenses)

(Indirect expenses are transferred)

b. For closing indirect incomes

Indirect income A/c (individual items) Dr.

To Profit and Loss A/c

(Indirect incomes are transferred)

c. For transferring Net Profit

Profit and Loss A/c Dr.

To Capital A/c

(Net Profit is transferred to Capital account)

d. For transferring Net Loss

Capital A/c Dr.

To Profit and Loss A/c

(Net Loss is transferred to Capital account)

Table 4.2.2
Format of Profit and Loss Account
Profit and Loss Account of DD-MM-YY

Dr.		Cr.	
Particulars	Amount	Particulars	Amount
To Gross Loss b/d	xxx	By Gross Profit b/d	xxx
" Salaries	xxx	" Interest Received	xxx
" Printing and Stationeries	xxx	" Dividend Received	xxx
" Rent, Rate and Taxes	xxx	" Rent Received	xxx
" Audit fees	xxx	" Commission Received	xxx
" Postage and Telegram	xxx	" Discount Received	xxx
" Legal charges	xxx	" Bad debts Recovered	xxx
" Audit Fees	xxx	" Income from Sub-Let	xxx
" Repairs	xxx	" Profit on sale of Asset or Investment	xxx
" Insurance	xxx	" Reserve For Discount on Creditors	xxx
" General Expenses	xxx	" Net Loss (If any) transferred to Capital Account	xxx
" Advertisement	xxx		
" Commission Paid	xxx		
" Depreciation	xxx		
" Charity	xxx		
" Advertisement and Sales Promotion Expenses	xxx		
" Distribution Expenses	xxx		
" Travelling Expenses	xxx		
" Discount Allowed	xxx		
" Bad Debts	xxx		
" Provision For Bad Debts	xxx		
" Provision For Discount on Debtors	xxx		
" Royalty Based on Sales	xxx		
" Net Profit transferred to Capital Account	xxx		
	xxxx		



Treatment of some special items

Treatment of some special items in the preparation of Profit and Loss Account is explained in detail here below.

a. Bad debts

When an amount due from a customer is not recoverable due to his insolvency or other reasons, it is treated as bad debts. It is a loss and therefore debited to Profit and Loss Account.

b. Bad debts recovered

It is the amount received from customers whose accounts had been already written off as bad. So, the account of the customer may not show any amount due to the firm. Hence the amount recovered now is treated as a fresh income and credited to Profit and Loss Account.

c. Salaries

These include salaries paid to office, godown and warehouse staff and should be shown in Profit and Loss Account being indirect expense.

d. Rent Rates and Taxes

These include offices and warehouse rent, municipal rates and taxes. Factory rent, rates and taxes should be debited to Trading Account and others to Profit and Loss Account.

e. Income tax

Income tax paid by a sole trader is his personal expenditure and therefore it should be treated as drawings and deducted from capital. Therefore, advance income tax paid, provision for income tax and income tax paid during the year is treated as drawings.

Illustration 4.2.2

From the following balances extracted at the close of the year ended 31 March 2022, prepare Profit and Loss Account of Ms Karthika and son at that date.

Particulars	Amount	Particulars	Amount
Gross Profit	100000	Discount allowed	1000

Carriage Outward	3500	Apprentice Premium received	2000
Salaries	6500	Printing Stationery	500
Rent	5100	Rates and Taxes	350
Fire Insurance premium	1000	Travelling expenses	200
Bad Debts	2100	Sundry Trade expenses	300
Income Tax Paid	3500	Rent received on sub letting	1000
Life Insurance premium	3000		

Solution

Profit and Loss Account of Ms Karthika and son for the year ended 31 March 2022

Particulars	Amount	Particulars	Amount
Carriage Outward	3500	Gross Profit	100000
Salaries	6500	Apprentice Premium	2000
Rent	5100	Rent received on sub letting	1000
Fire Insurance premium	1000		
Bad Debts	2100		
Discount	1000		
Printing Stationery	500		
Rates and Taxes	350		
Travelling expenses	200		
Sundry Trade expenses	300		
Net Profit transferred to capital Account	82450		
	103000		103000

4.2.1.3 Preparation of Balance Sheet

A Balance Sheet is a statement which shows the summary of personal accounts and real accounts. Debit balances of personal accounts and real accounts are put on the right hand side (Asset side) and credit balances are put on the left hand side (Liabilities side). If the two sides of the Balance Sheet do not tally, it shows that an error has occurred in its preparation.



Grouping and Marshalling of Balance Sheet

Classification of items having similar nature under one head is called Grouping. For example, the amounts that must be paid to different creditors are classified into the head 'Sundry creditors'.

Depending upon the nature of business, assets and liabilities are shown in the Balance Sheet in some specific order. Marshalling of Balance Sheet means the order in which assets and liabilities are shown in the Balance Sheet. It may be either in the order of permanence or in the order of liquidity. Most of the concerns exhibit the assets and liabilities in the Balance Sheet in the order of permanence, but in the case of financial institutions like banking companies and insurance companies, assets and liabilities are shown in the order of liquidity, that is the most liquid asset is shown as the first item (cash in hand) and the least liquid asset is shown as the last item (goodwill) in the Balance Sheet. Likewise, short term liabilities (bank overdraft) are shown as the first item and long-term liabilities (capital) are shown as the last item in the Balance Sheet.

Table 4.2.3
Format of Balance Sheet in the order of liquidity
Balance Sheet as on DD-MM-YY

Liabilities	Amount	Asset	Amount
Bank Overdraft	xxx	Cash in Hand	xxx
Sundry Creditors	xxx	Cash at Bank	xxx
Bills Payable	xxx	Investments	xxx
Outstanding Expenses	xxx	Bills Receivable	xxx
Loans	xxx	Sundry Debtors	xxx
Capital : xxx		Closing Stock	xxx
Add Net Profit xxx		Prepaid Expenses	xxx
Add additional capital xxx		Furniture	xxx
less drawings (xxx)	xxx	Machinery	xxx
		Premises	xxx
		Land and building	xxx
		Goodwill	xxx
	xxxx		xxxx

Table 4.2.4
Format of Balance Sheet in the order of permanence

Balance Sheet as on DD-MM-YY

Liabilities		Amount	Asset		Amount
Capital	xxxx	xxx	Goodwill		xxx
Add Net Profit	xxx		Land and Building		xxx
Add additional capital	xxx		Plant and Machinery		xxx
less drawings	(xxx)	xxxx	Furniture and Fittings		xxx
Loans		xxx	Prepaid Expenses		xxx
Bills Payable		xxx	Closing Stock		xxx
Outstanding Expenses		xxx	Bills Receivable		xxx
Sundry Creditors		xxx	Sundry Debtors		xxx
Bank Overdraft		xxx	Investments		xxx
			Cash at Bank		xxx
			Cash in Hand		xxx
					xxx
		xxxx			xxxx

Illustration 4.2.3

From the following Trial Balance, prepare Balance sheet for the year ended 31 December 2020.

Particulars	Amount (Dr.)	Amount (Cr.)
Capital		1500000
Drawings	130000	
Machinery	300000	
Land and building	1100000	
Furniture	120000	
Sundry debtors	200000	
Sundry creditors		220000
Bills receivable and payable	220000	60000
Bank overdraft		520000
Closing stock	400000	
Investment	80000	
Cash in Hand	50000	
Net Profit		300000
	2600000	2600000

Solution

Balance Sheet as on 31 December 2020

Liabilities	Amount	Asset	Amount
Bank overdraft	520000	Cash in Hand	50000
Bills payable	60000	Bills receivable	220000
Sundry creditors	220000	Investment	80000
Capital 1500000		Sundry debtors	200000
Add Net Profit 300000		Closing stock	400000
Less Drawings (130000)	1670000	Furniture	120000
		Machinery	300000
		Land and building	1100000
	2470000		2470000

4.2.2 Adjustments

Explanations and narrations given as a foot note of Trial Balance are called adjustments. For the purpose of completing the effect of the double-entry principle, item given in the adjustments must be considered at two places while preparing final accounts; either in the Trading Account and Balance Sheet or in the Profit and Loss Account and Balance Sheet or in the Trading Account and Profit and Loss Account or in the two sides of Trading Account or in the two sides of Profit and Loss Account or in the two sides of Balance Sheet.

The following are the adjustments to be considered while preparing the Final Accounts of a sole proprietor:

a. Closing stock

When preparing Trial Balance, there may not be a closing stock account because stock taking may not be completed at the end of the day of closing books of accounts. Therefore, usually closing stock is not given in the Trial Balance, but given in the adjustment. Closing stock is credited to the Trading Account and shown as an asset on the asset side of the Balance Sheet.

The adjusting entry is:

Closing Stock A/c Dr.

To Trading A/c

b. Outstanding expenses

While preparing final accounts, some expenses which are due during the accounting period might not have been paid. For example, a concern closes its books of accounts on 31 December. The salary, wages, rent, etc. of December may be paid only in the first week of January, next month. While preparing final accounts, these outstanding expenses should be considered so as to arrive at the correct profit or loss of the accounting year. If outstanding expense is given in the adjustment, it should be added to the respective item on the debit side of Trading Account or Profit and Loss Account and shown on the liability side of the Balance Sheet since it is a liability.

The adjusting entry record is:

Expenses A/c Dr.

To Outstanding expenses A/c

The expense account is debited because the expense of the current accounting year should be increased. Outstanding expense account is credited as it is a liability. Sometimes the amount of outstanding expenses will be given in the credit column of Trial Balance directly. It occurs when the Trial Balance is prepared after passing the adjustment entry. In such cases, the expense account is already reflected with the amount of outstanding expenses. Here, outstanding expense which is given inside the Trial Balance is considered like any other liability and shown in the liabilities side of the Balance Sheet.

c. Prepaid expenses or Expenses paid in advance

Prepaid expense or expense paid in advance means expenses paid during the accounting period but not due. It is related to the coming accounting years. For example, insurance premium paid ₹1000 for one year on first July 2020. While preparing Final Accounts on 31 December 2020, only half of the insurance premium is related to that accounting year, the remaining half is related to the accounting year 2021. Therefore, ₹500 must be deducted from insurance premium paid from the debit side of Profit and Loss Account and only the balance amount is shown as an expense in the Profit and



Loss Account of 2020. The remaining half, ₹500 is shown as an asset in the asset side of the Balance Sheet

The adjusting entry for prepaid expense is:

Prepaid Expense A/c	Dr.
To Expense A/c	

Expense account is credited because the expense of the current year shall be reduced and expense paid in advance account is debited because it is an asset. Sometimes the amount of prepaid expenses will be given in the credit column of Trial Balance directly. It occurs when the Trial Balance is prepared after passing the adjustment entry. In such cases, the expense account is already reflected with the amount of prepaid expenses. Here, prepaid expense which is given inside the Trial Balance is considered like any other asset and shown in the asset side of the Balance Sheet.

d. Accrued income or income earned but not received

Accrued income is also called income earned but not received. In certain cases, such as interest on investment, commission, etc. even though the income is due but it might not have been received. Since it is related to the current accounting year, it should be added to the respective item of income in the credit side of Profit and Loss Account and shown as an asset in the asset side of the Balance Sheet.

The adjusting entry is:

Accrued Income A/c	Dr.
To Income A/c	

Accrued income account is debited because it is an asset and income account is credited because the income of the current year should be increased. Sometimes the amount of accrued income will be given in the credit column of Trial Balance directly. It occurs when the Trial Balance is prepared after passing the adjustment entry. In such cases, the income account is already reflected with the amount of accrued income. Here, accrued income which is given inside the Trial Balance is considered like any other asset and shown in the asset side of the Balance Sheet.

e. Income received in advance

Income received in advance means income received but not due during the accounting

year, it is related to the coming accounting years. Therefore, the amount of income received in advance should be deducted from the respective income in the credit side of Profit and Loss Account and shown as a liability in the liability side of the Balance Sheet.

The adjusting entry is:

Income A/c	Dr.
To Income received in advance A/c	

The income account is debited because the amount of income to be credited to the Profit and Loss Account of the current year should be reduced. The income received in advanced account is credited because it is a liability. Sometimes the amount of income received in advance will be given in the credit column of Trial Balance directly. It occurs when the Trial Balance is prepared after passing the adjustment entry. In such cases, the income account is already reflected with the amount of income received in advance. Here, income received in advance which is given inside the Trial Balance is considered like any other liability and shown in the liabilities side of the Balance Sheet.

f. Bad debts

A business organization used to sell goods on credit to customers. The individual customer's account is listed in to a statement, the total amount due from such various customers are called trade debtors or sundry debtors. Sometimes, due to inability to pay the amount by some debtors, such as insolvency or some other reasons, the amount receivable from them may be irrecoverable and is termed as bad debts. Bad debt is a business loss.

The adjusting entry required for providing bad debt is:

Bad debt A/c	Dr.
To Sundry debtors A/c	

Bad debt account is debited because it is a loss. And sundry debtors account is credited because the amount receivable from sundry debtors is reduced. The accounting treatment is that the amount of bad debt is shown in the debit side of Profit and Loss Account and deducted from sundry debtors in the asset side of the Balance Sheet. Sometimes at the time of preparing Trial Balance, the above adjusting entry is passed and thereafter Trial Balance is prepared. Here bad debt is given in the debit column of Trial Balance and debited to the Profit and Loss Account only.

g. Provision for bad and doubtful debts

At the end of the accounting year, the businessman may feel that some of the debtors are doubtful. It means that the payment from some debtors may or may not be received. Such an amount cannot be written off as bad. As per the accounting principles of conservatism all possible losses must be provided and hence a provision needs to be created for meeting such anticipated losses. The provision so created is called provision for bad and doubtful debts. It is debited to the Profit and Loss Account and deducted from sundry debtors in the asset side of the Balance Sheet.

The adjusting entry is that

Profit and Loss A/c Dr.

To Provision for bad and doubtful debts A/c

If a provision for bad and doubtful debts account already exists in the Trial Balance, the amount of new bad debt should be written off from the provision for bad and doubtful debts account (old provision).

The journal entry record is:

Provision for bad and doubtful debts A/c Dr.

To Bad debts A/c

If the actual bad debt is greater than the provision already existing in the Trial Balance, a new provision for bad debt needs to be created.

Summary of treatment of bad debts and provision for bad debts

a) Bad debts are given in the debit column of Trial Balance.

This bad debt is called old bad debts and debited to the Profit and Loss Account only.

b) Bad debts are given in the adjustments

This bad debt is called a new/ additional bad debts. Therefore, it is debited to the Profit and Loss Account and deducted from sundry debtors in the asset side of the Balance Sheet.

c) Provision for bad and doubtful debts given in the adjustments

This provision is called new provision and is calculated as a certain percentage on sundry debtors. Here sundry debtors mean sundry debtors given in the Trial Balance minus new bad debts given in the adjustments. This new provision is debited to the Profit and Loss Account and deducted from sundry debtors in the asset side of the Balance Sheet.

d) Provision for bad and doubtful debts given in the credit column of Trial Balance

This provision is called old provision which is the excess amount left from provision for bad debts after deducting the actual bad debts of the previous year. Therefore, it is in the nature of an income of the current accounting year. Hence it can be shown either in the credit side of Profit and Loss Account or deducted from total of bad debts and new provision for bad debts in the debit side of Profit and Loss Account.

Table 4.2.5

Treatment of bad debts and provision for bad debts in the debit side of the Profit and Loss Account

Particulars	Amount
To Bad debts (given in the debit column of Trial Balance)	xxx
Add new bad debts (given in the adjustment)	xxx
Add new provision for bad debts (given in the adjustment)	xxx
less old provision (given in the credit column of Trial Balance)	xxx (xxx)
	xxx

Table 4.2.6

Treatment of sundry debtors in the asset side of the Balance Sheet

Asset	Amount
Sundry debtors	xxx
less bad debts (given in the adjustments)	(xxx)
less Provision for bad and doubtful debts (given in the adjustments)	(xxx)
	xxx

h. Provision for discount on debtors

Sometimes, some customers may be eligible to get a cash discount at the end of the year if the payment is made within a stipulated period. The actual payment will be made and discount will also be allowed in the next year. For anticipating this loss a certain amount is provided as provision for discount on debtors. This provision is calculated as a certain percentage on sundry debtors after deducting new bad debts and new reserve for bad debts given in the adjustments.

The adjusting journal entry is:

Profit and Loss A/c	Dr.
To Provision for discount on debtors A/c	

The amount is debited to the Profit and Loss Account and deducted from sundry debtors on the asset side of the Balance Sheet. If reserve for discount on debtors is given in the credit column of Trial Balance, it is the excess amount of reserve after deducting the actual discount of the previous year. It should be shown as an income on the credit side of Profit and Loss Account.

i. Reserve for discount on creditors

For making prompt payment creditors may give discount. Where a trader is receiving discount regularly, he can anticipate the same and make a provision for discount on creditors in the coming year. Reserve for discount on creditors is an income.

The adjusting entry is:

Reserve for discount on creditors A/c	Dr.
To Profit and Loss A/c	

The provision for discount on creditors is shown as an income in the credit side of Profit and Loss Account and deducted from sundry creditors in the liability side of the Balance Sheet. If provision for discount on creditors is given in the debit column of Trial Balance, it is the excess of provision over actual discount earned in the last year. Therefore, it is debited to the Profit and Loss Account of the current year only.

j. Depreciation

Depreciation means diminishing or decrease in the value of a fixed asset due to its constant use, obsolescence, elapse of time, etc. The value of fixed asset becomes zero or negligible amount after its life time. Therefore, proportionate amount of value of fixed asset should be treated as revenue expenditure. Revenue expenditure means expenditure incurred for earning income or revenue.

The adjusting entry required for providing depreciation is:

Depreciation A/c	Dr.
To Asset A/c	

The depreciation is debited to the Profit and Loss Account and the same is deducted from the respective asset in the asset side of the Balance Sheet.

If depreciation is given in the Trial Balance, it means that the adjusting entry is already passed and the value of fixed asset reduced to the extent of depreciation hence depreciation given in the Trial Balance need to be shown in the debit side of Profit and Loss Account only.

k. Interest on capital

Interest on capital can be allowed to the proprietor at nominal rate. Interest on capital is an expense to the business and it increases the capital balance, if it is not paid in cash. It is usually calculated on the opening balance of capital. If additional capital is introduced, interest on capital can be provided from the date of introduction of additional capital.

The adjusting entry for providing interest on capital is:

Interest on capital A/c	Dr.
To Capital A/c	

Interest on capital is debited to the Profit and Loss Account and added to the capital



balance in the liability side of the Balance Sheet since it results in the increase in capital balance. If interest on capital is given in the Trial Balance, it is to be shown only in the debit side of Profit and Loss Account.

l. Interest on drawings

Drawings mean the amount of cash, goods or asset taken by the proprietor from his business for personal use. Usually, interest on drawings is calculated as a certain percentage on drawings given in the Trial Balance. It is an income to the business.

The adjusting entry is

Drawings A/c Dr.
To Interest on drawings A/c

The interest on drawings is credited to Profit and Loss Account, added to drawings and total amount is deducted from capital in the liability side of the Balance Sheet. If interest on drawings is given in the Trial Balance it is credited to the Profit and Loss Account only.

m. Transfer to reserve

Reserve means the amount set aside out of profit for meeting any known or unforeseen contingencies in future. A business can create reserve only if there is profit. The adjusting journal entry is

Profit and Loss A/c Dr.
To General Reserve A/c

The amount of reserve is shown in the debit side of Profit and Loss Account and liability side of the Balance Sheet. If reserve is given in the Trial Balance, it needs to be shown only in the liability side of the Balance Sheet.

n. Adjusted purchases

Sometimes adjusted purchases may be given in the Trial Balance. Adjusted purchases mean opening stock + net purchases- closing stock.

Net purchases = Purchases - Purchase returns

If the adjusted purchase is given, the purchase account is increased by opening stock

o. Stock destroyed by fire

There are three situations in this event. They are goods destroyed by fire but, the full amount is admitted by insurance company, no loss is admitted by the insurance company and only a part of the loss is admitted by the insurance company. The following are the accounting treatment:

In this case, goods destroyed by fire are credited to the Trading Account. There is no loss to the business, the actual loss is fully paid or agreed to be paid by the insurance company. Goods destroyed by fire are credited to Trading Account and the amount receivable from the insurance company is shown in the asset side of the Balance Sheet as insurance claim or insurance company account.

A. Goods destroyed by fire A/c Dr.

B. Insurance Company Account / insurance claim A/c Dr.

◇ **Goods destroyed by fire and no amount is admitted by the insurance company**



A. Goods destroyed by fire A/c Dr.

To Trading A/c

B	Profit and Loss A/c	Dr.
	To Goods destroyed by fire A/c	

◇ **Goods destroyed by fire, the insurance company admitted only a part of the loss**

In this case, first of all goods destroyed by fire is credited to Trading Account as usual. Then, the amount of loss not admitted by the insurance company is debited to the Profit and Loss Account and the amount of claim admitted by the insurance company is shown in the asset side of the Balance Sheet as insurance claim / insurance company account.

A. Goods destroyed by fire A/c Dr.
To Trading A/c

B. Insurance claim/insurance company A/c Dr. (Claim admitted by the insurance company)

Profit and Loss A/c Dr. (Claim not admitted by the insurance company)

To Goods destroyed by fire A/c

p. Goods taken from business

Sometimes goods may be taken from the business out of purchases for different purposes such as personal use of the proprietor, office use and for distributing free as sample. This item is given in the adjustment only. The purchase of the business for trading purpose is reduced, therefore it should be deducted from purchases in the debit side of Trading Account.

◆ **Goods taken for personal use of the proprietor**

Sometimes goods may be taken by the businessman from his business, which is a form of drawings. In such case purchase account is reduced and drawings account is increased.

The adjusting journal entry is:

Drawing A/c	Dr.
To Purchase A/c	

(Goods taken for personal use adjusted reduced from purchase account)

The amount of goods taken for personal use is deducted from purchases in the debit side of Trading Account and added to drawings account and then finally deducted from capital in the liability side of the Balance Sheet.

◇ **Goods taken for office use**

Sometimes goods may be taken for office use. In such case, the value of goods is deducted from purchases in the debit side of Trading Account and debited to the Profit and Loss Account as stationery.

The adjusting entry is:

Stationary A/c	Dr.
To Purchase A/c	

◇ **Goods distributed as free or samples**

Sometimes out of the goods purchased, some article may be issued to the customers as free as a part of advertisement for promoting sales. This expense is actually a part of advertisement. The treatment is that the value of such goods is deducted from debit side of the Trading Account and debited to Profit and Loss Account as advertisement expenditure.

The adjusting entry is:

Advertisement A/c	Dr.
To Purchase A/c	

◇ **Goods sent on sale or return basis**

Sometimes goods may be sent to customers on sale or return basis. Only after getting confirmation from the customers, it is treated as actual sales. While preparing final accounts, some goods may be lying with the customers and no sale confirmation is

received. Adjustment in this respect should be carefully done.

While selling goods to customers, debtors account (customer's account) is debited and sales account is credited with invoice price. Therefore, goods with customers not confirmed till the last day of the accounting year as sales will be cancelled by reversing the entry.

The entry is:

Sales A/c	Dr.
To Sundry debtors A/c	

The invoice price of such sales should be deducted from sales account in the credit side of Trading Account and deducted from sundry debtors in the asset side of the Balance Sheet. The value of goods with customers not confirmed as sales (cost price) should be treated as stock with customers and credited to Trading Account and shown as an asset in the asset side of the Balance Sheet as goods with customers.

The entry is:

Stock A/c	Dr.
To Trading A/c	

q. Goods in transit

Goods in transit means goods purchased, not reached to the business till the closing day of the accounting year. The value of such goods should be accounted. Here the amount payable to the creditors should be recorded as a liability and goods in transit is recorded as an asset in the Balance Sheet. Here the value of asset and value of liabilities are increased.

The entry is:

Goods in transit A/c	Dr.
To Sundry creditors / suppliers A/c	

r. Commission payable on profit

Sometimes commission may be allowed or paid to managers, which is calculated as a certain percentage on the profit. Such commission may be calculated on the Net Profit

before charging such commission or after charging such commission. If it is mentioned that commission is payable on Net Profit before charging such commission, first of all Net Profit is calculated roughly and then commission payable is calculated as follows

$$\text{Commission payable} = \text{Net Profit} \times \frac{\text{Percentage of commission}}{100}$$

The commission so calculated is debited to Profit and Loss Account as commission payable and the balance in the Profit and Loss Account is the actual Net Profit. Since the commission payable is a liability, it should also be shown in the liability side of the Balance Sheet.

If commission is payable on Net Profit after charging such commission, first of all Net Profit is roughly calculated as mentioned above and commission payable is found out by applying the following equation.

$$\text{Commission payable} = \text{Net Profit} \times \frac{\text{Percentage of commission}}{100 + \text{Percentage of commission}}$$

The commission payable is debited to Profit and Loss Account and shown as a liability in the liability side of the Balance Sheet as mentioned in the above case.

Sometimes works manager is allowed a certain percentage of commission on Gross Profit. In such case commission is calculated on Gross Profit and debited to Profit and Loss Account and shown as a liability in the liability side of the Balance Sheet.

The adjusting entry for commission payable in all cases is

Profit and Loss A/c	Dr.
To Commission payable A/c	

If commission payable is given in the credit column of Trial Balance, it means that adjustment of commission is made in the commission account after passing adjusting entry. Hence commission payable is need to be shown in the liability side of the Balance Sheet only.

Illustration 4.2.4

The following is the Trial Balance of Mr. Sharma as at 31 December 2020. Prepare the Trading and Profit and Loss Account and Balance Sheet.

Particulars	Amount (Dr.)	Amount (Cr.)
Capital		750000
Opening stock	130000	
Cash	110000	
Bank	55000	
Machinery	200000	
Furniture	113000	
Purchases	250000	
Wages	50000	
Carriage	43000	
Salaries	60000	
Discount allowed	4000	
Discount received		5000
Advertising	40000	
Office expenses	50000	
Sales		500000
Debtors	190000	
Creditors		47000
Input CGST A/c	12500	
Input SGST A/c	12500	
Input IGST A/c	16000	
Output CGST A/c		10000
Output SGST A/c		10000
Output IGST A/c		14000
	1336000	1336000

Value of closing stock- ₹150000

Solution

Trading and Profit and Loss Account of Mr. Sharma for the year ended 31 December 2020

Particulars	Amount	Particulars	Amount
To opening stock	130000	By Sales	500000
Purchases	250000	Closing stock	150000
Wages	50000		
Carriage	43000		
	177000		
Gross Profit C/d			
	650000		650000
Office expenses	50000	By Gross Profit B/d	177000
Salaries	60000	Discount received	5000
Discount	4000		
Advertising	40000		
Net Profit transferred to capital	28000		
	182000		182000

Balance Sheet as on 31 December 2020

Liabilities	Amount	Asset	Amount
Creditors	47000	Cash	110000
Capital:		Bank	55000
Opening balance: 750000		Debtors	190000
Add Net Profit 28000	778000	Closing stock	150000
		Input CGST	2500
		Input SGST	2500
		Input IGST	2000
		Furniture	113000
		Machinery	200000
	825000		825000

Working notes:

Setting-off GST:

	Input	Output	Balance carried forward
IGST	16000	14000	2000
CGST	12500	10000	2500
SGST	12500	10000	2500

Illustration 4.2.5

The following data were extracted from the books of Ms. Megha as on 31 March 2020.

Prepare Trading and Profit and Loss Account and Balance Sheet after considering Adjustments.

	₹		₹
Capital	26000	Drawings	2000
Stock	16400	Taxes and insurances	1315
Wages	7000	Bad debts	550
Purchases	47000	Sundry creditors	2500
Motor car	2000	Bad debts reserve	900
Motor car expenses	1800	Bills payable	2850
Charity	105	Bank overdraft	4620
Buildings	11000	Cash	580
Loan	7880	Sales	65360
General expenses	4740	Machinery	9340
Sundry debtors	6280		

Adjustments:

- Closing stock was valued at ₹23000
- On 31 December 2020, a fire was occurred in the business and stock worth ₹10000 were destroyed. Insurance company admitted a claim of ₹8000.

- Write off further ₹180 as bad debts and maintain the bad debts reserve at 5% on debtors.
- Depreciate machinery at 10%
- Provide ₹700 for outstanding interest on loan.

Solution

Trading and Profit and Loss Account of Ms. Megha for the year ended 31 March 2020

Particular	Amount	Particulars	Amount
To Opening stock	16400	By Sales	65360
Purchases	47000	Closing stock	23000
Wages	7000	Stock destroyed by fire	10000
Gross Profit C/d	27960		
	98360		98360
General expenses	4740	By Gross Profit b/d	27960
Motor car expense	1800		
Charity	105		
Taxes and insurance	1315		
Bad debts	550		
Add new bad debts	180		
Add new reserve	305		
Less old reserve	(900)		
	135		
Depreciation on machinery	934		
Interest on loan	700		
Stock destroyed by fire	2000		
Net Profit transferred to capital account	16231		
	27960		27960

Balance Sheet as on 31 December 2020

Liabilities		Amount	Asset		Amount
Capital	26000		Building		11000
Add Net Profit	16231		Sundry debtors	6280	
Less drawings	(2000)	40231	Less new bad debts	<u>(180)</u>	
				6100	
			Less new reserve	<u>(305)</u>	5795
Loan	7880		Motor car		2000
Add interest outstanding	<u>700</u>	8580	Machinery	9340	
			Less depreciation	<u>(934)</u>	8406
Sundry creditors		2500	Cash		580
Bank over draft		4620	Closing stock		23000
Bills payable		2850	Insurance company		8000
			(claim)		
		58781			58781

Working notes:

- Treatment of stock destroyed by fire

Stock destroyed by fire is ₹10000. Insurance company admitted a claim of ₹8000 only. The balance ₹2000 is a loss. Therefore, Trading Account is credited ₹10000, Profit and Loss Account is debited ₹2000 and balance of ₹8000 is shown in the asset side of the Balance Sheet as amount due from the insurance company. The adjusting entry is:

Stock destroyed by fire A/c	Dr.	10000	
To Trading A/c			10000
Stock destroyed by fire A/c	Dr.	10000	
To Profit and Loss A/c			2000
To insurance company (claim) A/c			8000

Illustration 4.2.6

From the following data were extracted from the books of Mr. Ramesh prepare Trading and Profit and Loss Account for the year ending 31 March 2020 and Balance Sheet as on that date

	₹		₹
Capital	150000	Drawings	6300
Furniture	5120	Wages	46885
Bank charges	105	Office salaries	1420
Sales returns	1875	Carriage	5180
Rent and rates	3630	Purchase returns	1455
Sales	281505	Insurance	705
General expenses	7680	Plant and machinery	21640
Discount received	2985	Discount allowed	3960
Cash at bank	3870	Sundry debtors	65775
Purchases	199080	Stock	60225
Loan @ 5 %(Cr.)	15000	Bad debts	1380
Bills receivable	1860	Land and Building	32580
Provision for bad debts	4605	Sundry creditors	13720

(Trial Balance Total 469270)

- ◇ Closing stock was valued at ₹50000
- ◇ Depreciate plant and machinery by 10% and furniture by 5%
- ◇ Raised provision for bad debts to ₹7500.
- ◇ Insurance includes a premium of ₹360 on a policy expiring on 30 September 2020 on 28 March there was a fire, which destroyed goods worth ₹5000. The insurance company admitted a claim in full
- ◇ Purchases include a Typewriter costing ₹1500.
- ◇ The manager is allowed a commission of 10% on Net Profit before charging such commission.

Solution

Trading and Profit and Loss Account for the year ended 31 March 2020

Particular	Amount	Particulars	Amount
To opening stock	60225	By sales	281505
Purchase	199080	Less sales returns	(1875)
Less purchase returns	(1455)	Closing stock	50000
Less typewriter	(1500)	Stock destroyed by fire	5000
Wages	46885		
Carriage	5180		
“Gross Profit c/d	26215		
	334630		334630
To Interest on loan payable	750	By Gross Profit b/d	26215
Bank charges	105		
General expenses	7680	By Discount Received	2985
Rent, rates	3630		
Discount allowed	3960		
Office salary	1420		
Bad debts	1380		
Add new reserve	7500		
	8880		
Less old reserve	(4605)		
Insurance	705		
Less prepaid	(180)		
Depreciation			
Plant and machinery	2164		
Furniture	256		

Commission payable to manager	443		
Net Profit transferred to capital	3992		
	29200		29200

Balance Sheet as on 31 March 2020

Liabilities		Amount	Asset	Amount
Capital	150000		Cash at bank	3870
Add Net Profit	3992		Bills receivable	1860
	153992		Furniture	5120
Less drawings	<u>(6300)</u>	147692	Less depreciation	<u>(256)</u>
Loan	15000		Typewriter	1500
Add interest outstanding	<u>750</u>	15750	Sundry debtors	65775
Sundry creditors		13720	Less provision for bad debts	<u>(7500)</u>
Commission payable to Manager		443	Land and building	32580
			Plant and machinery	21640
			Less depreciation	<u>(2164)</u>
			Closing stock	50000
			Insurance company (claim)	5000
			Prepaid insurance	180
		177605		177605

Illustration 4.2.7

From the following Trial Balance as on 31 March 2021, prepare Trading and Profit and Loss Account for the year ended 31 March 2021 and a Balance Sheet as on that date.

Particulars	Amount (Dr.)	Amount (Cr.)
Opening stock	7000	
Purchases and Sales	7500	25000
Plant and machinery	7000	
Returns	280	200
Land and Buildings	3600	
Carriage inwards	150	
Carriage outwards	350	
Wages	2500	
Sundry debtors and Creditors	4800	2500
Coal and coke	350	
Gas and water	35	
Furniture and fixtures	1540	
Bad debts	150	
Bills receivable and Bills payable	2200	1050
Advertisement	1500	
Rent, rate, taxes	350	
Salaries	1600	
Trading expenses	100	
Cash in hand	75	
Cash at bank	2270	
Capital		15500
Drawings	900	
	44250	44250

The following additional information is provided.

- Closing stock was valued at ₹4000
- Depreciate plant and machinery by 10% and furniture and fixtures by 20%
- Bad debts reserve to be raised to 2.5% on sundry debtors.
- Interest on capital is to be provided at 5% p.a. and on drawings at 6% p.a.
- Advertisement expenses to be written off against revenue over 5 years.
- Outstanding liabilities to be provided for salaries ₹300
- Goods worth ₹2500 send to customers on sale or return basis. Till closing the books of accounts no confirmation is received from customers. The cost of such goods is ₹2000

Solution

Trading and Profit and Loss Account for the year ended 31 March 2021

Particular	Amount	Particulars	Amount
Opening stock	7000	Sales	25000
Purchases	7500	Less returns	(280)
Less returns	(200)		
	7300		
Carriage inwards	150	Less goods not confirmed	
Wages	2500	as sales	(2500)
Coal and coke	350		22220
Gas and water	35	Closing stock	4000
		Goods with customers	2000
Gross Profit c/d	10885		
	28220		28220

Bad debts	150		
Add new reserve	<u>58</u>	208	Gross Profit b/d
Advertisement $(1500 \times \frac{1}{5})$		300	
Salaries	1600		Interest on drawings
Add outstanding	<u>300</u>	1900	54
Trade expenses		100	
Rent, rate tax		350	
Depreciation on plant and machinery		700	
Depreciation on furniture		308	
Interest on capital		775	
Carriage outward		350	
Net Profit transferred to capital account		5948	
		10939	10939

Balance Sheet as on 31 March 2021

Liabilities	Amount	Asset	Amount
Capital	15500	Plant and machinery	7000
Add Net Profit	5948	Less depreciation	<u>(700)</u>
Add Interest on capital	<u>775</u>	Land and building	3600
	22223		
Less drawings	(900)	Sundry debtors	4800
Interest on drawings (54)		Less goods on	
	<u>(954)</u>	sale or return	
	21269	basis	<u>(2500)</u>

Sundry creditors	2500	2300	
Bills payable	1050	Less new reserve (58)	2242
Salaries outstanding	300		
		Furniture and fittings 1540	
		Less depreciation (308)	1232
		Bills receivable	2200
		Deferred advertisement	1200
		Cash in hand	75
		Cash at bank	2270
		Closing stock	4000
		Goods with customers	2000
	25119		25119

Working notes

- Calculation of provision for bad debts

Sundry Debtors	4800
Less goods with customers at selling price	(2500)
	2300
Provision for bad debts 2.5% of ₹2300	(58)
Debtors to be shown in the Balance Sheet	2242
- Goods at selling price of ₹2500 is with customers, not confirmed as sales. Therefore ₹2500 is deducted from sales in the credit side of Trading Account and deducted from sundry debtors in the asset side of the Balance Sheet. The adjusting journal entry is

Sales A/c	Dr.	2500	
	To Sundry debtors A/c	2500	

- The cost price of the goods ₹2000 is credited to Trading Account and shown in the asset side of the Balance Sheet. The entry is

Goods with customers A/c	Dr.	2000	
	To Trading A/c	2000	



Recap

- ◇ Direct expenses - Expenses directly related to purchases or manufacturing
- ◇ Indirect expenses - Expenses not directly related to purchases or manufacturing
- ◇ Gross Profit/loss - Sales minus cost of goods sold
- ◇ Gross Profit/loss - Transferred to Profit and Loss Account
- ◇ Net Profit/loss - Total revenue minus total expenses
- ◇ Net Profit - Added with capital in the Balance Sheet
- ◇ Net Loss - Deducted from capital in the Balance Sheet
- ◇ Marshalling of Balance Sheet - Order in which assets and liabilities are shown
- ◇ Adjustments - Transactions for which journal entries have not been passed
- ◇ Closing stocks - Goods unsold at the end of accounting year
- ◇ Outstanding expenses - Expenses due but not yet paid
- ◇ Prepaid expenses - Expenses paid in advance
- ◇ Outstanding or Accrued Income - Income earned but not yet received
- ◇ Income received in advance - Income received for coming years
- ◇ Depreciation - Decrease in value of asset over time due to wear and tear
- ◇ Bad debt - Irrecoverable portion of debt that is due from sundry debtors
- ◇ Interest on capital - Interest paid by business on owner's capital
- ◇ Interest on drawings- Interest charged by business on drawings of owner
- ◇ Transfer to general reserve - Amount kept for business growth from Net Profit

Objective Questions

1. To which side of Profit and Loss Account is the Gross Profit transferred?
2. To which side of Profit and Loss Account is the Gross Loss transferred?
3. What is it called when an amount is due from a customer and is not recoverable due to his insolvency or other reasons?
4. What is the business conducted by a single person known as?
5. What is the income due but not received known as?
6. What do you call for the expenses paid during the current year but related to the coming accounting years?
7. What is the term which is used to denote the decrease in the value of fixed asset due to wear and tear?
8. What do you call the income received in the current year which relates to the coming accounting years?
9. What is the expense which is due but not paid known as?

Answers

1. Credit side
2. Debit side
3. Bad debt
4. Sole proprietorship
5. Accrued income
6. Prepaid expense
7. Depreciation
8. Unearned income
9. Outstanding expense

Self-Assessment Questions

1. What do you mean by unexpired income?
2. Explain Marshalling of Balance Sheet.
3. How is income tax paid by the owner treated while preparing final accounts of a sole trader?
4. Create a format of Trading Account, Profit and Loss Account and Balance Sheet.
5. Explain the treatment of accrued income while preparing the final accounts of a sole trader?
6. What is a direct expense? Explain with examples.
7. What are the two methods used for preparing Balance Sheet? Develop format of preparing Balance Sheet using both methods.
8. Explain the treatment of outstanding expenses while preparing the final accounts of a sole trader?

Assignments

1. Consider the following adjustments and indicate necessary entries for the same. Describe the accounting treatment for each item.
 - i. Value of closing stock ₹200000
 - ii. Payment of wages pending was ₹10000.
 - iii. Prepaid rent ₹10000.
 - iv. Provide for interest on capital 5% per annum. (Capital ₹2000000)
 - v. Outstanding salary to be paid ₹85000

2. Find out Gross Profit or Gross Loss from the following information:

Opening stock	₹50000
Purchase	₹30000
Freight	₹3000
Carriage inwards	₹1500
Interest on drawings	₹1200
Closing stock	₹55000
Sales	₹135000

(Answer- Gross Profit- ₹105500)

3. Prepare Trading, Profit and Loss Account and Balance Sheet for the year ended 31st December 2022 from the following transactions:

	₹		₹
Purchase	252000	Bills receivable	21500
Carriage outwards	1000	Salaries	20000
Return outwards	2000	Sundry debtors	30000
Opening stock	40000	Commission allowed	1000
Sales	355000	Bad debt	1500
Sales return	5000	General expense	5000
Carriage inwards	5000	Interest received	3000
Bills payable	30000	Rent paid	3000
Machinery	40000	Discount allowed	2000
Factory expenses	5000	Dividend paid	5000
Capital	60000	Insurance	3000
Creditors	25000	Discount received	3000
Furniture and fitting	5000	Provision for doubtful debt	2000

Land and building	45000		
Bank overdraft	10000		

Additional information-

- Closing stock was valued at ₹42000
- Depreciation made on Plant and Machinery ₹2000
- Depreciation made on Buildings ₹1000
- Provision for Doubtful Debts at 5% on Sundry Debtors
- Outstanding Rent ₹1000
- Prepaid Salaries ₹1000
- Interest on Capital was given at 5%

(Answer- Gross Profit- ₹92000, Net Profit- ₹51000, B/S Total- ₹180000)

- Prepare Trading, Profit and Loss Account, and Balance Sheet for the year ending 31st March 2023 from the following information:

	₹		₹
Purchase	29000	Salaries	3000
Direct wages	5000	Sundry debtors	10000
Opening stock	8000	Commission allowed	400
Sales	65000	Bad debt	300
Sales return	500	Interest received	500
Carriage inwards	4000	Discount allowed	100
Bills payable	6200	Provision for doubtful debt	500
Machinery	20000	Cash	1200
Direct expenses	5000		
Capital	30000		
Creditors	12000		

Furniture and fitting	3000		
Land and building	20000		
Drawings	5000		
Purchase return	300		

Additional information-

- Closing stock was valued at ₹8000
- Depreciation made on Machinery – 10%
- Depreciation made on Buildings- 5%
- Provision for Doubtful Debts at 10% on Sundry Debtors
- Outstanding salaries ₹500
- Prepaid salary ₹100
- Interest on capital was given at 10%

(Answer- Gross Profit- ₹21800, Net Profit- ₹11600, B/S Total- ₹58300)

- From the following information, you are asked to prepare the final accounts of Mr. Sudheer as on 31 March 2023.

Particulars	₹	Particulars	₹
Capital	44200	Royalty	50000
Creditors	12000	Bank	10000
Purchase Returns	5000	Repairs	500
Sales	164000	Opening Stock	20000
Accounts Payables	5000	Rent	4000
Production Plant	40000	Factory Expenses	8000
Debtors	24000	Office Expenses	7000
Drawing	10000	Bad Debts	2000
Purchases	105000	Carriage	1500
Sales Returns	3000	Fuel and Power	1000

Adjustments:

- Closing Stock is valued at ₹14500.
- Bad debts written off ₹5000.



iii. Depreciate Production Plant by ₹4000

iv. Repairs due is ₹400

(Answer: Gross Loss- 5000, Net Loss – 27900, BS Total – 79500)

Suggested Readings

1. Maheswari, S. N. (2018). *Advanced Accounting*. Vikas Publishing House.
2. Paul, S. K. R. (2011). *Advanced Accounting*. New Central Book Agency (P) Ltd.
3. Jain, S. P., and Narang, K. L. (2019). *Advanced Accountancy*. Kalyani Publishers, New Delhi.
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BLOCK

Partnership Accounts



Unit 1

Introduction to Partnership

Learning Outcomes

After completing this unit, the learner will be able to:

- ◇ gain insights on the broad concept of Partnership
- ◇ identify the types of partnership
- ◇ familiarise with Partnership deed
- ◇ describe the rules applicable in the absence of a partnership deed

Prerequisites

Rajesh, Michael, and Balamurali, three friends with complementary skills, decide to open a coffee shop together. Rajesh will handle menu development and food preparation, Michael will oversee operations and finances, and Balamurali will manage marketing and customer engagement. To ensure their collaboration runs smoothly, they need a formal agreement outlining each partner's roles, contributions, and profit-sharing arrangements.

A partnership deed is crucial in this scenario as it clearly defines each partner's responsibilities and expectations, helping prevent misunderstandings and overlap in duties. It specifies how profits and losses will be distributed, sets procedures for decision-making and conflict resolution, and includes provisions for handling changes or dissolving the partnership if needed. This formal document provides legal protection by documenting the agreed terms, ensuring a more organized and harmonious business relationship.

Keywords

Partnership, Unlimited liability, Firm, Partnership deed, Types of Partners, Partners' Capital Accounts

Discussion

5.1.1. Meaning of Partnership

The partnership is an extension of the sole proprietorship concern. A partnership is a business carried on by two or more persons. The main objective of such a business is to earn profit and to share losses, if any, among themselves. In India, partnership concerns are governed by the Indian Partnership Act of 1932. The persons who have entered into a partnership are individually called 'partners' and it is collectively called a 'firm'.

5.1.2. Definition

According to Section 4 of the Indian Partnership Act 1932, a partnership may be defined as "the relation between persons who have agreed to share the profit of a business carried on by all or any of them acting for all".

5.1.3. Features of Partnership

- ◇ **Number of persons:** There must be at least two persons to form a partnership. The limit regarding the minimum number is fixed by the Indian Partnership Act of 1932 and the maximum limit is prescribed by the Companies Act of 1956. As per the recent amendments of the Companies Act 2013, it is stated that the maximum number of persons in a partnership is limited to 100. As per Rule 10 of the Companies (Miscellaneous) Rules 2014, maximum number of partners is limited to 50.
- ◇ **Agreement:** The relation of partnership arises from the agreement. Incompetent persons like minors, insolvents, etc. are not eligible to become partners in a partnership firm. Only legally competent persons can enter into an agreement of partnership.
- ◇ **Business objective:** A partnership can be formed only for the purpose of carrying on some lawful business to make profit. Any agreement for charitable purpose cannot be a partnership.
- ◇ **Sharing of profits:** The profit and losses of the business must be shared by all

the partners in an agreed ratio. In the absence of any agreed profit-sharing ratio, profit or losses should be shared equally.

- ◇ **Business must be carried on by all or any of them acting for all:** Partnership business can be conducted by all the partners jointly or any of them on behalf of others. This means that each partner has the right to participate in the business of the firm and other partners are bound by his actions. Hence there exists a principal and agent relationship among the partners.
- ◇ **Utmost good faith:** Partnership is conduct of utmost good faith. Hence every partner is morally and legally bound to be just and faithful to one another.
- ◇ **Unlimited liability:** The liability of the partners of the firm is unlimited. There is no distinction between partners' private properties and business properties as far as the firm's creditors are concerned. A partner is individually and also jointly liable for the payment of all the debts of the firm either from the firm's properties or from the partners' private assets.
- ◇ **No separate legal existence:** A partnership is not a legal entity. It has no separate existence apart from the partners.

5.1.4. Types of Partnership

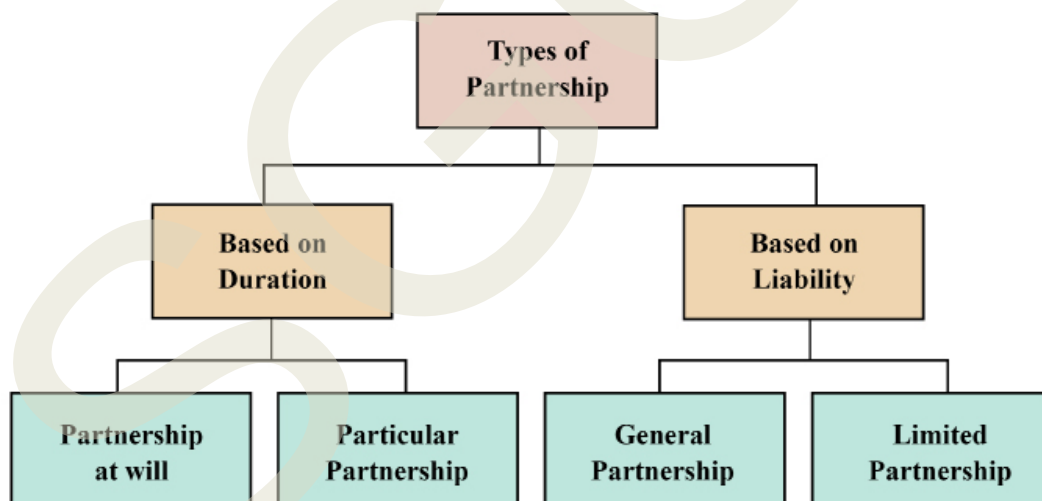


Figure 5.1.1

Types of Partnership

The above figure shows the different types of partnerships.

Partnership can be classified on the basis of two factors, viz., duration and liability.

5.1.4.1. Classification on the basis of duration

- ◇ Partnership at will: This type of partnership exists at the will of the partner. It can continue as long as the partners want it and is terminated when any partner gives notice of withdrawal from the partnership to the firm.
- ◇ Particular partnership: Partnership formed for the accomplishment of a particular project. It dissolves automatically when the purpose for which it was formed is fulfilled or when the time duration expires.

5.1.4.2. Classification on the basis of liability

- ◇ General partnership: In a general partnership, the liability of the partners is unlimited and joint. The partners enjoy the right to participate in the management of the firm. Registration of the firm is optional. The existence of the firm is affected by the death, lunacy, insolvency or retirement of the partners.
- ◇ Limited partnership: In a limited partnership, the liability of at least one partner is unlimited whereas the rest may have limited liability. Such a partnership does not get terminated with the death, lunacy, or insolvency of the limited partners. The limited partners do not enjoy the right of the management. Registration of such partnership is compulsory.

5.1.5 Partnership Deed

The partnership is created by an agreement between partners. This agreement may be either oral or in writing. It is not necessary that the agreement should be in writing. It is always better to have it in writing to avoid future disputes. A written document containing the terms and conditions of the conduct of partnership business is called partnership deed. It is also known as the Articles of partnership. The partnership deed should be properly drafted, should be in simple and clear language. All important matters of the business should be included. It should be signed by all the partners and stamped in accordance with the provisions of the Indian Stamps Act.

5.1.6 Objectives of Partnership Agreement

- ◇ To run the business smoothly
- ◇ To avoid future disputes among the partners
- ◇ To make the partners aware of their rights, duties, and liabilities

- ◇ To have a peaceful atmosphere for running the business smoothly
- ◇ To spell out the defined terms of the agreement

5.1.7 Contents of Partnership Deed

- ◇ Name and address of the firm
- ◇ Name and address of all the partners
- ◇ Nature and place of the business
- ◇ Date of commencement of the business
- ◇ Duration of partnership, if any
- ◇ Capital contributed or to be contributed by each partner of the firm
- ◇ Amount of drawings permitted to each partner during a given period
- ◇ Profit sharing ratio
- ◇ Rate of interest if payable on partner's capital
- ◇ Rate of interest allowable on partner's loan
- ◇ Salaries, commission, etc. payable to partners
- ◇ Rate of interest chargeable on partner's drawings
- ◇ Method of maintaining accounts of the firm
- ◇ Details of allocation of work among partners
- ◇ Rights, duties, and liabilities of partners
- ◇ Rules to be followed in the case of admission, retirement, and death of a partner
- ◇ Mode of auditor's appointment of the firm and details of the audit of books of accounts

5.1.8 Rules Applicable in the Absence of Partnership Deed

- ◇ Profits and losses are shared equally by the partner
- ◇ Interest on capital is not paid to the partner
- ◇ Interest on drawings is not charged from the partners
- ◇ Interest on the loan is paid at the rate of 6% per annum
- ◇ Remuneration, salary, or commission is not payable

Recap

- ◇ Partner - Member of a partnership.
- ◇ Firm - All partners are collectively known.
- ◇ Partnership - Agreement between two or more persons joined together.
- ◇ Agreement – Oral or Written.
- ◇ Partnership Deed – Written agreement between partners in a partnership.
- ◇ Indian Partnership Act - 1932.
- ◇ Minimum number of partners- Indian Partnership Act.
- ◇ Maximum number of Partners - Companies Act
- ◇ Agreement – Compulsory.
- ◇ Registration – Optional.

Objective Questions

1. To start a partnership business, what should be the minimum number of partners?
2. What type of agreement is used to form a partnership business?
3. What type of partnership is formed for the accomplishment of a particular project?
4. What is the written agreement of partnership known as?
5. In the absence of a partnership agreement, what will be the percentage of profit-sharing ratio between the partners?
6. Which Act governs partnerships in India?
7. How are individuals in a partnership referred to?
8. Which act limits the maximum number of persons in a partnership?

Answers

1. 2
2. Written or oral agreement
3. Particular partnership
4. Partnership Deed
5. Equal
6. Indian Partnership Act 1932
7. Partners
8. Companies Act 2013

Self Assessment

1. What are the key characteristics or features of a partnership, and how do they differentiate it from other forms of business organisations?
2. Name and briefly explain three different types of partnerships commonly found in business practice.
3. What is a partnership deed, and why is it important for a partnership? Discuss its role in establishing the rights, responsibilities, and obligations of the partners.
4. Identify five essential provisions that are typically included in a partnership deed, and explain their significance in governing the partnership.
5. Why is it important to have a Partnership Deed?
6. What are the objectives of a Partnership Deed?
7. What happens if there is no Partnership Deed in place?
8. What are the rules applicable in the absence of partnership deed?

Assignments

1. Prepare a short note regarding different types of partnership.
2. Identify a local business owner doing a partnership business. Study their experiences with running a partnership, including the reasons for choosing a partnership structure, the benefits they have gained, and any challenges they have faced.
3. List the advantages and disadvantages of forming a partnership.
4. Choose a business idea and outline a basic business plan for a partnership.

Suggested Readings

1. Maheswari, S. N. (2018). *Advanced Accounting*. Vikas Publishing House.
2. Paul, S. K. R. (2011). *Advanced Accounting*. New Central Book Agency (P) Ltd.
3. Jain, S. P., and Narang, K. L. (2019). *Advanced Accountancy*. Kalyani Publishers, New Delhi.
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Unit 2

Preparation of Partner's Capital Account

Learning Outcomes

After completing this unit, the learner will be able to:

- ◇ describe the rights and duties of partners
- ◇ identify the types of partners
- ◇ familiarise with the capital account of partners
- ◇ differentiate the fixed capital method and fluctuating capital method

Prerequisites

After much deliberation, three people decide to form a partnership business. They decided to start a business and split their profits and losses. They agreed that two of them would be involved in the business, while the remaining one would not be. What are these kinds of partners known as? What are the various kinds of capital accounts that can be prepared? To meet their own needs, the partners may withdraw funds from the business at regular or irregular intervals in expectation of gains. A firm may borrow money from its partners in addition to their capital commitment. What are the accounting treatments for these? This unit goes through all of this.

Keywords

Partnership accounts, Capital account, Fixed capital method, Fluctuating capital method

5.2.1 Rights of Partners

- ◇ Right to share profits
- ◇ Right to get interest on capital
- ◇ Right to take part in the management
- ◇ Right to verify the books of accounts
- ◇ Right to use the property of the firm

5.2.2 Duties of Partners

- ◇ Every partner is bound to diligently carry on the business of the firm to the greatest common advantage
- ◇ Every partner must be just and faithful to the other partners
- ◇ A partner is bound to keep and render true, proper, and correct accounts of the partnership and must permit other partners to inspect and copy such accounts
- ◇ A partner must not carry-on competing business, nor use the property of the firm for his private purposes
- ◇ Every partner is bound to share the losses with the others

5.2.3 Types of Partners

Partnership in business means a deal between two or more parties where they share profits. It is not always necessary that each partner have an equal level of participation or an equal share of profit in the business. The share of liabilities might also vary. Because of that, we have different types of partners in a firm. They are:

- ◇ **Active partner:** Such partners are actively engaged in the business:
- ◇ **Sleeping partner:** Such partners do not take part in the conduct of the business; they are also called Dormant partners.
- ◇ **Nominal partner:** This type of partner lends his/her name to the firm without any actual interest in terms of investing capital.
- ◇ **Partner in profit only:** This type of partner agrees to be a partner for profit and he/she does not take the risk of sharing losses.

- ◇ **Partner by estoppel:** These are partners by words, spoken or words written or represent themselves or permits to be represented to be a partner in the firm, who is not a real partner in the firm.
- ◇ **Limited Partners:** When a partner is admitted into a partnership firm with a special agreement, that he/she is entitled to share in the profits of the firm but not in the losses, he/she contributes to the capital of the firm, but he/she has no right to take part in the activities of the business firm. Limited partner liability is limited to the capital invested by him/her.
- ◇ **Sub-partner:** If a partner agrees to give his/her share of partner to an outsider, such outsider who gets the share in the profit of the firm is called as sub-partner.

5.2.4 Accounts of Partnership Firm

The double-entry system of book keeping is applied in the Partnership firm. These accounts are maintained in the same manner as a sole trader. In partnership, there are two or more partners; each partner's capital account has to be maintained separately. The partnership deed usually indicates the method of maintaining the partner's capital account. In the partnership account, there would be a different capital account for each partner.

5.2.4.1 Capital Account

Capital accounts are personal accounts. A firm keeps a separate capital account for each partner. The transactions relating to partners are recorded in their respective capital accounts. There will be a minimum of two partners, so separate capital accounts are to be prepared to find out their individual shares.

Table 5.2.1
Items on Capital Accounts of Partners

Debit side	Credit side
1. Drawings 2. Interest on drawings 3. Share of loss (As per Profit and Loss A/c)	1. Opening capital (capital introduced in the beginning) 2. Additional capital introduced 3. Assets brought in 4. Interest on capital 5. Salary to the partner 6. Commission to the partner 7. Share of Profit (As per Profit and Loss A/c)

Methods of Maintaining Capital Account

Mainly there are two methods of maintaining the capital accounts of partners. They are:

- Fluctuating Capital Method
- Fixed Capital Method

a. Fluctuating Capital Method or Floating Capital Method

Under the fluctuating capital method, only one account, viz., the capital account is maintained for each partner. It records all adjustments relating to drawings, interest on capital, salary, commission, share of profit or loss, etc. in the capital account itself. As a result, the balance in the capital account keeps on fluctuating. In the absence of any instruction, the capital accounts of the partners should be prepared under this method

Table 5.2.1
Specimen of Capital Account
Capital Account

Dr.		Cr.	
Particulars	Amount	Particulars	Amount
To Drawings	xxx	By Balance b/d	xxx
To Interest on drawings	xxx	By Cash/Bank (capital introduced)	xxx
To Profit and Loss Appropriation A/c (Share of Net loss)	xxx	By Interest on Capital	
		By Salary	xxx
		By commission	xxx
		By Profit and Loss Appropriation A/c (Share of Net Profit)	xxx
To Balance c/d	xxx		xxx
	XXXX		XXXX
		By Balance b/d	xxx

Illustration 5.2.1

Show how the following items will appear in the capital accounts of partners, X and Y when their capitals are fluctuating.

Particulars	X (₹)	Y (₹)
Capital on 1-04-2017	50000	35000
Drawings 2017-2018	15000	10000
Interest on drawings	700	500
Share of profit for 2017-2018	14000	10000
Interest on capital	5800	3500
Partner's salary	7000	

Solution

Capital Account of X and Y

Date	Particulars	X (₹)	Y (₹)	Date	Particulars	X (₹)	Y (₹)
31-03-2018	To Drawings	15000	10000	1-04-2017	By balance b/d	50000	35000
"	To Interest on drawings	700	500			5800	3500
"	To balance c/d	61100	38000	31-03-2018	By Interest on capital		
				"	By Salary	7000	
				"	By Profit	14000	10000
		76800	48500			76800	48500
				1-04-2018	By balance b/d	61100	38000

b. Fixed Capital Method

Under the Fixed Capital Method, two accounts, viz., the capital account and the current account are maintained for each partner. It is also credited with the additional capital contribution of the partner. It is debited with withdrawals made by the partners out of capital. All adjustments relating to drawing (other than out of capital) interest on drawings, interest on capital, salary, commission, the share of profit or loss, etc., are recorded in a separate account called the current account. As a result, the balance in the capital accounts will continue to show the same balance year after year (unless additional capital is introduced or drawings are made out of capital). But on the other hand, the balance of the current account will fluctuate from year to year.

Table 5.2.2
Specimen of Capital Account
Capital Account

Dr.		Cr.	
Particulars	Amount	Particulars	Amount
To Cash (Drawings out of Capital)	xxx	By Balance b/d	xxx
To Balance c/d	xxx	By Cash/Bank (Capital introduced)	xxx
	xxx		xxx
		By Balance b/d	xxx

Table 5.2.3
Specimen of Current Account
Current Account

Dr.		Cr.	
Particulars	Amount	Particulars	Amount
To Drawings	xxx	By Balance b/d	xxx
To Interest on drawings	xxx	By Commission	xxx
To Profit and Loss Appropriation A/c (Share of net loss)	xxx	By Interest on Capital	xxx
To Balance c/d	xxx	By Salary	xxx
		To Profit and Loss Appropriation A/c (Share of net profit)	xxx
	xxx		xxx
		By Balance b/d	xxx

Illustration 5.2.2

Show how the following items will appear in the capital accounts of partners X and Y under fixed the capital method.

	X	Y
Capital on 1-4-2017	60000	50000
Drawings during 2017-2018	15000	12000
Interest on drawings	500	400

Share of profit for 2017-2018	10000	7500
Interest on capital	6300	3600
Partners Salary	5000	4000
Commission	1000	1200

Solution

Capital Account of X and Y

Dr.				Cr.			
Date	Particulars	X (₹)	Y (₹)	Date	Particulars	X (₹)	Y (₹)
31-3-2017	To Balance c/d	60000	50000	1-4-2017	By Balance b/d	60000	50000
		60000	50000			60000	50000
				1-4-2018	By Balance b/d	60000	50000

Current Account of X and Y

Dr.				Cr.			
Date	Particulars	X (₹)	Y (₹)	Date	Particulars	X (₹)	Y (₹)
31-03-2018	To Drawings	15000	12000	31-03-2018	By Interest on capital	6300	3600
31-03-2018	To Interest on Drawings	500	400	31-03-2018	By Salary	5000	4000
31-03-2018	To balance c/d	6800	3900	31-03-2018	By Commission	1000	1200
				31-03-2018	By P/L A/c	10000	7500
		22300	16300			22300	16300
					By Balance b/d	6800	3900

5.2.5 Difference between Fixed capital and Fluctuating Capital Methods

Points	Fixed Capital Method	Fluctuating Capital Method
Number of accounts	Two accounts: Capital account and current account	One account: Capital Account
Nature	Remains almost unaltered	Fluctuates
Adjustments	Adjustments like interest on capital, drawings, interest on drawings, etc. are made in the current account	Adjustments are made in the capital account itself
Appearance in the Balance Sheet	Both capital and current account appear	Only capital account appears
Specific mention	It should be specifically mentioned in the partnership deed	Not necessary

5.2.6 Some of the Important Items/ Adjustments

5.2.6.1 Interest on Capital Account

No partner can claim interest on capital unless the agreement provides it. Usually, the partnership deed contains the provision for payment of interest on the partner's capital in order to compensate the partners who have contributed more capital compared to their profit-sharing ratio. Such interest is loss to the firm and a gain to the partners and hence should be credited to the capital account under Fluctuating Capital method and to Current Account under Fixed Capital Method. The corresponding debit should be given to the Profit and Loss Appropriation Account. Interest on capital is allowed to partners, if it is provided in the partnership agreement. The interest on capital is paid to the partners as compensation for their capital contribution to the firm. Interest is generally calculated on the opening capital and credited to capital account. Interest on additional capital will be calculated on time basis. The interest on capital is allowed considering three important factors

- ◇ Rate
- ◇ Amount
- ◇ Period

It should be noted that no interest on capital is payable if the firm is working at a loss.

Journal Entries

To provide interest on capital	Interest on capital A/c To Partner's capital A/c(Individually)	Dr.
To close interest on capital	Profit and Loss Appropriation A/c To Interest on capital A/c (Interest on capital closed by transfer to Profit and Loss Appropriation Account)	Dr.

Case I: When there is no addition to or withdrawal from the capital during the year

Illustration 5.2.3

A and B are partners sharing profits and losses equally. Their capitals on 1 January 2020 were A ₹30000, B ₹40000. Calculate interest on capital at 6% per annum for the year ending 31 December 2020.

Solution

Interest on Capital

$$A = 30,000 \times \frac{6}{100} = ₹1800$$

$$B = 40,000 \times \frac{6}{100} = ₹2400$$

Case II: When there is additional capital contribution during the accounting year

In this case, interest is calculated as follows

- On the opening capital for the full year
- On the additional capital from the date of contribution to the end of the period

Illustration 5.2.4

X and Y are partners in a firm. Their capital accounts showed the balance on 1 January 2020 as X ₹30000 and Y ₹20000. During the year 2020, X introduced additional capital of ₹10000 on 1 June 2020 and Y brought in ₹15000 on 1 July 2020. The interest on capital is allowed at 6% p.a. Accounts are closed on December 31 every year. Calculate the interest on capital to be allowed to X and Y for the year 2020.

Solution

	X	Y
For a full year on capital balance X- $30000 \times \frac{6}{100}$ Y- $20000 \times \frac{6}{100}$	1800	1200
For additional capital introduced X- $10000 \times \frac{6}{100} \times \frac{7}{12}$ Y- $15000 \times \frac{6}{100} \times \frac{6}{12}$	350	450
	2150	1650

Case III: If the opening balance is not given

If the opening capital is not given, it is arrived at by subtracting those items which have been added to the capital and by adding those items which have been subtracted. Thus, the calculation of opening capital will be as follows:

Table 5.2.4

Calculation of opening capital

Capital at the end of the year		xxx
Add		
Drawings	xxx	
Interest on drawings	xxx	
Share of loss, if any	<u>xxx</u>	xxx
		xxx
Less		
Partner's salary	xxx	
Partner's commission	xxx	
Partners' share of profit	xxx	
Additional capital if any	<u>xxx</u>	(xxx)
		xxx

Illustration 5.2.5

A and B are partners in a business. Their capital at the end of the year was ₹46000 and ₹34000 respectively. During the year 2020, A's drawings and B's drawings were ₹6800 and ₹10700 respectively. Interest on drawings charged was A ₹200 and B ₹300. A had been credited with a salary of ₹3000 and B with a commission of ₹4000. Profits during the year after making the above-mentioned adjustments were ₹30000. Calculate interest on capital @6% for the year ending 31 December 2020

Solution

In this case, the closing capitals are given. So, in order to calculate the interest on capital, the capital at the beginning is to be found out as follows:

Calculation of A's capital at the beginning of the year

Capital at the end of the year		46000
Add drawings		6800
Add interest on drawings		200
		53000
Less		
Salary	3000	
Share of profit = $30000 \times \frac{1}{2} =$	15000	(18000)
A's capital in the beginning		35000

$$\text{Interest on capital @ 6\%} = 35,000 \times \frac{6}{100} = 2100$$

Calculation of B's capital at the beginning of the year

Capital at the end of the year		34000
Add drawings		10700
Interest on drawings		300
Less: Commission	4000	45000
Share of profit = $30000 \times \frac{1}{2} =$	15000	(19000)
B's capital in the beginning		26000

Interest on capital for B @6% = $26,000 \times \frac{6}{100} = 1560$

5.2.6.2 Drawings Account

In order to meet the private requirements, the partners may at regular or irregular intervals, withdraw amounts from the business in anticipation of profits. These drawings may be in kind or in cash. Whenever drawings are made, they should be shown on the debit side of the Drawings Account of the respective partner and credit side of the Cash Account or Property Account as the case may be. At the end of the accounting period, the balance should be transferred to the Partner's capital Account under Fluctuating Capital Method. But under the Fixed Capital Method the balance should be transferred to the Current Account of the concerned partner.

However, withdrawals out of the capital, if any, should be debited to the respective partner's capital account irrespective of the method of maintaining the capital account.

5.2.6.3 Interest on Drawings Account

In order to discourage withdrawals by the partners from the business, the agreement may contain a provision to charge interest on partners' drawings. The interest charged on the partners' drawing is the income to the firm and loss to the respective partners. Hence it is shown on the debit side of the Partner's Capital Accounts and credit side of the Interest on Drawings Account. The Interest on Drawings Account is closed by transferring it to the Profit and Loss Appropriation Account.

Interest is to be charged on the withdrawal made by the partners if it has been specifically mentioned in the partnership deed. Partners usually withdraw amounts from the format at regular intervals. Hence considering three important aspects, rate, amount, and period, interest on drawings should be calculated.



Journal Entries

- **To charge interest on drawings**

Fluctuating capital method

Partner's capital A/c Dr.

To Interest on drawings A/c
(Interest charged on partner's capital)

Fixed capital method

Partners' current A/c Dr.

To Interest on drawings A/c
(Interest charged on partner's current account)

- **To close interest on drawings account**

Interest on drawings A/c Dr.

To Profit and Loss Appropriation A/c

(Interest on drawings account closed by transfer to Profit and Loss Appropriation Account)

Case I: Amount of withdrawal, rate of interest, and date of withdrawal given

Illustration 5.2.6

The year-end of a firm is 31 December every year. Abin, a partner withdraws ₹5000 on 1 July. Calculate interest on drawings at 9% per annum

Solution

$$\text{Interest on drawings} = 5000 \times \frac{6}{12} \times \frac{9}{100} = ₹225$$

Case II: Date of withdrawal not given. Amount and rate of interest given

Illustration 5.2.7

Rajeev, a partner withdraws ₹8000 in a year and interest is chargeable on the drawings at 12% per annum. Calculate interest on drawing.

Solution

$$\text{Interest on drawings} = 8000 \times \frac{6}{12} \times \frac{12}{100} = ₹480$$

Case III: Fixed amount withdrawn every month

It may be stated here that if a partner withdraws a fixed amount at regular intervals, the interest on drawings can be calculated on the basis of the average period. The calculation of average period depends upon whether the fixed amount is withdrawn on the first day of each month, middle of the month or at the end of each month

a) Fixed amount withdrawn on the first day of the month

$$\begin{aligned}\text{Average period} &= \frac{\text{Total period in months} + 1}{2} \\ &= \frac{12+1}{2} \\ &= \frac{13}{2} = 6.5\end{aligned}$$

$$\text{Interest on Drawings} = \text{Total Drawings} \times \frac{6.5}{12} \times \frac{\text{Rate of interest}}{100}$$

Illustration 5.2.8

Raju, a partner in a firm withdraws ₹4000 per month regularly on the first day of every month. Interest is at 12% per annum. Calculate interest on drawings

Solution

$$\text{Interest on drawing} = \text{Total drawings} \times \frac{6.5}{12} \times \frac{\text{rate of interest}}{100}$$

$$48000 \times \frac{6.5}{12} \times \frac{12}{100} = ₹3120$$

b) Fixed amount withdrawn on the last day of the month

$$\begin{aligned}\text{Average period} &= \frac{\text{Total period in months} - 1}{2} \\ &= \frac{12-1}{2} \\ &= \frac{11}{2} = 5.5\end{aligned}$$



$$\text{Interest on drawing} = \text{Total drawings} \times \frac{5.5}{12} \times \frac{\text{rate of interest}}{100}$$

Illustration 5.2.9

Santhosh, a partner in a firm withdraws ₹5,000 regularly on the last day of every month. Interest is at 12% p.a. Calculate interest on drawings

Solution

$$\text{Interest on drawing} = \text{Total drawings} \times \frac{5.5}{12} \times \frac{\text{rate of interest}}{100}$$

$$60000 \times \frac{5.5}{12} \times \frac{12}{100} = ₹3300$$

c) Fixed amount withdrawn in the middle of each month

$$\text{Average period} = \frac{\text{Total period in months}}{2}$$

$$= \frac{12}{2}$$

$$= 6$$

$$\text{Interest on drawing} = \text{Total drawings} \times \frac{6}{12} \times \frac{\text{rate of interest}}{100}$$

Illustration 5.2.10

Ramesh withdraws ₹10000 regularly in the middle of each month. Interest is at 12% per annum. Calculate interest on drawings.

Solution

$$\text{Interest on drawing} = \text{Total drawings} \times \frac{6}{12} \times \frac{\text{rate of interest}}{100}$$

$$= 120000 \times \frac{6}{12} \times \frac{12}{100} = ₹7200$$

5.2.6.4 Partner's Loan Account

Sometimes a firm may take loans from partners apart from their capital contribution. Such an amount will be credited in a separate loan account of concerned partners. It is not credited to the Partner's Capital Account because of the following reason:

- The loan amount can be withdrawn as soon as the firm's financial position improves
- The loan amount carries interest at 6% per annum, even if the interest on loan is not mentioned in the partnership deed
- Repayment of loan gets preference over the return of partners' capital when the firm is dissolved
- Partner's loan is shown separately on the liabilities side of the Balance Sheet. As and when the interest is due it is credited to the Partners' Capital Account. Interest on partner's loan account is closed by transferring it to the Profit and Loss Account.

5.2.6.5 Profit and Loss Appropriation Account

This is an extension of the Profit and Loss Account and is used to show the division of profit among the partners. It is prepared for adjusting transactions like interest on capital (when payable only out of profits), interest on drawings, partners' salary, commission, etc. This account should begin with profit or loss brought forward from the Profit and Loss Account. Further, the account should be credited with items of income to the firm and should be debited with items of expenses or losses to the firm. The balance in the account is divided among the partners in the agreed profit-sharing ratio or equally. Each partner's share of profit is credited to his Capital Account. If there is loss, the share of the same is debited to the Capital Account.

Table 5.2.5
Specimen of Profit and Loss Appropriation Account
Profit and Loss Appropriation Account

Dr.		Cr.	
Particulars	Amount	Particulars	Amount
To Profit and Loss A/c (Loss for the year)	xxx	By Profit and Loss A/c (Profit for the year)	xxx
" Interest on capital	xxx	" Interest on drawings	xxx
" Partners' salary	xxx	"Capital Accounts- share of loss	xxx
" Partners' commission	xxx		
" Reserve- transfer	xxx		
"Capital Accounts-share of profit	xxx		
	xxxx		xxxx



5.2.6.6 Usual adjustments in partnership accounts

In the case of sole trader's final accounts, the whole net profit is transferred to the capital of the proprietor. But in the case of Partnership, adjustments relating to interest on capital, interest on drawings, partner's salary or commission are to be made in the Profit and Loss Appropriation Account after calculating the net profit of the firm. Then the remaining profit or loss will be divided among the partners in the profit-sharing ratio. Following journal entries will be passed for distribution of profits among the partners:

- i. For interest on capital

Profit and Loss Appropriation A/c	Dr.
To Partners' Capital (or Current) A/c	

- ii. For salary or commission payable to partners

Profit and Loss Appropriation A/c	Dr.
To Partners' Capital (or Current) A/c	

- iii. For interest on drawings

Partners' Capital (Current) A/c	Dr.
To Profit and Loss Appropriation A/c	

- iv. For distribution of profit

Profit and Loss Appropriation A/c	Dr.
To Partners' Capital (Current) A/c	

Note: If loss, reverse entry will be passed

Illustration 5.2.11

On 1 January 2013 Kiran, Hari and Thomas entered into partnership contributing ₹60000, ₹70000, ₹80000 respectively and sharing profit and loss in the ratio of 1:2:2. Hari and Thomas are entitled to receive a salary of ₹7000 and ₹8000 respectively in a year. 6% interest is to be charged on capital. During the year Kiran withdraws ₹8000, Hari ₹7000 and Thomas ₹5000. Interest on drawings being ₹300, ₹250 and ₹200 respectively. Profit for the year 2013 before making the above adjustment was ₹83050. Pass necessary journal entries and prepare Profit and Loss Appropriation Account and the capital accounts of partners.

Solution

Journal

Date	Particulars	L.F.	Amount (Dr.)	Amount (Cr.)
	Profit and Loss A/c Dr. To Profit and Loss Appropriation A/c (Transfer of profit to profit and loss appropriation account)		83050	83050
	Interest on capital A/c Dr. To Kiran's Capital A/c To Hari's Capital A/c To Thoma's Capital A/c (Interest on capital credited to capital account)		12600	3600 4200 4800
	Profit and Loss Appropriation A/c Dr. To Interest on Capital A/c (Interest transferred to Profit and Loss appropriation account)		12600	12600
	Salaries A/c Dr. To Hari's Capital A/c To Thomas's Capital A/c (Salaries credited to capital account)		15000	7000 8000
	Profit and Loss Appropriation A/c Dr. To Salaries A/c (Salaries transferred to Profit and Loss Appropriation Account)		15000	15000
	Kiran's Capital A/c Dr. Hari's Capital A/c Dr. Thomas's Capital A/c Dr. To Interest on drawings A/c (Interest on drawings debited to capital accounts of partners)		300 250 200	750
	Interest on drawings A/c Dr. To Profit and Loss Appropriation A/c (Interest on drawings transferred to Profit and Loss Appropriation Account)		750	750
	Profit and Loss Appropriation A/c Dr. To Kiran's Capital A/c To Hari's Capital A/c To Thomas's Capital A/c (Distribution of profit among partners)		56200	11240 22480 22480

Profit and Loss Appropriation Account

Particulars	Amount	Particulars	Amount
Interest on capital:		Profit and Loss A/c	83050
Kiran 3600		Interest on drawings	
Hari 4200		Kiran 300	
Thomas 4800	12600	Hari 250	750
		Thomas 200	
Salary			
Hari 7000			
Thomas 8000	15000		
Profit			
Kiran 56200 x 1/5=11240			
Hari 56200 x 2/5= 22480	56200		
Thomas 56200 x 2/5=22480			
	83800		83800

Capital Account

Date	Particulars	Kiran	Hari	Thomas	Date	Particulars	Kiran	Hari	Thomas
01-01-2012	Drawings	8000	7000	5000	01-01-2012	Cash	60000	70000	80000
31-12-2013	Interest on drawings	300	250	200	31-12-2013	Interest	3600	4200	4800
31-12-2013	Balance c/d	66540	96430	110080	31-12-2013	Salary		7000	8000
						Profit and loss appropriation account	11240	22480	22480
		74840	103680	115280			74840	103680	115280
					01-01-2013	Balance b/d	66540	96430	110080

Illustration 5.2.12

A, B and C are in partnership sharing profits and losses in the ratio of 5:3:2. Their capital amount balances as on 31 March 2018 are as follows.

A ₹150000, (Cr.) B ₹110000 (Cr.) C ₹160000 (Cr.)

Following further information provided:

- i. ₹22000 is to be transferred to General Reserve.
- ii. A, B and C are paid a monthly salary in cash amounting to ₹2500, ₹1500 and ₹1800.
- iii. Partners are allowed interest on their closing capital balances @ 6%p.a. and are charged interest on drawings @ 5%.
- iv. A and C are entitled to a commission at 8% and 10% respectively of the net profit before making any appropriation.
- v. B is entitled to Commission at 15% of the net profit before charging interest on drawings but after making all other appropriations.
- vi. During the year A withdraw ₹2000, B ₹1750 and C ₹1250.
- vii. Firm's Accountant is entitled to a salary of 2000 per month and a commission of 12% of net profit after charging such commission.

The Net Profit of the firm for the year ended on 31 March 2018 before providing for any of the above adjustments was ₹276000.

You are required to prepare the Profit and Loss Appropriation Account for the year ended 31 March 2018.

Solution

Profit and Loss Appropriation Account

Particulars	Amount	Particulars	Amount
To General reserve	22000	By Net Profit	225000
To Salary to partners		By Interest on drawings	
A= 2500 $\times$ 12=30000		A= 24000 $\times \frac{5}{100}$ =1200	
B=1500 $\times$ 12=18000		B= 21000 $\times \frac{5}{100}$ =1050	
C=1800 $\times$ 12=21600	69600	C= 15000 $\times \frac{5}{100}$ =750	3000
To Interest on capital			
A=150000 $\times \frac{6}{100}$ =9000			
B= 110000 $\times \frac{6}{100}$ =6600			
C= 160000 $\times \frac{6}{100}$ =9600	25200		
To Commission to partners			
A=225000 $\times \frac{8}{100}$ =18000			
B= 10155			
C= 225000 $\times \frac{10}{100}$ =22500	50655		
To Partner's capital A/c			
A= 60545 $\times \frac{5}{10}$ =30272			
B= 60545 $\times \frac{3}{10}$ =18164			
C=60545 $\times \frac{2}{10}$ =12109	60545		
	228000		228000

Profit and Loss Account

Particulars	Amount	Particulars	Amount
To Salary	24000	By Profit	276000
To Commission	27000		
To Net Profit transferred			
to Profit and Loss Appropriation A/c	225000		
	276000		276000



Working Note:

Calculation of commission

$$\begin{aligned} &= \text{Profit after salary} \times \frac{12}{112} \\ &= 276000 - 24000 \times \frac{12}{112} \\ &= 252000 \times \frac{12}{112} \\ &= ₹27000 \end{aligned}$$

Interest on drawings

$$\text{A's Drawings } 2000 \times 12 = 24000$$

$$\text{Interest} = 24000 \times \frac{5}{100} = 1200$$

$$\text{B's Drawings } 1750 \times 12 = 21000$$

$$\text{Interest} = 21000 \times \frac{5}{100} = 1050$$

$$\text{C's Drawings } 1250 \times 12 = 15000$$

$$\text{Interest} = 15000 \times \frac{5}{100} = 750$$

Commission of B

Net profit for appropriation (excluding interest on drawings) – General Reserve – Interest on capital – Salaries to partners- Commission to A and C $\times \frac{15}{100}$

$$\begin{aligned} &(225000 - 22000 - 25200 - 69600 - 18000 - 22500) \times \frac{15}{100} \\ &67700 \times \frac{15}{100} = ₹10155 \end{aligned}$$

Illustration 5.2.13

A and B are partners with capitals of ₹100000 and ₹120000 respectively on 1 April 2017. The profit before making all adjustments for the year ended 31 March 2018 was ₹50000. Interest on capital is to be allowed at 6% p.a. B is entitled a salary of ₹15000 p.a. The drawings of the partners were A ₹10000 and B ₹12000. The interest on drawings are A ₹500 and B ₹250. Assuming A and B are equal partners, prepare capital accounts of partners under fluctuating capital method and fixed capital method.

Solution

Profit and Loss Appropriation Account

Dr.		Cr.	
Particulars	Amount	Particulars	Amount
To Interest on Capital		By Profit and Loss A/c (Profit for the year)	50000
A	6000	By Interest on Drawings	
B	7200	A	500
		B	250
To Salary-B	15000		
To Capital A/c's:			
A	11275		
B	11275		
	22550		
	50750		50750

Fluctuating Capital Method

Capital Account

Dr.				Cr.			
Date	Particulars	A	B	Date	Particulars	A	B
30/03/2018	To Drawings	10000	12000	1/04/2017	By Balance b/d	100000	120000
"	To Interest on drawings	500	250	31/03/2018	By Interest on Capital	6000	7200
"	To Balance c/d	106775	141225	"	By Salary		15000
				"	By Profit and Loss Appropriation A/c	11275	11275
		11275	153475			11275	153475
				1/04/2018	By Balance b/d	106775	141225

Fixed Capital Method
Capital Account

Dr.				Cr.			
Date	Particulars	A	B	Date	Particulars	A	B
31/03/2018	To Balance c/d	100000	120000	01/04/2017	By Balance b/d	100000	120000
		100000	120000			100000	120000
				01/04/2018	By Balance b/d	100000	120000

Current Account

Dr.				Cr.			
Date	Particulars	A	B	Date	Particulars	A	B
31/03/2018	To Drawings	10000	12000	31/03/2018	By Interest on Capital	6000	7200
"	To Interest on Drawings	500	250	"	By Salary		15000
"	To Balance c/d	6775	21225	"	By Profit	11275	11275
		17275	33475	01/04/2018	By Balance b/d	17275	33475
						6775	21225

Recap

- ◇ Capital account- Personal account
- ◇ Absence of agreement- Fluctuating capital method is followed
- ◇ Profit and Loss Appropriation Account - Extension of the Profit and Loss Account
- ◇ Fluctuating capital method- Capital account is maintained
- ◇ Fixed capital method- Capital account and Current account are maintained
- ◇ Active partner- Actively engaged in the business
- ◇ Nominal partner- Partner lends his name to the firm without any actual interest
- ◇ Sleeping partner- Dormant partner
- ◇ Partner in profit only- Shares only profit
- ◇ Partner by estoppel- Represent to be a partner
- ◇ Limited Partners- Limited liability
- ◇ Sub-partner - Outsider who gets the share in the profit
- ◇ Interest on capital - Credited to Capital Account
- ◇ Interest on drawings - Debited to Capital Account

Objective Questions

1. In which year was Indian Partnership Act enacted?
2. In which kind of partnership, one partner has unlimited liability and other partner has limited liability?
3. Which types of partnership have no agreement in terms of the duration of partnership?
4. Which type of partner is actively engaged in the business?

5. Which type of partner does not actively engaged in the business?
6. Which type of partners lends his name to the firm without any actual interest?
7. Which type of partner agrees to be a partner for profit amount and does not take risk of sharing losses?
8. What are the two different methods of maintaining capital account?

Answers

1. 1932
2. Limited liability partnership
3. Partnership-at-will
4. Active partner
5. Sleeping partner
6. Nominal partner
7. Partner in profit only
8. Fluctuating and fixed capital methods

Self-Assessment Questions

1. What are three fundamental rights that partners typically have in a partnership, and how do these rights contribute to the smooth functioning of the business?
2. Discuss two primary duties that partners owe to each other and the partnership, highlighting their importance in maintaining trust and integrity within the partnership.

3. Name and briefly explain three different types of partners commonly found in a partnership, emphasizing their roles and responsibilities within the partnership structure.
4. Why is it essential for a partnership firm to maintain proper accounts?
5. What is the significance of a capital contribution clause in a Partnership Deed?
6. How does a Partnership Deed typically address the process of resolving disputes among partners?
7. Name two types of liabilities that partners may have in a partnership and explain their implications.
8. Discuss the role of a sleeping partner in a partnership and their level of involvement in the business.
9. What are the potential consequences of breaching the terms outlined in a Partnership Deed?

Assignments

1. A is a partner in a partnership firm. He withdrew ₹10000 from the firm for personal use on the 1st of every month. Interest on drawings is charged at 8% per annum. Calculate the interest on drawings.

(Answer: Interest on drawings: ₹5200)

2. Ravanan is a partner in a partnership firm. He withdrew ₹8000 from the firm for personal use on the middle of every month. Interest on drawings is charged at 6% per annum. Calculate the interest on drawings.

(Answer: Interest on drawings: ₹2880)

3. Duncan Willa is a partnership business operated by three partners: A, B, and C. The partnership agreement states that interest on capital will be allowed at 10% per annum. Additionally, Partner A is entitled to a salary of ₹1000 per month, Partner B receives a salary of ₹800 per month,

and Partner C receives a salary of ₹600 per month. The partners' capital balances at the beginning of the year were as follows:

Partner A's Capital: ₹50000

Partner B's Capital: ₹40000

Partner C's Capital: ₹30000

The net profit for the year, before considering any of the above appropriations, amounted to ₹120000.

Prepare the Profit and Loss Appropriation Account for the year and determine the final profit that will be distributed among the partners after considering all the relevant appropriations.

(Answer: Net profit available to partners: ₹79200)

4. Arun, Anu, and Manu are partners in a firm. They contributed ₹150000, ₹100000, and ₹50000 as their capital. They decided to share the profit and loss of the firm in the ratio of their capital. Arun gets a salary of ₹25000 p.a. from this firm, and Anu is entitled to get a commission of ₹20000 p.a. They decided to charge interest on capital at 10% p.a. After considering all the above transactions, the firm earned a profit of ₹600000 at the end of the year. Prepare the capital account using the fluctuating capital method.

(Answer: Capital balance- Arun: ₹490000, Anu: ₹330000, Manu: ₹155000)

5. Ms. Smitha and Ms. Anitha are partners in a business. They contributed ₹50000 and ₹30000, respectively, as their capital. The partnership agreement specifies that the capital remains fixed throughout the year, and profits and losses are to be shared equally. Interest on capital is to be charged at the rate of 10% p.a. During the year, the business earned a profit of ₹40000. Calculate the capital balance of each partner at the end of the year using the Fixed Capital Method

(Answer: Capital A/c balance – Smitha: ₹50000, Anitha: ₹30000. Current A/c balance: Smitha: ₹25000, Anitha: ₹23000)

Suggested Readings

1. Maheswari, S. N. (2018). *Advanced Accounting*. Vikas Publishing House.
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Unit 3

Partnership Final Accounts

Learning Outcomes

After completing this unit, the learner will be able to:

- ◇ know the concept of partnership final accounts and its preparation
- ◇ compare the gross profit and net profit
- ◇ discriminate Trading account and Profit and Loss Account
- ◇ familiarise with Profit and Loss Appropriation Account

Prerequisites

As previously discussed, a partnership is a business agreement in which two or more individuals collaborate to work cooperatively and share profits and losses. Partners must understand their company's profitability and sustainability. They must be aware of the firm's financial performance and condition. The partners wish to assess the net profit or loss, calculate the partners' proportional shares, and ensure that profits and losses are distributed fairly. Partners can examine the profitability and sustainability of the firm and comply with legal and regulatory requirements by generating final accounts. Final accounts also allow partners to assess the effectiveness of their operations, identify areas for improvement, and make required changes to increase profitability. The absence of final accounts in a partnership can lead to legal and compliance difficulties, such as non-compliance with reporting requirements and potential conflicts arising from disagreements among partners about profit distribution.

Keywords

Final accounts, Profit and Loss Appropriation Account, Balance Sheet

5.3.1 Final Accounts of Partnership

A business can be started in the form of a sole proprietorship, a partnership firm or a company. Earlier, you have studied how to prepare Profit and Loss Account and Balance Sheet of a sole proprietorship. Practically there is no difference between the Final Accounts of a sole trader and partnership. These two different types of organisations adopt the same principle and pattern for the preparation and presentation of their final accounts. After learning different methods of maintaining capital accounts of partners learners might have a fair idea about the partnership of firm. But in order to get a complete understanding of Partnership firm, they have to understand how the financial statements will be prepared. Financial statements are prepared at the end of the accounting period to know the net result of the business.

Financial statements (Final accounts) are the statements which show the financial performance and financial position of the business. Final Accounts of Partnership firm include the following:

- ◇ Trading and Profit and Loss Account
- ◇ Profit and Loss Appropriation Account
- ◇ Balance Sheet

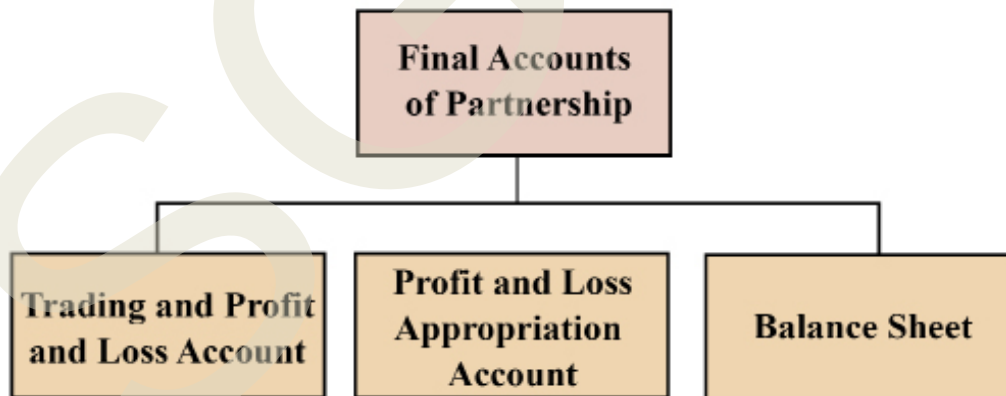


Figure: 5.3.1
Final Accounts of Partnership

The main objective of maintaining accounts is to:

- ◇ Find out the profit or loss made by the business (By preparing Trading and Profit

- and Loss Account).
- ◇ Ascertain the financial position of business (By preparing Balance Sheet).

5.3.1.1 Trading Account

Trading Account shows Gross Profit earned or Gross Loss incurred. It is credited with sales, other direct incomes, and closing stock. It is debited by direct expenses, i.e., opening stock, purchases etc.

Table 5.3.1
Format of a Trading Account
Trading Account for the year ended...

Dr.		Cr.	
Particulars	Amount	Particulars	Amount
To Opening stock	xxx	By Sales	xxx
		Less: Return inwards (xxx)	xxx
To Wages	xxx	By Closing stock	xxx
To Carriage inwards	xxx		
To Freight, octroi, and cartage	xxx		
To Gross profit transferred to Profit and Loss Account	xxx		
	xxxxx		xxxxx

The trading account is an account that shows the gross profit or gross loss of a business during a specific period. It is prepared by recording all the direct expenses and direct income of the business along with opening stock, purchase, sales and closing stock. Direct expenses are those expenses that are incurred directly for the production of goods or the provision of services. Direct incomes are the income earned directly from the sale of goods or services.

After recording all the direct expenses and income in respective sides of the Trading Account, balance is calculated to ascertain Gross Profit or Gross Loss. If the total of credit side is more than that of debit side, the excess is Gross Profit. If the total of debit side is more than that of credit side, excess is Gross Loss. Gross Profit is transferred to the credit side of the Profit and Loss Account and Gross Loss is transferred to the debit side of the Profit and Loss Account.

5.3.1.2 Profit and Loss Account

Profit and Loss Account shows the Net Profit earned or Net Loss incurred. It is credited with Gross Profit and other indirect incomes and debited with gross loss and indirect expenses. The difference between the totals of two sides is either Net Profit or Net Loss

Table 5.3.2**Format of Profit and Loss Account**

Profit and Loss Account for the year ended ---

Dr.		Cr.	
Particulars	Amount	Particulars	Amount
To gross loss transferred from Trading account	xxx	By gross profit transferred from Trading account	xxx
To salaries	xxx	By discount received	xxx
To rent, rates, and tax	xxx	By rent received	xxx
To stationery and printing	xxx	By commission earned	xxx
To postage and telegram	xxx	By interest earned	xxx
To audit fees	xxx		
To legal charges	xxx		
To telephone charges	xxx		
To insurance premium	xxx		
To business promotion expense	xxx		
To repairs and renewals	xxx		
To interest	xxx		
To depreciation	xxx		
To sundry expense	xxx		
To conveyance	xxx		
To bank charges	xxx		
To establishment expenses	xxx		
To general expenses	xxx		
To electricity expenses	xxx		
To loss by fire, theft	xxx		
To commission	xxx		
To advertisement	xxx		

To carriage outwards	xxx		
To discount allowed	xxx		
To travelling expense	xxx		
To bad debt	xxx		
To net profit transferred to capital account	xxx		
	xxxx		xxxx

After the preparation of Trading Account, the Profit and Loss Account is prepared. Profit and Loss Account starts with the Gross profit on the credit side or Gross Loss on the debit side.

Trading Account and Profit and Loss Account are prepared together, that is Trading Account is a part of Profit and Loss Account. Profit and Loss Account is the second stage of the preparation of Final Accounts. In Profit and Loss Account, all the indirect expenses and indirect incomes are recorded. Indirect expenses are those expenses that are paid for keeping up and running the business. Indirect incomes are those incomes which are not directly associated with manufacture of goods.

The Profit and Loss Account is prepared to find out the Net Profit or Net Loss. If the total of the credit side exceeds the total of the debit side, the difference is Net Profit. If the total of the debit side exceeds the total of credit side, the difference is Net Loss. The difference (Net Profit or Net Loss) is transferred to the Capital Account.

5.3.1.3 Balance Sheet

Balance Sheet shows the assets and liabilities of a firm on a particular date. It is a statement prepared to show the financial position of the business on a particular date.

Table 5.3.3
Format of Balance Sheet

Balance Sheet of ----- as at -----

Liabilities	Amount	Assets	Amount
Sundry or trade creditors	xxx	Cash in hand	xxx
Bills payable	xxx	Cash at bank	xxx
Bank overdraft	xxx	Bills receivable	xxx
Employee provident fund	xxx	Sundry debtors/ Book debt	xxx
Loan	xxx	Loan	xxx
Mortgage	xxx	Closing stock	xxx
Reserves or reserve fund	xxx	Loose tools	xxx
Capital xxx		Investment	xxx
Add		Furniture and fittings	xxx
Net profit xxx		Plant and machinery	xxx
Interest on capital xxx		Land and building	xxx
Less		Freehold/leasehold land	xxx
Drawings xxx		Business premises	xxx
Interest on drawings xxx		Patent and trademark	xxx
Income tax xxx		Goodwill	xxx
Net loss xxx	xxx		
	xxxx		xxxx

Balance Sheet is prepared to know the financial position of the business on a particular date. After the preparation of Trading and Profit and Loss Account, Balance Sheet is prepared. It shows the assets and liabilities on a given date. Debit and Credit balances of those ledger account not closed by transfer to Trading and Profit and Loss Account are shown in the Balance Sheet. The difference between the total of Assets minus Liabilities will be the Capital.

5.3.2 Differences between the final accounts of sole trading concern and partnership firm.

- ◇ In a sole trading concern, it is not necessary to prepare a Profit and Loss Appropriation Account. But a partnership firm has to appropriate its profit for the period among the partners. The details of division of profit are shown by preparing a Profit and Loss Appropriation Account
- ◇ The Balance Sheet of sole trading concern shows only one capital account. However, the Balance Sheet of partnership firm shows the capital account balances of each partner separately. If the capitals are fixed, both the Capital Account and Current Account balances are shown separately.

Illustration 5.3.1

From the following particulars extracted from the books of a partnership firm. Prepare Trading and Profit and Loss Account for the year ended 31 March 2018 and Balance Sheet on that date.

Particulars	Amount	Particulars	Amount
Capital		Loan	2000
X- 50000		Discount allowed	1000
Y- 50000	100000	Land	25000
Cash at bank	5000	Sales	250000
Cash in hand	2000	Carriage inwards	1500
Building	28400	Gas	4500
Wages	30000	Sundry creditors	23000
Salary	25000	Sundry debtors	30000
Rent and rates	3500	Purchase return	4000
Printing and stationery	2500	Sales return	2000
Stock on 01-04-2017	15000	Bills receivable	8000
Purchase	150000	Discount received	700
Insurance	1800	Travelling expense	3500
Machinery	25000	Furniture	7000
Drawings	9000		
X- 5000			
Y- 4000			

Provide the following

1. Prepaid Insurance ₹500
2. Depreciation (a) Machinery-10% (b) Furniture -5%
3. Each partner is to receive 3% Interest on Capital
4. Outstanding wages ₹1500 outstanding salaries ₹1000
5. Write off Bad Debts 2000 and create a Reserve for bad Debts at 5% on Debtors
6. Value of closing stock ₹20000

Solution

Trading and Profit and Loss Account for the year ended 31-3-2018

Particulars	Amount	Particulars	Amount
To Opening stock	15000	By Sales	250000
To Purchases	150000	Less returns	(2000)
Less Returns	(4000)	By Closing Stock	20000
To wages	30000		
Add Outstanding wages	31500		
	<u>1500</u>		
To Carriage inwards	1500		
To Gas	4500		
To Gross Profit c/d	69500		
	268000		268000
To Salaries	25000	By Gross Profit b/d	69500
Add Outstanding	1000	By Discount received	700
To Rent and rates	3500		
To Printing and stationary	2500		
To Insurance	1800		
Less prepaid	(500)		
To Discount allowed	1000		
To Travelling Expenses	3500		
To Depreciation;			
Machinery	2500		
Furniture	<u>350</u>		
	2850		
To Bad Debts	2000		
To Reserve for Bad Debts	1400		
To Net Profit transferred to Profit and Loss Appropriation A/c	26150		
	70200		70200

Profit and Loss Appropriation Account for the year ended 31-3-2018

Particulars	Amount	Particulars	Amount
To Interest on Capital		By Net Profit Transferred	26150
X 1500			
Y <u>1500</u>	3000		
To Capital Accounts			
X 11575			
Y <u>11575</u>	23150		
	26150		26150

Balance Sheet as on 31 March 2018

Liabilities	Amount	Assets	Amount
Sundry or trade creditors	23000	Cash in hand	2000
Loan	2000	Cash at bank	5000
Outstanding liabilities		Bills receivable	8000
Wage: 1500			
Salary: <u>1000</u>	2500		
Capital		Sundry debtors/ Book debt	30000
X 50000		Less	
Add		Bad debt (2000)	
Interest on capital 1500		Reserve for discount <u>(1400)</u>	26600
Net profit 11575		Closing stock	20000
Less		Prepaid insurance	500
Drawings <u>(5000)</u>	58075	Furniture 7000	
Y 50000		Less depreciation <u>(350)</u>	6650
Add		Machinery 25000	
Interest on capital 1500		Less depreciation <u>(2500)</u>	22500
Net profit 11575		Building	28400
Less		Land	25000
Drawings <u>(4000)</u>	59075		
	144650		144650

Recap

- ◇ Trading Account- Direct expenses and direct income
- ◇ Gross Loss - Excess of debit over the credit side in the Trading Account
- ◇ Gross Profit - Excess of credit over the debit side in the Trading Account
- ◇ Profit and Loss Account - Indirect expenses and losses, indirect incomes and gains
- ◇ Net Profit - Excess of credit over the debit side in the Profit and Loss Account
- ◇ Net Loss - Excess of debit over the credit side in the Profit and Loss Account
- ◇ Balance Sheet - Financial position
- ◇ Profit and Loss Account - Nominal account

Objective Questions

1. What will be the interest on partner's capital, if partnership deed is silent?
2. What will be the interest on partner's loan, if partnership deed is silent?
3. Which is the additional account prepared at the time of preparation of final account of partnership?
4. Which account is an extension of Profit and Loss Account?
5. Which type of account is Profit and Loss Account?
6. Which statement shows the financial position of the partnership firm?
7. Which category of accounts represents the financial resources owned by the company?

Answers

1. Nil
2. 6%
3. Profit and Loss Appropriation Account
4. Profit and Loss Appropriation Account
5. Nominal
6. Balance Sheet
7. Assets

Self-Assessment Questions

1. What is the purpose of a trading account, and how does it contribute to determining the gross profit or loss of a business?
2. Identify two types of expenses that are typically included in the trading account. Explain why these expenses are relevant to determining the gross profit or loss.
3. Explain the role of a Profit and Loss Account in financial reporting, and discuss its significance in assessing the overall profitability of a business.
4. Name two types of income that are commonly reported in the Profit and Loss Account. Describe their impact on determining the net profit or loss of a business.
5. What is the purpose of an income statement in financial reporting, and how does it differ from a Profit and Loss Account?
6. Explain the concept of gross profit and its significance in assessing the financial performance of a business.

7. Name two types of indirect expenses that are commonly included in the Profit and Loss Account. Discuss their impact on determining the net profit or loss.
8. What is the relationship between the gross profit, indirect expenses, and the net profit of a business?

Assignments

1. Prepare a projected Trading and Profit and Loss Account for a partnership based on anticipated sales, costs, and expenses.
2. Analyse a sample Profit and Loss Appropriation Account and identify its key components, such as partner salaries, interest on capital, and profit distribution
3. Define the concept of a Profit and Loss Appropriation Account and explain its significance.
4. From the following Trial Balance of Madhav and Manu, you are required to prepare Trading and Profit and Loss Account for the year ended 31 March 2019 and Balance Sheet as on that date.

Trial Balance as on 31 March 2019

Debit Balance	Amount	Credit Balance	Amount
Opening stock	25000	Sundry creditors	28000
Building	50000	Sales	175000
Carriage	1780	Capital:	
Factory insurance	2700	Madhav	150000
Postage	1600	Manu	50000
Bills Receivable	15200	Outstanding salaries	2000
Sundry Debtors	52200	Bills payable	28000
Return inwards	1600	Return outward	1800
Purchases	68900		

Audit fees	1800	Current A/c	
Manufacturing expenses	1820	Madhav	3000
Electricity charges	2600	Manu	2000
General expense	3400		
Export duty	1000		
Cash in hand	104000		
Conveyance	4100		
Furniture	64000		
Office salaries	2000		
Rent	3700		
Drawings:			
Madhav	1200		
Manu	2200		
Loose tools	32000		
	439800		439800

Adjustments:

- Profit sharing ratio-3:1
- Commission to partners at 1% on Gross Profit
- Goods taken by Manu for personal use ₹900
- Depreciation was charged as follows: Furniture @5%
- Interest on Capital to partners 2.5% p.a
- Write off ₹1000 as bad debt
- Maintain 3% as provision on debtors
- Closing Stock ₹ 23700
- Outstanding audit fees ₹400
- Outstanding carriage ₹600
- Building is valued at ₹46500

(Current account balance: Madhav ₹54303 Manu ₹17061, Balance Sheet total ₹330364)

Suggested Readings

1. Maheswari, S. N. (2018). *Advanced Accounting*. Vikas Publishing House.
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BLOCK

Reconstitution of Partnership

Unit 1

Admission of Partner

Learning Outcomes

After completing this unit, the learners will be able to:

- ◇ gain insights on the concept of admission of a new partner
- ◇ learn the accounting treatment at the time of admission of a partner
- ◇ compute the new profit-sharing ratio and sacrificing ratio
- ◇ find out the value of goodwill through various methods

Prerequisites

Vivek and Sriram were running a bakery on partnership basis. After successfully completing five years of business, they were planning to expand their business by starting one more branch of the bakery. But the cash and resources they had with them for meeting the expansion requirements were limited. They planned to admit a new partner so that the resources for meeting the expansion requirements can be met. At this point, Sachin, Vivek's friend, offered to invest capital in exchange for becoming a new partner.

In this scenario, Vivek and Sriram must share a portion of the profit of the business with the new partner, Sachin. In what proportion will they share? How will they handle the existing reserves of the firm? According to the provisions of the Indian Partnership Act 1932, a new partner can be admitted with the unanimous consent of all the existing partners. Upon the admission of a new partner, they must establish the profit-sharing ratio, ascertain the value of goodwill, and revalue the assets and liabilities. The aforementioned issues should be resolved through negotiations between the incumbent partners and the incoming partner. This unit elucidates the accounting procedures to be adopted during the admission of a partner.

Keywords

New profit-sharing ratio, Sacrificing ratio, Revaluation Account, Goodwill

Discussion

6.1.1 Admission of a partner

The constitution of a partnership firm may change without the firm coming to an end. Such changes can be due to the following situations:

- ◇ Admission of a new partner
- ◇ Retirement of a partner
- ◇ Death of a partner

In order to collect additional capital, managerial skill, etc. the partners of a firm may decide to admit a new person into the partnership. When an existing partner allows a person to become a partner, it is known as admission of a partner. This unit discusses the various aspects related with the admission of a new partner.

As per section 31 (1) of the Indian Partnership Act 1932, a person can be admitted only with the consent of all the existing partners. A person who is admitted as a partner does not thereby become liable for any act of the firm done before he became a partner. However, the new partner acquires two rights in the firm:

- i. The right to share in the assets of the firm- the new partner contributes certain assets in cash or in kind as capital in return for obtaining the right to share in the assets of the firm.
- ii. The right to share in the future profits of the firm- The new partner brings an amount called premium in return for obtaining the right to share in the future profits of the firm. Premium is the payment that one has to make for the purpose of enjoying the fruits of another person's efforts. The old partners sacrifice their share of profit when a new partner is admitted.

The need for admitting new partner in the business arises due to the following reasons:

- i. For acquiring more capital

- ii. For enhancing the goodwill of the firm
- iii. For reducing competition
- iv. For expanding the capacity of the firm

6.1.2 Adjustments connected with admission

The following are the adjustments connected with the admission of a new partner:

- i. Calculation of new profit sharing ratio and sacrificing ratio
- ii. Revaluation of assets and liabilities
- iii. Distribution of reserves and other accumulated profits or losses
- iv. Re-arrangement of partners' capital
- v. Treatment of Goodwill

6.1.2.1 Calculation of new profit sharing ratio and sacrificing ratio

Partnership agreement contains the ratio of sharing profits and losses of the firm. If the partnership deed is silent, the profits and losses are shared among the partners equally. The profit-sharing ratio of the firm changes, when a new partner is admitted. The new profit-sharing ratio after the admission of a partner is determined on the basis of the following principles:

- a. If there is no agreement, the share of all the partners will be equal. If the newly admitted partner's share of profit alone is given, the remaining portion will be shared by the old partners equally.
- b. If the share of profit of the newly admitted partner and old profit sharing ratio of the old partners are given, the remaining portion will be shared by the old partners in their old profit sharing ratio.
- c. When the new partner gets his share of profit from one or more old partners, the remaining portion will be shared by the old partners in their old profit-sharing ratio.

Sacrificing ratio

The profit sharing ratio of the firm changes, when a new partner is admitted. Often the change in the ratio on the admission of a new partner causes a decrease in the share of all the old partners. The ratio of decrease or loss in the share of old partners due to the admission of a new partner is known as sacrificing ratio.

If the old partners share the remaining portion in their old profit sharing ratio, the old profit sharing ratio will be the sacrificing ratio. On the other hand, if the new partner gets his share in a different proportion, that proportion will be the sacrificing ratio. In case, after admission of a partner a new profit sharing ratio of all the partners is given, the ratio of the difference between the old profit sharing ratio and the new profit sharing ratio of the old partners will be the sacrificing ratio.

$$\text{Sacrificing ratio} = \text{Old ratio} - \text{New ratio}$$

Illustration 6.1.1

A and B are partners in a firm, C was admitted as a partner in their firm for $\frac{1}{5}$ share. Compute the new profit sharing ratio

Solution

Here C's share of profit alone is given, the remaining portion will be shared by the old partners equally. Assume A and B were equal partners.

Let the total profit of the firm is 1, that is $\frac{5}{5}$

Hence the profits left for the old partners to be shared in the old ratio

= 1-share of the new partner

$$\text{New partner C's share} = \frac{1}{5}$$

$$\text{Amount of share left for A and B} = 1 - \frac{1}{5} = \frac{4}{5}$$

Old ratio of A and B - 1:1 (Equal share)

New share of A = Remaining share x A's old share

$$\frac{4}{5} \times \frac{1}{2} = \frac{4}{10} = \frac{2}{5}$$

New share of B = Remaining share x B's old share

$$\frac{4}{5} \times \frac{1}{2} = \frac{4}{10} = \frac{2}{5}$$

$$\text{New profit sharing ratio} = \frac{2}{5} : \frac{2}{5} : \frac{1}{5}$$

$$= 2:2:1$$

Illustration 6.1.2

X and Y were partners in a firm sharing profits and losses in the ratio of 3:2. Z was admitted as a partner in their firm for $\frac{1}{5}$ share. Compute the new profit sharing ratio and sacrificing ratio.

Solution

$$\text{New Partner Z's share} = \frac{1}{5}$$

$$\text{Remaining share of X and Y} = 1 - \frac{1}{5} = \frac{4}{5}$$

New share of X = Remaining share x old share of X

$$= \frac{4}{5} \times \frac{3}{5} = \frac{12}{25}$$

New share of Y = Remaining share x old share of Y

$$= \frac{4}{5} \times \frac{2}{5} = \frac{8}{25}$$

$$\text{Z's share} = \frac{1}{5} \text{ i.e., } \frac{1}{5} \times \frac{5}{5} = \frac{5}{25}$$

Hence the new profit sharing ratio = 12:8:5

Sacrificing ratio = Old ratio - New Ratio

$$\text{X's sacrifice} = \frac{3}{5} - \frac{12}{25}$$

$$= \frac{15}{25} - \frac{12}{25} = \frac{3}{25}$$

$$\text{Y's sacrifice} = \frac{2}{5} - \frac{8}{25} = \frac{2}{25}$$

Hence, sacrificing ratio = 3:2

Illustration 6.1.3

Arun and Varun were partners in a firm. Kiran was admitted as a partner in their firm for $\frac{1}{4}$ share. Kiran gets whole of the share from Arun. Compute the new profit sharing ratio



Solution

New partner Kiran's share = $\frac{1}{4}$

New share of Arun = Old share- Sacrificing share

$$= \frac{1}{2} - \frac{1}{4} = \frac{1}{4}$$

New share of Varun = Old share itself (He doesn't sacrifice anything)

$$= \frac{1}{2}$$

Hence the new profit sharing between Arun, Varun and Kiran = $\frac{1}{4} : \frac{1}{2} : \frac{1}{4}$

$$= \frac{1}{4} : \frac{2}{4} : \frac{1}{4} = 1:2:1$$

Note- Here the entire share of Kiran is sacrificed by Arun

6.1.2.2 Revaluation of assets and liabilities

On admission of a partner, the assets and liabilities are often revalued. This is to ensure that the assets and liabilities are shown at their true values and to avoid any gain or loss to the new partner due to incorrect valuation of assets and liabilities of the firm. The profit or loss arising on account of such revaluation may be adjusted in the old Partners' Capital Account alone in their old profit sharing ratio. For this purpose, Revaluation Account is prepared.

Revaluation Account or profit and loss adjustment account

A Revaluation Account is a nominal account prepared to bring the assets and liabilities of the firm to their true values and to find out the profit or loss arising therefrom. In this account increase in the value of assets and decrease in the value of liabilities and provisions are credited and decrease in the value of assets and increase in the value of liabilities and provisions are debited. Unrecorded assets and liabilities are also brought into account by crediting and debiting them respectively in the Revaluation Account. The balance in the Revaluation Account is the profit or loss on revaluation of assets and liabilities and it is transferred to old partner's capital account in the old profit-sharing ratio.

Table 6.1.1

The journal entries connected with revaluation of assets and liabilities are:

Particulars	LF	Amount	Amount
For increase in the value of assets Assets A/c Dr. To Revaluation A/c		xxx	xxx
For decrease in the value of assets Revaluation A/c Dr. To Assets A/c		xxx	xxx
For increase in the value of liabilities Revaluation A/c Dr. To Liabilities A/c		xxx	xxx
For decrease in the value liabilities Liabilities A/c Dr. To Revaluation A/c		xxx	xxx
For recording any unrecorded asset Asset A/c Dr. To Revaluation A/c		xxx	xxx
For recording any unrecorded liability Revaluation A/c Dr. To Liability A/c		xxx	xxx
For Revaluation profit Revaluation A/c Dr. To Old partners' capital A/c		xxx	xxx
For Revaluation Loss Old partners' capital A/c Dr. To Revaluation A/c		xxx	xxx

Table 6.1.2**Items to be shown on the Revaluation Account**

Debit side	Credit side
Decrease in the value of assets	Increase in the value of assets
Increase in the value of liabilities	Decrease in the value of liabilities
Recording unrecorded liability	Recording unrecorded assets
Revaluation profit -(Old partners' capital)	Revaluation Loss- (Old Partners' capital)

Illustration 6.1.4

X and Y were partners sharing profits and losses as 60% and 40% respectively. Their Balance Sheet as on 1 January, 2023 stood as under

Liabilities	Amount	Assets	Amount
Sundry creditors	192000	Cash in hand	8000
Bills payable	68000	Sundry debtors	112000
Capital accounts		Stock	80000
X - 180000		Plant and Machinery	160000
Y - 160000	340000	Land and Building	240000
	600000		600000

They admit Z into the firm subject to the following modification:

- Z will bring in ₹100000 as his capital
- Stock was to be reduced by ₹8000
- Land and Buildings were to be valued at ₹320000
- A provision of 2.5% was to be created for doubtful debts
- A liability of ₹5200 for outstanding expenses had been omitted to record in the books. Pass necessary journal entries, prepare the Revaluation Account and partner's capital accounts and show the Balance Sheet after the admission of Z.

Solution

Journal

Date	Particulars	L.F.	Amount (Dr.)	Amount (Cr.)
	Cash A/c Dr. To Z's capital A/c (Cash brought in by Z for capital)		100000	100000
	Revaluation A/c Dr. To Stock A/c (Stock depreciated)		8000	8000
	Revaluation A/c Dr. To Provision for doubtful debts A/c (Provision kept for doubtful debt)		2800	2800
	Land and buildings A/c Dr. To Revaluation A/c (Land and buildings revalued)		80000	80000
	Revaluation A/c Dr. To Outstanding liabilities A/c (Outstanding liabilities recorded)		5200	5200
	Revaluation A/c Dr. To X's capital A/c To Y's capital A/c (Profit on Revaluation transferred)		64000	38400 25600

Revaluation Account

Particulars	Amount	Particulars	Amount
To Stock	8000	By Land and Buildings	80000
To Provision for doubtful debts	2800		
To Outstanding liabilities	5200		
To Profit transferred to Capital Accounts			
X	38400		
Y	<u>25600</u>		
	64000		
	<u>80000</u>		<u>80000</u>

Capital Accounts

Particulars	X	Y	Z	Particulars	X	Y	Z
Balance c/d	218400	185600	100000	Balance b/d	180000	160000	-
				Bank			100000
				Revaluation A/c	38400	25600	
	218400	185600	100000		218400	185600	100000

Balance Sheet as on 1 January 2023 after the admission of Z

Liabilities	Amount	Assets	Amount
Sundry creditors	192000	Cash in hand (8000+100000)	108000
Bills Payable	68000	Sundry Debtors	112000
Outstanding liabilities	5200	Less Provision	(2800)
Capital		Stock	80000
X 218400		Less depreciation	(8000)
Y 185600		Plant and Machinery	160000
Z <u>100000</u>	504000	Land and building	240000
		Add appreciation	<u>80000</u>
	769200		320000
			769200

6.1.2.3 Distribution of reserves and other accumulated profits or losses

When a person is admitted as a partner, he gets right to share future profits of the business and he has to suffer the future losses of the firm, which is from the date on which he is admitted. Since the new partner is not entitled to the share of past profits, the reserve and profit and loss account balance appearing on the liabilities side of the Balance Sheet of the old firm should be credited to the old Partners' Capital Account in their old profit sharing ratio. In case the Profit and Loss account appears on the assets side of the Balance Sheet, it is the accumulated loss of the old firm. This should also be shared by the old partners in their old profit-sharing ratio. The following journal entries are passed:

1. For reserve and undistributed profits

Reserves A/c Dr.

Profit and Loss A/c Dr.

To Old partners' capital A/c

2. For accumulated losses

Old partners' capital	A/c	Dr.
-----------------------	-----	-----

To Profit and Loss A/c

Illustration 6.1.5

A and B were partners sharing profits and losses in the ratio of 3:2. Their Balance Sheet as at 31 March, 2023 stood as under:

Liabilities	Amount	Assets	Amount
Sundry creditors	180000	Cash at bank	10000
Bills Payable	60000	Sundry debtors	100000
Reserves	20000	Bills Receivable	12000
Capital Accounts:		Stock	80000
A: 180000		Plant and Machinery	160000
B: 180000	360000	Land and Buildings	240000
		Profit and Loss Account	18000
	620000		620000

They admit C into the firm subject to the following modifications:

1. C will bring in ₹80000 as his capital
2. Plant and Machinery was to be reduced by ₹8000
3. Land and buildings were to be valued at ₹340000
4. A provision of 2% was to be created for doubtful debts
5. A liability of ₹4000 for outstanding expenses had been omitted to record in the books.

Pass necessary journal entries, prepare Revaluation Account and Partners' Capital Accounts and show the Balance Sheet after the admission of C.



Solution

Journal

Date	Particulars	L.F.	Amount (Dr.)	Amount (Cr.)
	Bank A/c Dr. To C's capital A/c (Cash brought in by C for capital)		80000	80000
	Revaluation A/c Dr. To Plant and Machinery A/c (Plant and Machinery depreciated)		8000	8000
	Revaluation A/c Dr. To Provision for doubtful debts A/c (Provision kept for doubtful debts)		2000	2000
	Land and Buildings A/c Dr. To Revaluation A/c (Increase in the value of land and buildings)		100000	100000
	Revaluation A/c Dr. To Outstanding liabilities A/c (Outstanding liabilities recorded)		4000	4000
	Reserves A/c Dr. To A's capital A/c To B's capital A/c (Reserves distributed in old ratio)		20000	12000 8000
	A's capital A/c Dr. B's capital A/c Dr. To Profit and Loss A/c (Accumulated loss debited to old partners' capitals)		10800 7200	18000
	Revaluation A/c Dr. To A's Capital A/c To B's Capital A/c (Profit on revaluation transferred)		86000	51600 34400

Revaluation Account

Particulars	Amount	Particulars	Amount
To Plant and Machinery	8000	By Land and Buildings	100000
To Provision for Doubtful debt	2000		
To Outstanding liabilities	4000		
To Profit transferred to Capital Accounts			
A	51600		
B	<u>34400</u>		
	86000		
	100000		100000

Capital Accounts

Particulars	A	B	C	Particulars	A	B	C
Profit and Loss A/c	10800	7200		Balance b/d	180000	180000	
Balance c/d	232800	215200	80000	Bank			80000
				Revaluation A/c	51600	34400	
				Reserve	12000	8000	
	<u>243600</u>	<u>222400</u>	<u>80000</u>		<u>243600</u>	<u>222400</u>	<u>80000</u>

Balance Sheet as on 31 March 2023 after the admission of C

Liabilities	Amount	Assets	Amounts
Sundry creditors	180000	Cash at bank (10000+80000)	90000
Bills Payable	60000	Sundry debtors	1,00,000
Outstanding Liabilities	4000	Less provision	<u>(2000)</u>
Capitals		Bills Receivable	12000
A	232800	Stock	80000
B	215200	Plant and Machinery	160000
C	<u>80000</u>	Less depreciation	<u>(8000)</u>
	528000		152000
		Land and Building	240000
		Add appreciation	<u>100000</u>
			340000
	<u>772000</u>		<u>772000</u>

6.1.2.4 Rearrangement of Partner's capital

At the time of admission of a new partner, it may be sometimes agreed that the capitals of all partners should be in proportion to their respective share in profits. It may be on the basis of new partner's capital. In certain cases, the new partner may be required to bring in sufficient capital based on the capitals of existing partners. In both cases, the capitals of all the partners, on the date of admission are adjusted in their profit-sharing ratio. Then the two arrangements are:

- i. Adjustment of old Partners' Capital Accounts on the basis of incoming partner's capital.
- ii. Bringing in proportionate capital by the incoming partner based on the capitals of existing partners

Adjustment of old Partners' Capital Accounts on the basis of incoming partner's capital.

If the capital of the new partner is given, the same can be used as a base for calculating the new capital of the old partners. On this basis, the capital of the firm can be ascertained and the capital of each partner is arrived at according to the profit-sharing ratio.

Illustration 6.1.6

X and Y are partners sharing profits and losses in the ratio of 2:1. They admit Z as a partner with $\frac{1}{6}$ share of profits on the condition that he should bring in ₹60000 as capital.

The capital of old partners after all adjustments in respect of goodwill, revaluation of assets and liabilities, reserve, etc. has been worked out at ₹160000 for X and ₹130000 for Y. It is agreed that partners' capital will be according to the new profit-sharing ratio.

Determine the new capitals of X and Y and pass necessary journal entries assuming that the partners whose capital falls short, brings in the amount of deficiency and the partner who has an excess, withdraws the excess amount.

Solution

Z's capital for $\frac{1}{6}$ share = 60000

Based on Z's capital, total capital of the firm = $60,000 \times \frac{6}{1} = 360000$

X's share of profit = $\frac{5}{6} \times \frac{2}{3} = \frac{10}{18}$



X's capital will be = $360000 \times \frac{10}{18} = 200000$

Y's share of profit = $\frac{5}{6} \times \frac{1}{3} = \frac{5}{18}$

Y's capital will be = $3,60,000 \times \frac{5}{18} = 100000$

The capital of X and Y, after all adjustments are ₹160000 and ₹130000 respectively. Hence X will contribute ₹40000 (200000- 160000) and Y will withdraw ₹30000 (130000 – 100000). The journal entry will be as follows:

Date	Particulars	LF	Amount (Dr.)	Amount (Cr.)
	Cash A/c Dr. To X's Capital A/c (The amount brought in by X to make his capital up to ₹200000)		40000	40000
	Y's Capital A/c Dr. To Cash A/c (The excess amount withdrawn by Y to make his capital equal to ₹100000)		30000	30000

Alternatively, the surplus or deficiency in each partner's capital account can be transferred to respective current account. Thus, in the above example if the adjustment is made by opening current account the entries would be

Date	Particulars	LF	Amount (Dr.)	Amount (Cr.)
	X's Current A/c Dr. To X's Capital A/c (The deficiency in capital debited to current A/c)		40000	40000
	Y's Y's Capital A/c Dr. To Y's Current A/c (The excess in capital credited to current account)		30000	30000

Bringing in proportionate capital by the incoming partner based on the capitals of existing partners

If the new partner is to bring in proportionate capital, the amount will be ascertained on the basis of the total of capitals (after all adjustments have been made) of the existing



partners and the total of their share of profits.

For example, if after adjustments, the total capital of old partner's capital accounts comes to ₹40000. The new partners' share is $\frac{1}{5}$. The total will be ₹50000 ($40000 \times \frac{5}{4}$).

The new partner will bring ₹10000 ($50000 \times \frac{1}{5}$) as his share of capital in the firm.

6.1.2.5 Accounting Treatment of Goodwill

Goodwill is the value of the reputation of a firm in respect of profits expected in future over and above the normal rate of profits. Goodwill is an invisible and intangible asset.

Factors affecting goodwill

Goodwill is the extra profit earning capacity of a business. So the factors which help in increasing the earning capacity of the business will affect the value of goodwill. The following are the important factors that help in the creation of goodwill:

- a. **Location of the business**- A well-chosen site that is convenient for clients can boost exposure and draw more business. A company's reputation and client base can grow if it is situated in a prominent neighbourhood close proximity to its intended market, which will increase goodwill.
- b. **Nature of business**- The kind of goods or services a firm offer is referred to as its nature. A company's goodwill may benefit if it engages in business in a renowned or in-demand industry or sector.
- c. **Period of business**- Established companies with a longer track record tend to enjoy greater market credibility and confidence. Customers frequently consider longevity to be a sign of dependability and experience, which can help build goodwill.
- d. **Management of the business**- Building goodwill requires effective management. Positive relationships with customers, employees, and other stakeholders can be fostered by a well-managed company with skilled, moral executives who take wise judgements. A customer-focused strategy, open communication, and strong leadership are all elements that can boost goodwill.
- e. **Investment of the business**- A company's degree of investment may have an effect on goodwill. Investments in Research and Development, infrastructure, technology, and personnel training can raise the calibre of goods and services and raise consumer satisfaction. Businesses that prioritise investments to produce value tend to be perceived more favourably by customers, which contributes to goodwill development.

- f. Monopoly*- A monopoly position may occasionally aid in the development of goodwill. When a company has a monopoly over a certain market, it can take advantage of the lack of rivalry to set higher prices, make more money, and build a strong brand. However, it's important to keep in mind that monopolies can also encounter criticism and regulatory difficulties, making the development of goodwill in such circumstances challenging.

Need for valuation of goodwill

In a partnership business, valuation of goodwill is a must under certain circumstances. They are:

- At the time of admission of a new partner
- At the time of retirement or death of a partner
- When there is a change in the profit sharing ratio
- At the time of amalgamation of two or more firms
- When there is a sale of partnership business

Method of valuation of goodwill

The method of valuation of goodwill is usually mentioned in the partnership deed. The following are the methods of valuation of goodwill:

- Simple profit method or average profit method
- Weighted average profit method
- Super profit method
- Capitalization of profit method
- Annuity method

i. Simple profit method or Average profit method:

Under this method, value of goodwill is determined by multiplying the average profit of the past years by an agreed number of years of purchase. For example: if the goodwill is valued at 5 years purchase of the average profit of the past five years, i.e, ₹2000, the value of goodwill will be ₹10000 (2000 x 5)

$$\text{Average profit} = \frac{\text{Total Profit}}{\text{Number of years}}$$

$$\text{Value of goodwill} = \text{Average profit} \times \text{Number of purchasing years}$$

Illustration 6.1.7

A firm values goodwill on the basis of three years purchase of the average profits of the preceding five years. The profits of the business for the last five years were 2019 ₹4000, 2020 ₹ 4500, 2021 ₹6000, 2022 ₹3000, and 2023 ₹7500. Compute the value of goodwill.

Solution

$$\begin{aligned}\text{Total profit of last five years} &= 4000 + 4500 + 6000 + 3000 + 7500 \\ &= ₹25000\end{aligned}$$

$$\text{Average profit} = \frac{\text{Total profit}}{\text{No. of years}}$$

$$\text{Total profit} = ₹25000$$

$$\text{Number of years} = 5 \text{ years}$$

$$\text{Average profit} = \frac{\text{Total profit}}{\text{Number of years}} = ₹5000$$

$$\begin{aligned}\text{Value of goodwill} &= \text{Average profit} \times \text{Number of purchasing years} \\ &= 5000 \times 3 = ₹15000\end{aligned}$$

ii. Weighted average profit method

Under this method value of goodwill is determined by multiplying the weighted average profit of the past years by an agreed number of years of purchase. Each year's profit is multiplied by the respective number of weights to get weighted profit. Weighted average profit is obtained by dividing the total of products of weighted profit with total of weights.

$$\text{Weighted Average profit} = \frac{\text{Total product}}{\text{Total weight}}$$

$$\text{Value of goodwill} = \text{Weighted average profit} \times \text{Number of years purchase}$$

Illustration 6.1.8

A firm values goodwill on the basis of 2 years purchase of the weighted average profit of proceeding 3 years. The profit of the business of the last three years were

2021 ₹4000, 2022 ₹7000, 2023 ₹2000. If the respective number of weights is 1, 2, and 3. Compute the value of goodwill.

Solution

$$\text{Weighted average profit} = \frac{\text{Total product}}{\text{Total weight}}$$

Year	Profit	Weight	Product
2021	4000	1	4000
2022	7000	2	14000
2023	2000	3	6000
Total		6	24000

$$\text{Total product} = ₹24000$$

$$\text{Total of weights} = 6$$

$$\text{Weighted average profit} = \frac{24000}{6} = ₹4000$$

$$\begin{aligned} \text{Value of goodwill} &= \text{Weighted average profit} \times \text{Number of years purchase} \\ &= 4000 \times 2 = ₹8000 \end{aligned}$$

iii. Super profit method

Super profit is the excess of actual or average profit over the normal profit. Normal profit means the profit expected from similar business. It is the expected return on capital employed. Normal profit is calculated by multiplying the capital employed and the rate of general expectation. Under super profit method, goodwill is valued by multiplying the super profit and the number of years in which the super profit will be available in future. If the actual or average profit is less than the normal profit, there is no goodwill.

$$\text{Super profit} = \text{Actual profit} - \text{Normal profit}$$

$$\text{Normal profit} = \text{Capital employed} \times \text{Rate of expectation}$$

$$\text{Goodwill} = \text{Super profit} \times \text{Number of purchasing years}$$



Illustration 6.1.9

The average profit of a firm for the last 5 years is ₹10000 and the capital invested is ₹60000. Return expected from a similar business is 10%. Goodwill is valued at 3 years purchase of super profit. Find out the amount of goodwill.

Solution

$$\begin{aligned}\text{Average Profit} &= ₹10000 \\ \text{Normal Profit} &= \text{Capital employed} \times \text{Rate of Expectation} \\ &= 60000 \times \frac{10}{100} \\ &= ₹6000 \\ \text{Super Profit} &= \text{Actual Profit} - \text{Normal Profit} \\ &= 10000 - 6000 = ₹4000 \\ \text{Goodwill} &= \text{Super profit} \times \text{Number of years} \\ &= 4000 \times 3 = ₹12000\end{aligned}$$

iv. Capitalisation of profit method

Under this method, the profits are capitalised taking into consideration the general expectation in the same industry.

There are two methods for finding out goodwill by capitalisation method

- Capitalisation of average profit method
- Capitalisation of super profit method

Capitalisation of Average profit method: - According to this method, the following steps are adopted for valuing goodwill:

- ◇ Average profit is calculated
- ◇ Average profit is capitalised at normal rate of return and this is known as Normal Capital employed
- ◇ Actual capital employed or Net tangible asset of the business is calculated

- ◇ Excess of normal capital employed over actual capital employed will be value of goodwill

$$\text{Goodwill} = \text{Capitalised Average Profit} - \text{Net tangible assets}$$

Capitalisation by Super Profit method: Under this method it is estimated as to how much capital will be required to earn super profit at normal rate of profit. This capitalised value of super profit is treated as goodwill.

$$\text{Goodwill} = \frac{\text{Super Profit}}{\text{Normal Rate of Return}} \times 100$$

Illustration 6.1.10

The profits of a firm for the last 5 years were ₹40000, ₹42000, ₹45000, ₹50000 and ₹53000. The net tangible asset is ₹270000. Return expected from a similar business is 10%. Find out the amount of goodwill under capitalisation of average profit and capitalisation of super profit methods.

Solution

Under capitalisation of Average profit method:

$$\text{Average profit} = \frac{\text{Total profit}}{\text{Number of years}}$$

$$\begin{aligned} \text{Average profit} &= \frac{40000 + 42000 + 45000 + 50000 + 53000}{5} \\ &= ₹46000 \end{aligned}$$

$$\begin{aligned} \text{Capitalisation of average profit} &= \frac{46000 \times 100}{10} \\ &= ₹460000 \end{aligned}$$

$$\begin{aligned} \text{Goodwill} &= \text{Capitalised Average Profit} - \text{Net tangible assets} \\ &= 460000 - 270000 = ₹190000 \end{aligned}$$



Under capitalisation of Super profit method

Average Profit = ₹46000

Normal Profit = ₹27000 (10 % of 270000, assume ₹270000 is average capital employed)

Super Profit = 46000 – 27000 = ₹19000

$$\begin{aligned}\text{Goodwill} &= \frac{\text{Super Profit}}{\text{Normal Rate of Return}} \times 100 \\ &= \frac{19000}{10} \times 100 = ₹190000\end{aligned}$$

v. Annuity Method

It is a variation of number of years purchase method. It takes in to consideration the time value of money. The following procedure has been used for the calculation of goodwill.

- ◇ Super profit is calculated.
- ◇ Calculate present value of super profit at a certain rate for certain period.
- ◇ If the present value of annuity is less than ₹1, then the amount of goodwill will be Super profit/ Present value of Annuity.

$$\text{Goodwill} = \frac{\text{Super profit}}{\text{Present Value of Annuity}}$$

- ◇ If the present value of annuity is more than ₹1 then the amount of goodwill will be Super profit x Present value of annuity

Illustration 6.1.11

Average Capital employed is ₹500000. Profits for the four years were ₹50000, ₹70000, ₹75000 and ₹85000. The present value of an annuity of one rupee at 5% p.a. for four years is ₹2.82012. Return on capital employed is expected 11%. Calculate goodwill under annuity method.

Solution

$$\text{Average profit} = \frac{\text{Total Profit}}{\text{Number of years}}$$

iv. Revaluation method

Under this method, the new partner does not bring in his share of goodwill in cash. Instead, a goodwill account was raised in the firm's book. When the new partner does not bring in his share of goodwill in cash, the goodwill is raised in the books of account by crediting the old partners in the old profit sharing ratio. When goodwill account is raised in the books of account, there are two possibilities:

- a) No goodwill appears in the books at the time of admission and
- b) Goodwill already appears in the books at the time of admission.

When no goodwill appears in the books

Here the goodwill account must be raised at its full value by debiting goodwill account with its full value and crediting the old Partners' Capital Accounts in their old profit sharing ratio. The journal entry will be

Goodwill A/c Dr.
 To Old Partner's capital A/c

(Goodwill raised at full value in the old ratio)

Note: Goodwill thus raised will appear in the Balance Sheet at its full value.

When goodwill already appears in the books

If books already show some balance in the goodwill account, the adjustment for goodwill in the old Partners' Capital Accounts shall be made only for the difference between the agreed value of goodwill and the amount of goodwill appearing in books.

The journal entry will be

When value of goodwill appearing in the books is less than the agreed value

Goodwill A/c Dr.
 To Old partners' capital A/c (Individually)

(Goodwill raised to its agreed value)

When the value of goodwill appearing in the books is more than the agreed value

Old partners' capital A/c Dr. (Individually)

To Goodwill A/c

(Goodwill brought down to its agreed value)

Note: Agreed value of goodwill will appear in the Balances sheet.

Illustration 6.1.12

Kamal and Neraj are partners in a firm sharing profit and losses in the ratio 1:1. Cyril, a new partner brings ₹25000 as capital but is unable to bring anything for goodwill. Goodwill of the firm is ₹18000 and the new profit sharing ratio is fixed as 4:3:2. Pass journal entries assuming that the partners do not want goodwill to appear in the Balance Sheet.

Solution

Cash A/c	Dr.	25000	
	To Cyril's capital A/c		25000
(Cash brought in by Cyril as capital)			
Goodwill A/c	Dr.	18000	
	To Kamal's capital A/c		9000
	To Neraj's capital A/c		9000
(Goodwill raised at its full value)			
Kamal's capital A/c	Dr.	8000	
Neraj's capital A/c	Dr.	6000	
Cyril's capital A/c	Dr.	4000	
	To Goodwill A/c		18000
(Goodwill written-off)			

Recap

- ◇ Admission of a new partner- New partner joins an existing firm
- ◇ Sacrificing ratio- Old ratio minus new ratio
- ◇ If partnership deed is silent- Profits and losses are shared equally
- ◇ New profit sharing ratio- Agreed percentage for sharing future profits and losses
- ◇ Goodwill- Value assigned to a firm's reputation
- ◇ Revaluation Account- Assessing true value of firm's assets and liabilities
- ◇ Reserve and undistributed profits/loss- Transferred to old partner's capital account
- ◇ Average profit method- $\text{Goodwill} = \text{Average profit} \times \text{Number of purchasing years}$
- ◇ Weighted average profit method- $\text{Goodwill} = \text{Weighted average profit} \times \text{Number of years purchase}$
- ◇ Super profit method- $\text{Goodwill} = \text{Super profit} \times \text{Number of years}$
- ◇ Capitalisation of average profit method- $\text{Goodwill} = \text{Capitalised Average Profit} - \text{Net tangible assets}$
- ◇ Capitalisation of super profit method - $\text{Goodwill} = \frac{\text{Super Profit}}{\text{Normal Rate of Return}} \times 100$

Objective Questions

1. What is the equation to calculate sacrificing ratio?
2. Where should the goodwill be debited at the time of the admission of a partner if the goodwill is raised at full value?
3. In which ratio should the reserve and undistributed profit be credited to old partner capital account at the time of admission of a new partner?
4. In which ratio should the goodwill bought in by an incoming partner in cash to join a partnership firm is shared by the old partner?

5. What is the common method used to adjust the capital accounts during the admission of a new partner?
6. What type of account is Revaluation Account?
7. What will be the ratio when the partnership deed is silent about it?
8. What is the purpose of calculating the new partner's capital in the partnership?
9. Which document is prepared to officially record the admission of a new partner?

Answers

1. Old ratio-New ratio
2. Goodwill Account
3. Old profit sharing ratio
4. Sacrificing ratio
5. Revaluation of assets and liabilities
6. Nominal account
7. Profits and losses are shared equally
8. To allocate profits/losses
9. Partnership agreement

Self-Assessment Questions

1. What do you mean by admission of a new partner? What is the purpose of admitting a new partner in a firm?
2. What is sacrificing ratio?
3. What is the role of the partnership agreement in the admission of a new partner?
4. What is Revaluation Account? Develop a format of the same.
5. What is the treatment of goodwill at the time of admission when goodwill is brought in cash by the new partner?
6. What steps are typically involved in the admission process of a new partner?
7. Explain the treatment of reserves and accumulated profit at the time of admission of a new partner?
8. How does the admission of a new partner affect the existing partner's ownership percentage?

Assignments

1. M and N are partners in the firm, sharing profit and loss in the ratio of 3:2. P is admitted into the firm as the new partner. They decided to share the future profit and loss of the firm in the ratio of 2:2:1. P brings in ₹31500 as his share of capital and ₹11600 as premium for goodwill. The premium for goodwill brought in by the new partner is withdrawn by the old partner. Pass journal entries.
2. Amrith and Sanjay are partners. The profit-sharing ratio between Amrith and Sanjay is 7:5. Kalyan, a new partner joins the firm for $\frac{1}{6}$ share in profits. He acquires $\frac{1}{24}$ from Amrith and $\frac{1}{8}$ from Sanjay. Determine the new profit sharing ratio.

(Answer 13:7:4)

3. Aslam and Meerat are partners. The profit sharing ratio is 1:1. The following is the Balance Sheet of their firm as on 31 December 2021.

Balance Sheet as on 31 December 2021

Liabilities	Amount	Asset	Amount
Bills payable	8000	Cash in hand	13000
Creditors	33000	Debtors	22000
Capitals:		Stock	45000
Aslam: 80000		Furniture	10000
Meerat: 60000	140000	Land	91000
	181000		181000

Arjun is admitted as a new partner who has brought in ₹80000 as capital. Value of Land should be increased by ₹30000. Stock is to be reduced to ₹40000. Creditors are paid off up to ₹3000. Prepare Revaluation account and pass journal entries.

(Revaluation Loss: ₹7000)

4. Pritvi and Govind are partners sharing profit and loss in the ratio of 3:2. The following is the Balance Sheet of their firm as on 31 December 2021.

Balance Sheet as on 31 December 2021

Liabilities	Amount	Asset	Amount
Reserve	20000	Cash in hand	4000
Creditors	74000	Sundry Debtors	30000
Capitals:	100000	Stock	45000
Pritvi: 60000		Machinery	30000
Govind: 40000		Land	80000
		Profit and Loss Account	5000
	194000		194000

Bhaskar is admitted as a new partner who has brought in ₹50000 as capital. He obtains $\frac{1}{6}$ share of future profit. Value of Land should be revalued to ₹120000 and machinery at 20% less than book value. Provision for doubtful debts is maintained at 5%. A liability of ₹2500 on repair bill outstanding be recorded in the books. Pass journal entries and prepare Revaluation Account, capital account, and Balance Sheet.

(Answer: Revaluation profit: ₹30000, Balance Sheet total: ₹271500)

5. The average profit of a firm for 5 years is ₹30000. The normal rate of return is 15%. The firm has tangible asset of ₹160000. Find out the value of goodwill using capitalisation method.

(Answer: ₹40000)



Suggested Readings

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Unit 2

Retirement and Death of Partner

Learning Outcomes

After completing this unit, the learners will be able to:

- ◇ gain insights on the concept of retirement of a partner
- ◇ learn the accounting treatment at the time of retirement and death of a partner
- ◇ compute the new profit sharing ratio and gaining ratio
- ◇ calculate the total amount due to the retiring partner or nominee of a deceased partner

Prerequisites

Retirement and demise of partners are the two occurrences in a partnership business, altering the ownership structure and impacting its operation. Assume Athul, Salim, and Govind effectively managed a partnership enterprise for a decade. Regrettably, owing to poor health, Govind aspired to retire from the partnership.

In this scenario, the responsibility falls upon Athul and Salim to reconcile Govind's accounts and allocate his equitable portion of the business's profits. It's vital to recognise that the business's triumph resulted from the collaborative endeavours of all three partners. Hence, Govind is entitled to a segment of the firm's goodwill, reserves, and accrued profits. Moreover, Govind is also accountable for shouldering his portion of any losses incurred during his tenure as a partner. The same rules are pertinent in the event of a partner's demise. The surviving partners must determine the future profit-sharing ratio and devise a strategy for managing the goodwill's value and existing reserves. This unit emphasises the proper handling of diverse accounts upon a partner's retirement or demise.



Keywords

Retirement, Death of a partner, New profit sharing ratio, Gaining ratio

Discussion

6.2.1 Retirement of a Partner

In partnership, the ideas of retirement and death have a significant impact on the functioning of the firm. The ownership structure, profit sharing agreements, and long-term viability of the firm may all be significantly impacted by these occurrences.

Withdrawal of a partner from the firm's business is termed as 'Retirement of a Partner'. Such withdrawal takes place either by consent of other partners or as per the Provisions of Partnership Deed or by giving notice.

According to section 32(1) of the Indian Partnership Act, a partner can retire from the partnership in the following ways:

- a. With the consent of all the partners
- b. In accordance with the agreement by the partners
- c. Where the partnership at will, by giving notice in writing to all the other partners stating his intention to retire.

A person who is retired from the firm is known as a retiring partner or outgoing partner. When a partner retires, his claims are to be determined and settled. The amount payable to the retiring partner depends on his capital and current account balances, share of undistributed profit or loss, share of goodwill and share of profit or loss on revaluation of assets and liabilities. The retiring partner is not liable for any liabilities incurred by the firm after his retirement. The retirement of a partner involves the following adjustments:

- ◇ Calculation of profit- sharing ratio and gaining ratio
- ◇ Revaluation of assets and liabilities
- ◇ Distribution of reserves and other accumulated profits or losses
- ◇ Treatment of goodwill
- ◇ Disposal of the amount due to the retiring partner

6.2.1.1 Calculation of new profit-sharing ratio and gaining ratio

New Profit-sharing ratio: When a partner retires from a partnership, the continuing partners' share of profit increases. This increase in the share of profit may be in the proportion in which they were sharing before the retirement or in a different proportion that was mutually agreed by them. The ratio in which the continuing partners decide to share the future profit and losses is known as new profit-sharing ratio.

Gaining ratio: When a partner retires from a firm, the remaining partners share of profit increases. The ratio in which the continuing partners acquire the outgoing partner's share is called as gaining ratio. It is the excess of continuing partners' new share over their old share of profits. If the continuing partners maintain their relative ratio, the gaining ratio and new ratio will be the same.

$$\text{Gaining ratio} = \text{New ratio} - \text{Old ratio}$$

The following are the different situations where gaining ratio and new profit ratio is calculated:

- i. If nothing is mentioned in question regarding new ratio and gaining ratio.
- ii. If gains of the remaining partners are separately given.
- iii. If remaining partners take retiring partner's share in a specific ratio.
- iv. If entire share of retiring partner is taken by only one partner.

If nothing is mentioned in question regarding new ratio and gaining ratio

The new ratio of remaining partners will be calculated by deleting the ratio of the retiring partner from the old ratio. Here the gaining ratio and new ratio will be the same. It means no change in the relative proportion of the remaining partners.

Illustration 6.2.1

X, Y, and Z shared profits and losses in the ratio of 5:3:2. X retired. Find the Gaining ratio.

Solution

Old ratio of X, Y and Z = 5:3:2

If X retires the new ratio = 3:2



Gaining ratio = New ratio – Old ratio

$$\begin{aligned}\text{Y's gaining} &= \frac{3}{5} - \frac{3}{10} \\ &= \frac{6}{10} - \frac{3}{10} = \frac{3}{10}\end{aligned}$$

$$\begin{aligned}\text{Z's gaining} &= \frac{2}{5} - \frac{2}{10} \\ &= \frac{4}{10} - \frac{2}{10} = \frac{2}{10} \\ &= 3:2\end{aligned}$$

Note: Since Y and Z maintain their relative ratio, the gaining ratio and the new ratio will be the same.

If gains of the remaining partners are separately given

In this case new ratio is calculated as follows:

A, B and C have been sharing profits and losses in the ratio of 8:5:3. A retires, B take $\frac{2}{16}$ from A and C take $\frac{6}{16}$ from A. Compute new and gaining ratio.

New ratio = Old ratio + gain

$$\text{New ratio of B} = \frac{5}{16} + \frac{2}{16} = \frac{7}{16}$$

$$\text{New Ratio of C} = \frac{3}{16} + \frac{6}{16} = \frac{9}{16}$$

$$\text{New ratio of B and C} = 7:9$$

$$\text{Gaining Ratio of B and C} = 2:6 = 1:3$$

If remaining partners take retiring partner's share in a specific ratio, new ratio is calculated as follows:

Here the gaining ratio will be the ratio in which the remaining partners acquire the share of the retiring partners share.

Illustration 6.2.2

A, B and C are partners sharing profits in the ratio of 4:3:2. B retires from the firm and his share was taken by A and C in the ratio of 2:1. Find out the new and gaining ratio.

Solution

New Ratio = Old ratio + Part of share taken from the retiring partner

$$\text{Part of share taken from B by A} = \frac{3}{9} \times \frac{2}{3} = \frac{6}{27}$$

$$\text{New ratio of A} = \frac{4}{9} + \frac{6}{27} = \frac{18}{27}$$

$$\text{Part of share taken from B by C} = \frac{3}{9} \times \frac{1}{3} = \frac{3}{27}$$

$$\text{New ratio of C} = \frac{2}{9} + \frac{3}{27} = \frac{9}{27}$$

$$\text{New ratio of A and C} = 18:9 = 2:1$$

$$\text{Gaining ratio of B and C} = 2:1$$

If entire share of retiring partner is taken by only one partner

Consider a case where, A, B and C are partners sharing profits and losses in the ratio of 2:2:1. B retires and his share is entirely taken by C. Calculate new ratio. In this case new ratio can be calculated as follows:

$$\text{New ratio of A} = \frac{2}{5} \text{ (no change)}$$

$$\text{New ratio of C} = \frac{1}{5} + \frac{2}{5} = \frac{3}{5}$$

$$\text{New ratio of A and C} = 2:3$$

6.2.1.2 Revaluation of assets and liabilities

The process of revaluing the assets and liabilities at the time of retirement is same as that of the revaluation of assets and liabilities at the time of admission of a new partner. The profit and loss on revaluation will be shared by all the partners in the old ratio. The revalued amount of the assets and liabilities are shown in the Balance Sheet.

At the time of retirement of a partner, undistributed profit or loss of the old firm should be transferred to all Partners' Capital Accounts in their old profit-sharing ratio. The accounting treatment would be as follows:

Reserve A/c Dr.

To All Partners' capital A/c

All Partners' Capital A/c Dr.

6.2.1.4 Treatment of Goodwill

Remaining Partners' capital A/c Dr.

Following are the various situations regarding adjustment of goodwill:

- In such cases, the retiring partner's portion of goodwill should be shared by the continuing partners in their gaining ratio.

Illustration 6.2.3

A, B and C are partners sharing profits in the ratio of 5:3:2. C retires and the goodwill is valued at ₹40000. Give entries in the books of the firm regarding treatment of goodwill

Solution

- C's share of goodwill = $40000 \times \frac{2}{10} = 8000$
- New ratio between A and B = 5:3
- Since A and B continue to share in the same relative proportions as before, gaining ratio is same as new ratio (5:3)

Date	Particulars	L.F.	Amount (Dr.)	Amount (Cr.)
	A's capital A/c Dr.		5000	
	B's Capital A/c Dr.		3000	
	To C's capital A/c			8000
	(B's share of goodwill credited to his capital account)			

◇ Only one of the continuing partners gain on retirement of a partner

In such a case, the partner who has gained should compensate the share of goodwill due to the retiring partner.

Illustration 6.2.4

A, B and C are partners sharing profits in the ratio of 3:2:1. B retired from business and his share of profit is completely taken over by C. The goodwill of the firm is valued at ₹30000. Pass necessary journal entry of goodwill treatment.

Date	Particulars	L.F.	Amount (Dr.)	Amount (Cr.)
	C's capital A/c Dr.		10000	
	To B's capital A/c			10000
	(Share of goodwill adjusted from C's capital A/c)			

Working note: - Calculation of goodwill

$$\text{Total goodwill} = ₹30000,$$

$$\text{B's share of goodwill} = 30000 \times \frac{2}{6} = 10000$$

Since only C has gained, C could compensate the entire amount ₹10000 to B

- ◇ **Some of the continuing partners sacrifice on retirement of a partner while others gain.**

This may happen when continuing partners decide to change their profit-sharing ratio at the time of retirement. In such a case, the gaining partners should compensate the sacrificing partners (including retiring partner) for retiring partners' share of goodwill.

Illustration 6.2.5

A, B, C and D are partners sharing profits and losses in the ratio of 4:3:2:1. C retires from the firm and the continuing partners decide to change their profit sharing ratio on an equal basis. Goodwill of the firm was valued at ₹120000. Pass the necessary journal entry for goodwill treatment.

Solution

Working Note:-

Calculation of Gaining / Sacrificing ratio

Gaining ratio = New ratio - Old ratio

$$A = \frac{1}{3} - \frac{4}{10} = \frac{10-12}{30} = \frac{2}{30} \text{ (Sacrifice)}$$

$$B = \frac{1}{3} - \frac{3}{10} = \frac{10-9}{30} = \frac{1}{30} \text{ (Gain)}$$

$$D = \frac{1}{3} - \frac{1}{10} = \frac{10-3}{30} = \frac{7}{30} \text{ (Gain)}$$

$$\text{A's sacrifice} = \frac{2}{30}$$

$$\text{B's Gain} = \frac{1}{30}$$

$$\text{C's Sacrifice} = \frac{6}{30}$$

$$\text{D's Gain} = \frac{7}{30}$$

Calculation of goodwill share of C

$$\text{Total Goodwill} = 120000$$

$$\text{C's share} = \frac{2}{10} \text{ of } 120000 = 24000$$

$$\text{Goodwill share of A} = 120000 \times \frac{2}{30} = 8000$$

$$\text{Goodwill share of B} = 120000 \times \frac{1}{30} = 4000$$

$$\text{Goodwill share of D} = 120000 \times \frac{7}{30} = 28000$$

Date	Particulars	L.F.	Amount (Dr.)	Amount (Cr.)
	B's capital A/c Dr.		4000	
	D's capital A/c Dr.		28000	
	To A's capital A/c			8000
	To C's capital A/c			24000
	(Goodwill credited to sacrificing partners A and C is borne by the gaining partners B and D)			

6.2.1.5 Disposal of the amount due to the retiring partner

The retiring partner is entitled for the amount due to him from the firm. The amount due to the retiring partner is ascertained by preparing capital account incorporating all the adjustments like share of goodwill, undistributed profits or losses, accumulated reserves, profit or loss on revaluation of assets and liabilities, etc. The amount due is either paid off immediately or paid in instalments. When it is not paid immediately, it will be transferred to his loan account.

Journal entry is:

Retiring Partners Capital A/c Dr.
 To Cash/Bank/ Retiring Partners' Loan A/c

Illustration 6.2.6

A, B, and C are partners sharing profits and losses in the ratio of 3:2:1. The Balance Sheet of the firm as on 31-12-2021 stood as follows:

Balance Sheet as on 31-12-2021

Liability	Amount	Assets	Amount
Sundry creditors	36000	Cash at bank	3000
Bills payable	10000	Debtors 32000	
		Less provision (1000)	31000
Reserve fund	24000	Stock	50000
Capital		Motor van	16000
A 80000		Plant and Machinery	70000
B 60000		Factory Building	90000
C 50000	190000		
	260000		260000

B retires on that date subject to the following adjustments:

- The goodwill of the firm to be valued at ₹36000
- Plant and Machinery to be depreciated by 10% and Motor van to be depreciated by 15%
- Stock to be appreciated by 20% and buildings by 10%
- Provision for doubtful debts to be increased by ₹3900

Pass journal entries to give effect to the above adjustments and prepare Revaluation Account, Partners' Capital Accounts, B's Loan Account and Balance Sheet after B's retirement.

Solution

Date	Particulars	L.F.	Amount (Dr.)	Amount (Cr.)
3-12-21	Reserve Fund A/c Dr. To A's Capital A/c To B's Capital A/c To C's Capital A/c (Reserve fund transferred to Partners' Capital Account)		24000	12000 8000 4000
	A's Capital A/c Dr. C's Capital A/c Dr. To B's Capital A/c (B's share of goodwill be adjusted to A and C in the gaining ratio)		9000 3000	12000
	Revaluation A/c Dr. To Plant and Machinery A/c To Motor Van A/c To Provision for bad debts A/c (Losses on revaluation debited in the Revaluation Account)		13300	7000 2400 3900
	Stock A/c Dr. Building A/c Dr. To Revaluation A/c (Profit on Revaluation of stock and building)		10000 9000	19000
	Revaluation A/c Dr. To A's Capital A/c To B's Capital A/c To C's Capital A/c (Net profit on revaluation transferred to Partner's Capital A/c)		5700	2850 1900 950
	B's Capital A/c Dr. To B's Loan A/c (B's capital transferred to Loan)		81900	81900

Revaluation Account

Particulars	Amount	Particulars	Amount
To Plant and Machinery	7000	By Stock	10000
To Motor car	2400	By Buildings	9000
To Provision for Bad Debts	3900		
To Profit transferred to:			
A 2850			
B 1900			
C <u>950</u>	5700		
	19000		19000

Partners' Capital Accounts

Particulars	A	B	C	Particulars	A	B	C
To B's capital A/c	9000	-	3000	By Balance b/d	80000	60000	50000
To B's loan A/c	-	81900	-	By Reserve Fund	12000	8000	4000
To Balance c/d	85850	-	51950	By A's capital A/c	-	9000	-
				By C's capital A/c	-	3000	-
				By Revaluation A/c	2850	1900	950
	94850	81900	54950		94850	81900	54950
				To Balance b/d	85850		51950

B's loan Account

Particulars	Amount	Particulars	Amount
Balance c/d	81900	By B's capital A/c	81900
	81900		81900
		Balance b/d	81900

Balance Sheet as on 31 December 2022

Liability	Amount	Assets	Amount
Sundry creditors	36000	Cash at bank	3000
Bills payable	10000	Debtors	32000
B's Loan	81900	Less: Provision	(4900)
		Stock	50000
Capital Accounts		Add Appreciation 20%	10000
A 85850		Motor Van	16000
C 51950	137800	Less 15% depreciation	(2400)
		Plant and Machinery	70000
		Less Depreciation 10%	(7000)
		Factory buildings	90000
		Add Appreciation 10%	9000
	265700		265700

6.2.2 Death of a Partner

When a partner dies, his legal representatives are entitled to all the rights stated in respect of the retirement of partners. Death may occur on any day, the representatives of the deceased partner will be entitled to the share of the profit earned from the beginning of the year to the date of death. Partnership deed describes the method of ascertaining such profits. The representatives are entitled to the following:

- The amount standing to the credit of the deceased Partners' Capital Account
- His share in the goodwill of the firm, still to be brought into books
- His share of the profit on revaluation of assets and liabilities but his share of loss, if any, on such revaluation will be deducted.
- His share of undistributed profits or reserve
- Interest on capital if described in any section of the partnership deed
- His share of the proceeds of the joint life policy, if any
- His salary, remuneration, etc. up to the date of death
- Proportionate share of profit from the last Balance Sheet to the date of death

The accounting treatments are very similar to those applicable in the case of retirement of a partner. However the following are the differences between retirement and death.

- ◇ Retirement may take place usually at the end of an accounting period, whereas, death may occur at any time
- ◇ On retirement, the amount due to the retiring partners is usually transferred to his Loan account. But, in death, such amount is transferred to his Executor's loan Account.

Illustration 6.2.7

A, B and C are partners sharing profits and losses in the ratio of 2:2:1. Their Balance Sheet as on 31 December, 2021 was as follows:

Balance Sheet as on 31 December, 2021

Liability	Amount	Asset	Amount
Sundry creditors	60000	Cash and Bank balances	20000
Reserve fund	30000	Sundry debtors	50000
Capitals		Closing stock	80000
A 30000		Machinery	80000
B 50000			
C 60000	140000		
	230000		230000

A died on 30 April, 2022 and the partnership deed provided that in the event of death of a partner, his executors should be entitled to:

- a. His capital on the date of previous Balance Sheet
- b. His proportion of reserve on the date of last Balance Sheet
- c. His proportion of profit to date of death on the basis of previous years' profits
- d. His share of goodwill calculated on the basis of three year purchase of the average profits of the past four years

The profits of the firm for the past four years were: 2018 ₹46000, 2019 ₹40000, 2020 ₹38000, 2021 ₹36000

Ascertain the amount payable to the executors of the deceased partner. And also draft journal entries.

Solution

Journal

Date	Particulars	L.F.	Amount (Dr.)	Amount (Cr.)
	Reserve fund A/c Dr. To A's Capital A/c (Transfer of A's share of reserve)		12000	12000
	Goodwill A/c Dr. To A's Capital A/c (Transfer of A's share of goodwill)		48000	48000
	Profit and Loss Appropriation A/c Dr. To A's Capital A/c (Transfer of his share of profit)		4800	4800
	A's Capital A/c Dr. To A's Executor's loan A/c (Transfer of amount due to A's Executors Loan account)		94800	94800

A's Capital Account

Particulars	Amount	Particulars	Amount
To A's Executor's Loan A/c	94800	By Balance b/d	30000
		By Reserve	12000
		By Goodwill	48000
		By Profit and Loss A/c	4800
	94800		94800

Working Notes:

Calculation of Goodwill = Average profit x No. of Purchasing year

Total profit = 46000+40000+ 38000 + 36000 = ₹160000

Average Profit = $\frac{160000}{4} = ₹40000$

Firm's goodwill = 40000 x 3 = ₹120000

A's share of goodwill = 120000 x $\frac{2}{5}$ = ₹48000

Calculation of A's share of profit from January 1 to 30 April 2022

Last years' profit = ₹36000

A's share = $\frac{2}{5}$

Share of profit for 4 months = $\frac{4}{12}$

A's share of profit from January 1 to 30 April = 36000 x $\frac{4}{12}$ x $\frac{2}{5}$ = ₹4800



Recap

- ◇ Retirement of a partner- Withdrawal of a partner from partnership
- ◇ Gaining ratio- New ratio minus old ratio
- ◇ New profit sharing ratio- Agreed percentage for sharing future profits and losses
- ◇ Revaluation Account- Assessing true value of firm's assets and liabilities
- ◇ Reserve and undistributed profits/loss- Transferred to all partner's capital account
- ◇ Goodwill- Value assigned to a firm's reputation
- ◇ Treatment of goodwill- Retiring partner is compensated in gaining ratio
- ◇ Settlement of retiring partner- Paid off immediately or transferred to his loan account
- ◇ Settlement of deceased partner- Amount is transferred to his Executor's loan Account

Objective Questions

1. What is the equation for calculating gaining ratio?
2. What is the equation for calculating new ratio at the time of retirement of a partner?
3. In case of retirement of partner, in which ratio is the profit on revaluation credited to the capital account of partners?
4. In which ratio will the remaining partners contribute to the retiring partner for parting with the firm's future profits in favour of remaining partners?
5. To which account is the amount due to the deceased partner is transferred?
6. When a partner retires from a partnership, what happens to their ownership interest in the firm?
7. When a partner retires, what impact does it have on the partnership's legal existence?
8. To which account is the amount due to the retiring partners is transferred?

Answers

1. New ratio - Old ratio
2. Old ratio + Gain of remaining partners
3. Old profit sharing ratio
4. Gaining ratio
5. Executor's loan Account
6. It is transferred to the remaining partners
7. The partnership continues with the remaining partners
8. Loan account

Self-Assessment Questions

1. What is gaining ratio?
2. Explain the treatment of goodwill at the time of retirement of a partner?
3. List out the items that the representatives of the deceased partner are entitled to receive at the time of death of a partner.
4. What steps are typically involved in the retirement of a partner?
5. Briefly explain how the reserves and undistributed profits/losses are adjusted at the time of retirement of a partner.
6. What is a Revaluation Account?
7. Differentiate between the treatment of funds upon the retirement of a partner and the death of a partner.
8. What happens to the retiring partner's rights to the partnership's assets and liabilities?

Assignments

1. Rakhi, Krithika, and Meena are partners sharing profit and losses in the ratio 2:2:1. Meena retires and his share of goodwill is valued at ₹60000. The new profit sharing ratio is 3:2. Pass journal entries.
2. Raju, Rahim, and Simi are partners with the profit sharing ratio 4:3:2. Rahim retires from partnership and his share of goodwill is valued at ₹4800. The new profit sharing ratio is 5:3. Compute gaining ratio.

(Answer- Gaining ratio 13:11)

3. Ahmed, Binoy and Cyril are partners sharing profit in the ratio 3:2:1. Ahmed retires from the partnership. In order to settle his claim, the following revaluation of assets and liabilities was agreed upon:
 - i. The value of Land and Building is decreased by ₹12000
 - ii. The value of Investment is increased by ₹2000.
 - iii. The value of Machinery is increased by ₹25000.
 - iv. A provision for outstanding bill standing in the books at ₹1,000 is now not required.

Give journal entries and prepare Revaluation Account

(Answer- Profit in Revaluation Account- ₹16000)

4. Keerthi, Suraj, and Arpit are partners with profit sharing ratio of 3:2:1. The following is the Balance Sheet as on 31 December 2021.

Balance Sheet as on 31 December 2021

Liabilities	Amount	Asset	Amount
Reserve	15000	Cash in hand	6000
Creditors	6000	Sundry debtors	12000
Capitals:		Stock	10000
Keerthi: 15000		Investment	15000
Suraj: 10000		Building	8000
Arpit: 5000	30000		
	51000		51000

Suraj died on 31 March 2022. New ratio is 3:1. He is entitled to the following:

- i. Capital to the credit of Suraj at the time of his death and interest at 6% p.a.
- ii. His share of profit till date of death based on last years' profit

- iii. His share of goodwill calculated by taking 3 times the amount of average profit of last three years.
- iv. Profits of last three years- ₹8000, ₹7000, ₹9000
- v. His share in reserve

Pass journal entries and prepare Suraj's capital account and executor's loan account.

(Suraj's executor's account- ₹23900)

Suggested Readings

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