



# Institute of Open and Distance Education

Faculty of Commerce

## Financial Accounting

Financial Accounting



**1BCOM4**



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Chhattisgarh, Bilaspur

A STATUTORY UNIVERSITY UNDER SECTION 2(F) OF THE UGC ACT

**1BCOM4**

**Financial Accounting**

1BCOM4, Financial Accounting

Edition: March 2024

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Published by:

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# UNIT I

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# LESSON

# 1

## AN INTRODUCTION TO FINANCIAL ACCOUNTING

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## 1.0 AIMS AND OBJECTIVES

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After studying this lesson, you should be able to:

- Explain accounting and its needs
- Discuss the concepts of accounting
- Explain the accounting conventions
- Describe the concept of double entry system

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## 1.1 INTRODUCTION

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Accounting is the language of business. It plays an important role in recording financial transactions. If the volume of sales of the products and the numbers of transaction of the business are very high, it is impossible for the businessman to keep all these transactions in his mind. Thus a need of recording of all these business transactions arises. The recording of the transactions and finding out the business profits is the essence of accounting. It is the medium, which shows financial performance of a business enterprise to the outside world. Through accounting, all business transactions are recorded and at the end of the financial year, the results of the business performance is assessed in the form of final accounts, on the basis of some accepted principles and rules, etc. The scope of business is very wide with production and sales are made at a large scale. This tremendous growth of business has increased the volume of business transactions in manifold. Every business enterprise will be anxious at the end of the year to find out whether its goods have been sold at a profit or at a loss and what is the financial position of the business. Similarly, information is also required for planning, control and decision-making, which can be provided only when all the business transactions are recorded, classified and summarised in a proper manner. For this purpose, the work of recording transactions started and that gave birth to bookkeeping at the elementary stage and accounting at the advanced stage.

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## 1.2 MEANING OF ACCOUNTING

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Accounting is an extension of bookkeeping. Where bookkeeping ends, accounting begins. Bookkeeping records the business transactions in account books. Accounting aims at recording, classifying and summarizing the business transactions in a useful manner.

Accounting is defined by different authors and institutions in different ways. Some of the most important definitions are given below:

According to the committee on accounting terminology of the American Institute of Certified Public Accountants (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 results thereof.”

“Accounting is the process of identifying, measuring and communicating economic information to permit informed judgments and decisions by users of the information.”

–*The American Accounting Association*

“Accounting system is a means of collecting, summarizing, analyzing and reporting in tabular terms, information about the business.”

–*Robert N. Anthony*

“Accounting as the science of recording and classifying business transactions and events, primarily of a financial character, and the art of making significant summaries, analysis and interpretations of those transactions and events and communicating the results to persons who must make decisions or form judgements.”

–*Smith and Ashburne*

Thus, it is clear from the above definitions of accounting that, accounting is a science as well as an art of recording transactions of economic nature and also a technique of analyzing and interpreting the same.

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## 1.3 FUNCTIONS OF ACCOUNTING

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Accounting has the following functions:

- **Recordkeeping function:** The basic and primary function of accounting is to keep systematic record of business transactions, which can be expressed in terms of money (monetary terms). It relates to journalisation, posting and preparation of final statements. The purpose is to report regularly to the interested parties, by means of financial statements. It is based on trading, profit and loss account and balance sheet of the business, that the earning capacity and financial position of the business can be ascertained.
- **To assist management:** Accounting provides meaningful and valuable information to the management in performing various functions viz., planning, organising, controlling, coordinating, decision-making, etc. Decision-making is greatly assisted by accounting as it is based on the results disclosed by it.
- **Compliance with legal requirements:** Auditing is not possible without accounting, thus accounting has to be made of such a standard as to comply with the legal requirements. Auditing is compulsory in case of registered firms. Accounting is a base and with its help, various returns, documents, statements, etc., are prepared.
- **Language of business:** Accounting is the language of business. Various business transactions are communicated through accounting to various parties – owners, creditors, government, public, employees and the managers, etc. This is done through preparation of various accounting reports, which includes not only the income statement and position statement but also the additional information in the form of graphs, diagrams, ratios, fund flow statements, etc. Accounting shows a real and true position of the business.

In addition to the above, the five essential functions of accounting are as follows:

1. **Recording:** This is the basic function of accounting. It is essentially concerned with not only ensuring that all business transactions of financial character are in fact recorded but also that they are recorded in an orderly manner. Recording is done in a book known as “Journal”.
2. **Classifying:** Classification is concerned with the systematic analysis of the recorded data, with a view to group transactions or entries of one nature at one place. The work of classification is done in a book termed as “Ledger.”
3. **Summarising:** This involves presenting the classified data in a manner, which is understandable and useful to the internal as well as external end-users of accounting statements. This process leads to the preparation of the following statements: (1) Trial Balance, (2) Income statement and (3) Balance sheet.
4. **Analysis and Interpretation:** This is the final function of accounting. The recorded financial data is analysed and interpreted in a manner that the end-users



can make a meaningful judgement about the financial condition and profitability of the business operations. The data is also used for preparing the plan and framing the policies for executing such plans.

5. **Communicate:** The accounting information after being meaningfully analysed and interpreted has to be communicated in a proper form and manner to the proper person. This is done through preparation and distribution of accounting reports, which includes besides the usual income statement and the balance sheet, additional information in the form of accounting ratios, graphs, diagrams, funds flow statements, etc.

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## 1.4 OBJECTIVES OF ACCOUNTING

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The main objectives of accounting are as follows:

- **To keep or maintain records of business transactions:** The main objective of accounting is to maintain a complete and systematic record of business transactions. It is the first step in the preparation of financial statements. All the business transactions are first recorded in the Journal or Subsidiary books and then posted into the ledger. With the help of this, the chances of errors and frauds will be less and financial results and financial positions of the business will reveal its true and fair position.
- **To ascertain profit or loss:** The second main objective of accounting is to ascertain profit or loss of the business enterprise. For this, trading and profit and loss account is prepared at the end of each accounting period. If the amount of revenue for the period is more than the expenditure incurred, in earning that revenue, the difference is said to be profit. In case the expenditure exceeds the revenue, there is said to be loss. Thus, revenues are matched with the expired costs.
- **To ascertain the financial position of the business:** Balance sheet is required to be prepared in order to ascertain the financial position of the business on a particular date. Balance sheet shows the value of assets on one side and the liabilities and capital on the other side. Excess of assets over liabilities represent the capital and indicates the financial soundness of the business. In fact, Balance Sheet is a list of assets, liabilities and capital. Resources owned by the business are assets and obligations towards the outsiders and owners are known as liabilities and capital, respectively.
- **To provide information to various parties:** Accounting provides useful and meaningful information to those who have interest in the business. All the interested parties such as managers, owners, investors, creditors, banks, customers, employees, government departments, etc., want to get reliable information. Accounting records generate such information, which may be helpful for the formulation of overall policies.

In addition to the above, the other objectives are:

- (a) To provide information about the utilisation of resources,
- (b) To have control over the assets and property of the firm,
- (c) To file tax returns,
- (d) To check accounting errors funds and misappropriation of funds.
- (e) To fulfil the legal requirements,
- (f) To know the cash position, and
- (g) To facilitate rational decision-making.

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## 1.5 BOOKKEEPING

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Bookkeeping is that branch of knowledge, which tells us how to keep a record of financial transactions. It is the process of recording financial transactions and keeping financial records. Bookkeeping is mainly concerned with the recording of the financial data or events measurable in terms of money. Thus, it helps us to keep a complete record of business transactions in a systematic manner by which the financial position of business enterprise for a certain period may be ascertained. Accounting, on the other hand, includes the design of an accounting information system that meets the user's needs. Accounting includes not only the maintenance of accounting records but also the preparation of financial and economic information, which involves the measurement of transactions and other events related to the entity. Various authors have defined bookkeeping in this way:

*Bookkeeping is the art of recording business transactions in a systematic manner.*

–A H Rosenk amph

*Bookkeeping is the recording of financial transactions of a business in a methodical manner so that information on any point in relation to them may be quickly obtained.*

–A J Favell

*Bookkeeping is the science of recording transactions in money or money's worth in such a manner that at any subsequent day the nature and effect of each transactions, and the combined effect of all the transactions, may be clearly understood so that the accounts prepared at any time from the records thus kept may show the owner of the book his true financial position.*

–L C Cropper

*Bookkeeping is the science and art of correctly recording in the books of accounts all those business transactions that result in the transfer of money or money's worth.*

–R N Carter

From the above definitions, the following characteristics of bookkeeping emerge:

1. Bookkeeping is primarily related to the systematic record of business transactions.
2. Every transaction is properly analysed before recording.
3. Bookkeeping is a systematic method of recording.
4. The transactions to be recorded should be expressed in monetary terms.
5. It is both a science as well as an art.
6. The recording is done in proper books of accounts such as journal, ledger, and subsidiary books.
7. It gives sufficient information about the position of various accounts.

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## 1.6 IMPORTANCE AND LIMITATIONS OF ACCOUNTING

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A proper accounting system is essential to any business whether big or small in order to manage its daily functions and keeps the business running successfully. For any successful business, the main obligation is to maximise profits, minimise any loss and at the same time maintain its position as a responsible entity within the society.

With the development of commerce, it has attained a position of great importance. Indeed, it can be truly said that accounting has become the foundation on which the whole fabric of modern commerce rests. Though there is no legal obligation on an

ordinary trader to keep the records, every business house finds it essential and convenient to keep the systematic records to know where exactly it stands. Moreover, it is legally binding on some forms of business, such as joint stock companies, to prepare periodically, statements in proper forms showing the position of the business. Being known as “The Language of business,” accounting is one of the methods of communicating information about the business. It is also meant for protecting the properties of business and communicating the results obtained from the financial statements to the intended parties like shareholders, debtors, creditors and investors while meeting the legal requirements.

### 1.6.1 Importance of Accounting

According to Welsch and Anthony, a good system of accounting is a storehouse of valuable information. While there are various advantages of accounting, but a good accounting, system helps:

- To ascertain the profitability and solvency of the business
- To represent the financial stability of a business
- To assess the present position of the business, i.e., profit and loss
- To prepare a comparative analysis of the financial results and the position of trading and non-trading concerns
- The management in taking decisions in adverse situations, price fixation, declaring dividends, etc.
- The company to overcome future uncertainties
- The governments to fix the tax rate, subsidies, etc.
- The company in taking decisions
- To provide information to various parties such as owners, creditors, investors, governments, etc.

### 1.6.2 Limitations of Accounting

The main limitations of accounting are as follows:

- Accounting records only those transactions, which can be measured in monetary terms. It means non-monetary factors are not considered in accounting.
- Accounting transactions are recorded in the books at the price paid, that is, the cost. The effect of price-level changes is not brought into the books because the comparison of the various years becomes difficult.

*Example:* The sale to total asset in 2009 would be much higher than in 2002 due to the rising prices and fixed assets are being shown at the cost and not at the market value. In other words, accounting does not disclose the present value of all assets of the business.

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## 1.7 USERS OF ACCOUNTING INFORMATION

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Accounting provides useful and meaningful information of the business. It provides information about the activities of the organisation to various individuals or groups for their use in making judgements. Accounting information helps users to make better financial decisions. Users of financial information may be both internal and external to the organisation.

### 1.7.1 Internal Users

Internal users of accounting information include the following:

- **Management:** Managers need accounting information for analysing the organisation's performance and position and taking appropriate measures to improve the company's results. They use accounting information in an appropriate manner so that various functions such as planning, organising, controlling, coordinating, etc., can be performed.
- **Employees:** Employees need information for assessing company's profitability and its consequence on their future remuneration and job security. Their decisions are based upon perception of business status acquired through financial statements.
- **Owners:** Owners invest their capital in business. They want to analyse the viability and profitability of their investment and determine any future course of action. They are interested to know the profits or losses of the business and its financial position as well on a particular date.

Accounting information is presented to internal users usually in the form of management accounts, budgets, forecasts and financial statements.

### 1.7.2 External Users

External users of accounting information include the following:

- **Creditor:** Creditors are the persons who provide long-term finance or supply goods on credit. They are interested in knowing the credit worthiness of the business. Terms of credit are set according to the assessment of their customers' financial health. Creditors include suppliers as well as lenders of finance such as banks.
- **Tax Authorities:** These authorities need information for determining various tax liabilities, i.e., sales tax, wealth tax, income tax, etc.
- **Investors:** Investors, i.e., the existing and potential investors have direct interest in business and they need information about the past performance and its earning potential and growth prospects in the future. Investors want to make sure that they can earn a reasonable return on their investment before they commit any financial resources to the business.
- **Customers:** Customers want high quality goods at a reduced price. The price decision is based on the cost of production plus the estimated profit margin. They require information for assessing the financial position of its supplier, which is necessary for a stable source of supply in the long-term.
- **Government:** The government is interested in knowing the financial statements of an enterprise for assessing the income tax, VAT, excise duty, GST etc. Information is also required in order to fix the tax rates, introduce new rates, computing national income, getting reports on the performance, cost structure of the business.
- **Unions:** These groups want information regarding profit and financial position of the business enterprise to realise their demands.
- **Regulatory Authorities:** These agencies need accounting information for ensuring that the company's disclosure of accounting information is in accordance with the rules and regulations set in order to protect the interests of the stakeholders, who rely on such information in forming their decisions.



- **Researchers:** They need information in order to study deeply the financial operations that can enhance their practical knowledge in accounting. Financial accounting generates reports and statements by which the researchers can evaluate how well a business has achieved its goals and its financial strength.

External users are communicated accounting information usually in the form of financial statements. The purpose of financial statements is to cater for the needs of such diverse users of accounting information in order to assist them in making sound financial decisions.

Accounting is a very dynamic profession, which is constantly adapting itself to the varying needs of its users. Over the past few decades, accountancy has branched out into different types of accounting to cater for the different needs of the users.

## 1.8 ACCOUNTING AS AN INFORMATION SYSTEM

Earlier, the accounting work was manual and accounting department used to take excessively long time in processing the transactions and generating the accounting reports. The modern technology has enabled the accounting department in:

- Eliminating the redundancy
- Reducing the number of people involved in processing of transaction by removing the unnecessary control points
- Posting the transactions from electronic voucher to ledger, preparing the trial balance, profit and loss account and balance sheet. The accounting information system is divided into the given sub-systems, as shown in Figure 1.1.

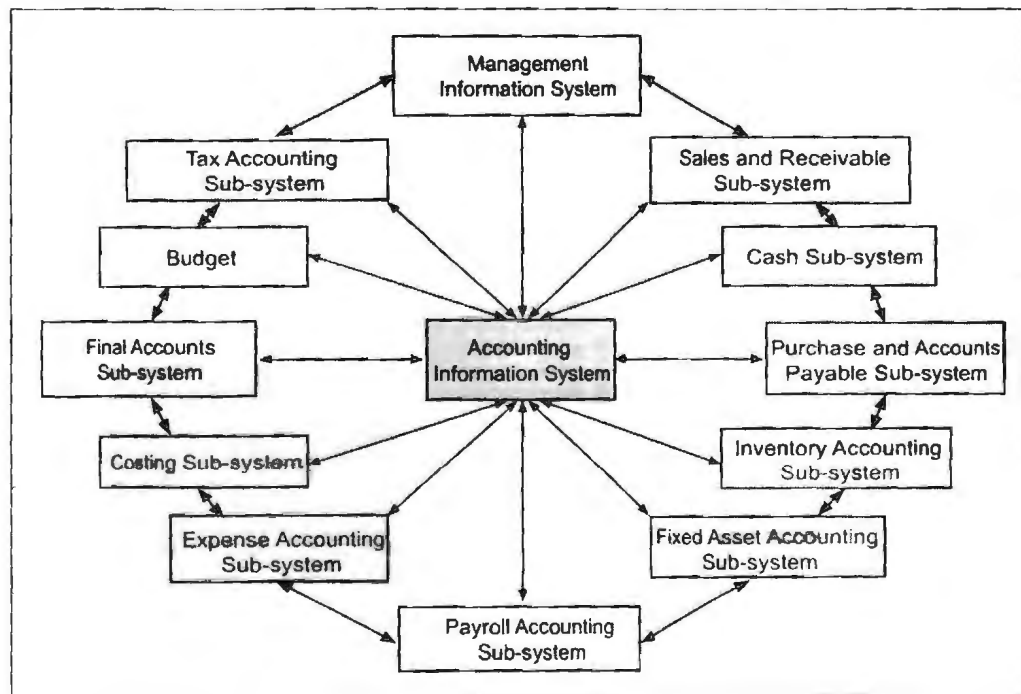


Figure 1.1: Accounting Information System

Accounting Information System (AIS) is the collection, storage, processing of financial, and accounting data that are used by decision makers. An accounting information system is generally a computer-based method for tracking accounting activity in conjunction with information technology resources. The resulting statistical reports can be used internally by management or externally by other interested parties including investors, creditors and tax authorities.

Six elements compose the typical accounting information system:

1. **People** – the system users
2. **Procedure and Instructions** – methods for retrieving and processing data
3. **Data** – information pertinent to the organisation's business practices
4. **Software** – computer programs used to process data
5. **Information Technology Infrastructure** – hardware used to operate the system
6. **Internal Controls** – security measures to protect sensitive data

Accounting provides a vital service by supplying the information to the decision-makers. It is a link between business activities and decision-makers. Accounting is a process of recording, processing and communication of information to the ultimate users.

Accounting Information System (AIS) combine the study and practice of accounting with the design, implementation and monitoring of information systems. Such systems use modern information technology resources together with traditional accounting controls and methods to provide the users the financial information necessary to manage their businesses.

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## 1.9 ACCOUNTING PRINCIPLES

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A general law or rule adopted or professed as a guide to action, a settled ground or basis of conduct or practice is known as principle.

A principle is said to have relevance if it results in more meaningful and useful information about the business to the users. It is said to be objective when the information furnished is not influenced by the bias or personal judgement of those furnishing the same. It is objective when it is supported by facts. A principle is said to be feasible when its adoption does not create problems of collecting information or increasing the cost. Thus, a principle has three attributes, namely, relevance, objectivity and feasibility.

Accounting principles are broadly classified into three categories, these are:

1. Basic Accounting Assumptions
2. Basic Accounting Principles (Concepts)
3. Modifying Accounting Principles (Conventions)

### 1.9.1 Basic Accounting Assumptions

- **Separate Business Entity:** A business firm or enterprise is regarded as a separate person or entity by itself. It is considered as a separate entity by its owner(s). For example, 'R' is the owner of 'R—Enterprise'. But for accounting and legal purposes, 'R—Enterprise' is one person and 'R' is another person. This assumption helps in keeping the business transactions strictly free from the effect of personal affairs of the owner. This helps to look at the business objectively. It helps in the continuity of that business even if the owner changes. It also helps to look at the properties of the business and its responsibilities towards others, as two different aspects.

For instance, if 'R' has invested cash of ₹ 2,00,000 in 'R—Enterprise' then from the point of 'R—Enterprise' on one hand the enterprise has a cash property of ₹ 2,00,000 and on the other hand, it has a responsibility to return it to 'R' finally.

In accounting terms, the property is called **asset** and the responsibility is called **liability**.

Thus the 'separate entity' concept helps to identify asset and liability of the business. It also helps to look at two sides of the same transaction. Here, on one side the business 'R—Enterprise' is able to consider ₹ 2,00,000 cash as asset and on the other, the same is a liability towards the owner 'R'. In a similar way, suppose 'K' has agreed to lend ₹ 3,00,000 to 'R—Enterprise' for some reason. Now the property side increases by ₹ 3,00,000 cash while there is an additional liability towards 'K' let us write these in a format.

**R Enterprise**

Property or asset ₹	Responsibility or liability ₹
Cash from R 2,00,000	Towards R 2,00,000
Cash loan from K 3,00,000	Towards K 3,00,000

As a matter of practice and conventionally we could show the above as follows:

**R Enterprise**

Liabilities	Assets
R 2,00,000	Cash 5,00,000
K 3,00,000	

The second one is acceptable globally. We thus introduced here how 'one' transaction can have two faces just as a coin has two faces. This has its own conveniences too. It is easy to verify or cross check in case one of them is recorded wrongly. You would notice that it helps to keep the two sides balanced i.e., the total of each side is equal (₹ 5,00,000)

- **Going Concern Concept:** It is expected that 'R Enterprise' continues its existence. Any other person or institution such as 'K' dealing with the former would like to be sure that 'R Enterprise' will go on functioning. This is important as 'K' will expect the amount to be returned over a period of time as the business of 'R Enterprise' does well. As per International Accounting Standards, it is a fundamental accounting assumption underlining the preparation of financial statements. Under this assumption, "the enterprise is normally viewed as a growing concern, that is, as continuing in operation for the foreseeable future. It is assumed that the enterprise has neither the intention nor the necessity of liquidation or of curtailing materially the sale of its operations". Under this assumption, the assets of the business are valued by the accountants on the basis of going concern concept, historical cost and expected life of the assets.

- **Money Measurement Concept:** As per this assumption, only those transactions of the business are recorded in the accounting which can be measured in money.

For example, if R has invested ₹ 200000 in the "R—Enterprise" then it can be recorded in the books of "R—Enterprise" but on the other hand, if R has put a lot of efforts for the welfare of the company then the efforts cannot be measured in terms of money.

- **Accounting Period Assumption:** According to this assumption, it is assumed that R Enterprise will prepare its final records for a particular time period. Generally this segment of time is one year either calendar year or a financial year. Sometimes, it may be less than twelve months i.e., quarterly, half yearly, etc. Reports made for less than twelve months are called interim reports and are less reliable than annual reports. At the end of each segment (period) profit and loss account (accounts prepared to calculate the net profit for a time period) and

balance sheet (balance sheet is the record of all assets and liabilities of the organisation) are prepared. As per the going concern concept, the income of the business can be measured at the time of the liquidation (when company is going to close) of the business or at the time when business is sold. But practically it is very difficult to wait for such a long period which is not definite. So it is important to prepare the final accounts for a particular time period.

### 1.9.2 Basic Accounting Principles (Concepts)

These basic accounting principles are commonly accepted/agreed principles by the accountants to record the business financial transactions. These are as follows:

- **Revenue Reorganization Principle:** It is also called revenue realization principle. As per this principle, the revenue is recorded in accounting when the sales have taken place. If there is expectation that there will be a particular transaction in future, that is not recorded in accounting. Revenue/sales is considered to be made when title of ownership of goods passes from the seller to buyer and the buyer become legally liable to pay.

For example, if R Enterprise is expecting that S Ltd. will purchase some goods from their company in future than it cannot record it as a sales transaction in the books of accounts. The transaction will be recorded only when there is actual transfer of goods by R Enterprise to S Ltd.

However, this principle has some exemptions which are as follows:

- ❖ In the case of sales made on the basis of hire purchase system where ownership is not transferred at the time of sales but transferred at the time of final payment. Herewith, sales are presumed to the extent of instalments received.
- ❖ In the case of contract accounts, if the contract is for a long period, revenue cannot be realized until the contract is not completed. Here, only a part of total revenue is treated as realized.
- **Cost Principle:** This principle is closely related to the going concern concept. As per this principle, every transaction of the business should be recorded at its historical cost and not at its market price. At the time of recording of the transactions, their market price is not considered.

For example, if a Machine is purchased by “R—Enterprise” for ₹ 1 lakh and its market price is ₹ 2.50 lacs, then recording of this transaction is done at ₹ 1 lakh being its actual cost/or cost of its acquisition.

Sometimes its market price may be less than or more than its actual cost but its actual cost is recorded in accounts because of cost principle. Under this principle, the historical cost of a transaction becomes the base cost for the subsequent years.

- **Dual Aspect Principle:** This is the basic principle of accounting. As per this principle, every financial transaction of the business has dual effect and recorded at two places. Therefore, it is called double entry system. On the basis of this principle, it is said that every debit must have an equivalent credit and every credit must have an equivalent debit because every transaction of the business has two aspects.

For example, if Mr. R started business for cash ₹ 2,00,000 there will be two aspects of this transaction. In one aspect cash is coming into business while in the other aspect the business has to pay this amount to Mr. R because Mr. R has given the amount to the business.



This transaction can be expressed in the following equation:

$$\begin{aligned}\text{Capital} &= \text{Assets (Cash)} \\ ₹ 2,00,000 &= ₹ 2,00,000\end{aligned}$$

Here cash (assets) is the resource of the business and capital is the claim of the proprietor as business has to return this amount to the proprietor.

Further if the “R—Enterprise” purchases a furniture of ₹ 20,000 on credit, the above equation will change as follows:

$$\begin{aligned}\text{Capital} + \text{Creditors} &= \text{Cash} + \text{Furniture} \\ ₹ 2,00,000 + 20,000 &= ₹ 2,00,000 + ₹ 20,000 \\ \text{Capital} + \text{Liabilities} &= \text{Assets}\end{aligned}$$

Thus we find that in the above equations the total of assets is always equal to the liabilities. Technically we can say that for every debit there is an equivalent credit. This relationship of assets and liabilities is also called accounting equation.

- **Full Disclosure Principle:** As per this principle, the financial statements should disclose true and fair view so that these may provide accurate and sufficient information to the users of financial statements (the statements which include the financial data for a particular time period). Disclosure principle means to give all the information relating to the economic activities of the business to the owner, creditors and investors. Now-a-days this principle is getting more importance as big business organisations are being run in the form of limited companies. As per Companies Act, 1956, the profit and loss account and the balance sheet of the company must show true and fair view of the company. Therefore, companies are showing foot notes for some items as investments, contingent liabilities, etc., along with the balance sheet.
- **Matching of Cost and Revenue Principle:** The matching concept suggests that the revenue earned in an accounting year is matched with the expenses incurred during the same period to generate that revenue. This matching concept is vital to measure the financial results of a business.

For example, in case of a seasonal business, majority of sales may take place only in four months of a year whereas fixed expenses like salaries, rent, etc., are incurred throughout the year. Matching concept suggests that to find out the profitability, the expenses incurred to generate revenue are to be matched against those revenues.

- **Objectivity Principle:** It is also known as objective evidence concept. As per this principle, the transactions which are recorded in accounting must be on the objective and factual basis. There should be a voucher or documentary evidence behind each entry in the accounting. The entry must be free from personal bias and based on the rational approach. If the entries are made without evidence, it will lose the confidence of the several users of the financial statements about their reliability. For the auditing of the financial statements, there is also a need of objective evidence.

### 1.9.3 Modifying Accounting Principles (Conventions)

Basic accounting assumptions and principles provide us the various rules to prepare the financial statements. If these financial statements are relevant and reliable, they will give many useful information to the various users of the financial statements. In order to prepare the true and fair financial statements, there is a need to modify the

accounting assumptions and principles. These modified accounting principles are as follows:

- **Conservation (Prudence):** According to this principle, all possible losses are taken into account but all probable/unrealized profits/gains are left out. For example, stock can be valued either at cost or market price whichever is lower. Similarly, provision for doubtful debts (Money owed to an organisation, which is unlikely to receive) or provision for depreciation can also be arranged as per the conservatism. It can be a useful tool in such situations but if it is not used properly, it may lead to unfavourable results.

For example, if a machine is purchased and the cost of machine is charged as an expense, then profit as well as assets would be underestimated.

Now-a-days conservatism has been replaced by prudence which means the principle of conservatism is applied by the accountants only in case of doubts or uncertainties with prudence. The theme of the principle of conservatism is an under-statement of profit or assets rather than over-statement of profit or assets.

- **Consistency:** In order to enable the management to compare the results for several years of the business, whatever accounting policy is adopted in one year must be adopted in the coming years.

According to Kohlar, there are three forms of consistency:

- (a) Vertical consistency is used in the different financial statements of the business on the same date. For instance, depreciation on fixed assets is used in the income statement and the balance sheet on the same date.
  - (b) Horizontal consistency enables the comparison of the profit or performance of a business in a year with the performance of another year for example the depreciation methods.
  - (c) Dimensional consistency refers to the same principles or practices of accounting adopted by the different firms in an industry.
- **Timeliness:** Accounting information given in the financial statements must be reliable and relevant. In order to be relevant, information must be given in time. If late and obsolete information is provided, it will hamper the management and the users of the financial statements to take appropriate, timely and rational decision.
  - **Materiality:** According to this concept, materiality means that only a part of information should be disclosed and attached with financial statements which influence the decisions of shareholders, investors and creditors, etc., and the other insignificant details must be ignored. Moreover, an item of information may be material for one purpose while that may be immaterial for other. This is a subjective matter.

For example, the cost of the component may be very much significant for small businessman while it may be insignificant for a large businessman. In one more example, the Companies Act permits to ignore the paise at the time of preparing financial statements because for the income tax purpose the income is rounded off to the nearest ten.

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## 1.10 DIFFERENT BRANCHES OF ACCOUNTING

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The main objectives of accounting are to record the business transactions and to provide the necessary information to the internal and external users of the financial statements.

In order to achieve the above objectives, the accounting is classified into following branches:

- **Financial Accounting:** It is the original form of accounting. It refers to the recording of daily business financial transaction. Recording of the transaction is done in such a way that the profit of the business may be ascertained after a definite period and the picture of the financial position of the business may be presented.
- **Cost Accounting:** As the name indicates, this accounting is related with the ascertainment of cost of the product in a period. Under this system, record of raw materials used in production, wages and labour paid and other expenses incurred on production are kept to control the costs.
- **Management Accounting:** The accounting which provides the necessary information to the management is called management accounting. Under this, the analysis and interpretation of the accounts, prepared by financial accounting, are done in a manner so that the managers may forecast, plan for future and frame the policy.
- **Tax Accounting:** Under tax accounting, the accountants prepare the accounts as per the provisions of taxation. The accounts prepared as per taxation provisions may differ from the accounts prepared as per financial accounting.
- **Inflation Accounting:** The financial statements are prepared on the basis of historical cost which do not present the true picture of the financial position and correct profit or loss of the business due to inflation. Thus the fresh financial statements are prepared keeping in mind the price level changes under inflation accounting.
- **Human Resource Accounting:** Human Resource Accounting means the accounting for human being as now in an organization human beings are treated as an asset like other physical assets. It is recorded in the books like other assets. HRA deals with the measurement of costs on recruiting, selecting, hiring, training, placing and development of the employees in one side and on the other side it deals with the present economic value of the employees. For the determination of the value of human being different methods are used under HRA.
- **Responsibility Accounting:** Responsibility accounting is a special technique of management under which accountability is established according to the responsibility delegated to the various levels of management. Management information and reporting system is instituted to give adequate feedback in terms of the delegated responsibility. Under this system, units of an organization, under a specified authority in a person, are developed as responsibility centre and evaluated individually for their performance.

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## 1.11 DOUBLE ENTRY SYSTEM

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Double entry system is a system wherein every transaction is being recorded in two different ledger accounts.

For example, if a company makes some purchases against cash, two accounts shall get affected:

- (a) Purchase Account
- (b) Cash Account

Since the company has made some purchases, hence purchase account shall be debited and cash account shall be credited.

The double entry system works on an equation which is:

$$\text{Assets} = \text{Liabilities} + \text{Owner's equity}$$

If the transactions are recorded under double entry system, then in that case the assets of the company shall be equal to the sum of the liabilities and owners' equity. Following are some transactions of the business to explain it.

1. Mr. Kamlesh started business with cash of ₹ 2,00,000.

In this transaction, one side cash is coming into business and in the other side, capital is being brought by Mr. Kamlesh. Thus:

$$\begin{aligned} \text{Capital} &= \text{Assets (Cash)} \\ ₹ 2,00,000 &= ₹ 2,00,000 \end{aligned}$$

2. In the next transaction, if a plant of ₹ 50,000 is purchased in cash, this transaction will also leave two sides. In one side, cash is going and in other side, plant is coming. In this situation, the accounting equation will be as follows:

$$\begin{aligned} \text{Capital} &= \text{Plant} + \text{Cash (Assets)} \\ ₹ 2,00,000 &= ₹ 50,000 + (₹ 2,00,000 - 50,000) \end{aligned}$$

3. If loan of ₹ 1,50,000 is taken from the SBI, it will also affect the accounting equation by two sides. In one side, cash will increase and on the other side, liabilities of the business will increase. This affect may be depicted as follows:

$$\begin{aligned} \text{Capital} + \text{Liability (Loan)} &= \text{Plant} + \text{Cash} \\ ₹ 2,00,000 + 1,50,000 &= ₹ 50,000 + (1,50,000 + 1,50,000) \\ ₹ 3,50,000 &= ₹ 3,50,000 \end{aligned}$$

4. If some goods of ₹ 20,000 are purchased on credit, it will also affect the accounting equation in two ways. In one side, it increases the goods and in other side, it increases the liability (creditors). Now the changed form of the above accounting equation will be as follows:

$$\begin{aligned} \text{Capital} + \text{Loan} + \text{Creditors} &= \text{Plant} + \text{Cash} + \text{Goods} \\ ₹ 2,00,000 + 1,50,000 + 20,000 &= ₹ 50,000 + 3,00,000 + 20,000 \\ ₹ 3,70,000 &= ₹ 3,70,000 \\ \text{Capital} + \text{Liabilities} &= \text{Assets} \end{aligned}$$

By observing the effect of above transactions on the accounting equation, we note that total of assets always remains equal to the total of capital and liabilities. Thus the principle of double entry system may be summarized as for every debit side there is an equivalent credit side and vice versa.

### 1.11.1 Advantages of Double Entry System

Double entry system of accounting offers the following advantages:

- **Each and Every Transaction is Recorded:** Under the double entry system, each and every transaction is being recorded, so it allows in keeping the complete accounts.
- **Helps in Matching of Arithmetical Accuracy:** Since the entries are made in two accounts, it helps in matching the arithmetical accuracy of the accounts. as the amount debit accounts are equal to the amount credit accounts.
- **Helps in Making Profit and Loss Account Easily:** It helps in making in profit and loss easily as all the revenues and expenses can be accumulated easily at one place and profit and loss account can be made.



- **Helps in Preparation of the Balance Sheet:** Since the impact on assets and liabilities is also taken simultaneously while making the journal entries, hence it helps in preparation of the balance sheet also.
- **Errors and Mistakes can be Detected:** Since for every transaction entries in two accounts are being made, hence it helps in identifying of the errors and mistakes.
- **Details of all the Transactions can be Obtained:** The details of all information can be obtained very quickly.
- **Total Amount Due and Own by the Creditors and Debtors can be Known:** The total amount payable to debtors and amount due to creditors can be easily known.

### 1.11.2 Disadvantages of Double Entry System

The disadvantages of the double entry system are as follows:

- All the transactions are being booked in two accounts, hence one account is debited and one account is credited, therefore, it results in increase in size of books and it creates the complications.
- The bookkeeping under double entry system requires the expert knowledge.
- The system of the double entry system is quite complicated; hence there is a greater chance of errors and mistakes.

### 1.11.3 Steps Involved in a Double Entry System

Most of the organisations adopts the double entry system, for keeping the books of accounts: hence the steps involved in double entry system can be summed up in the following manner:

- **Passing Journal Entries:** Journal is an original book of accounting and it records the effect of all the transactions. Whenever a journal entry is being passed, two accounts are affected, one account is being debited and other is credited. Hence for each and every monetary transaction a journal entry is being passed.
- **Preparation of Ledgers:** Once the Journal entries are being passed, the next step comes in of preparing the ledgers, it is a collection of the accounts, and it helps in doing the grouping of accounts.
- **Trial Balance Preparation:** The next step is preparing Trial Balance; it is a summary balance of the ledgers account.
- **Preparation of Final Accounts:** Then finally the income statement and balance sheet is being prepared.

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## 1.12 TYPES OF ACCOUNTS

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The objective of the bookkeeping is to keep the complete records of each and every transaction, normally any kind of business transactions classified into the following categories:

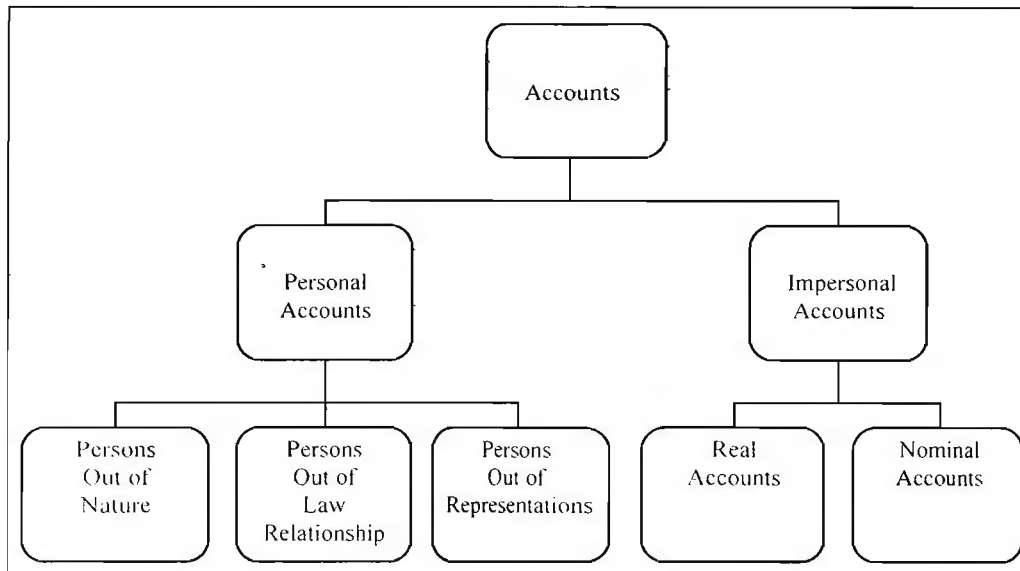
- Transactions which are related to persons.
- Transaction which are related to properties and persons.
- Transactions which are related to the expenses and income of the organisation.

The accounts are of following types:

- **Personal Accounts:** Personal accounts are the accounts, which records the transactions related to the persons.

- **Real Accounts:** Real accounts are the accounts which records the transactions related to the properties and assets.
- **Nominal Accounts:** Nominal accounts are the accounts, which records the transactions related to the expense and income.

Further it can be explained in the following manner:



**Figure 1.2: Types of Accounts**

All accounts of the enterprise are broadly classified into two categories, viz, Personal accounts and Impersonal accounts. Impersonal accounts are further classified into two categories, viz, Real accounts and Nominal accounts.

### **Personal Accounts**

It is an account which deals with a due balance either to or from these individuals in a particular period. A personal account normally reveals the outstanding balance of the firm to individuals e.g., suppliers, or outstanding balance from individuals e.g., customers. This is the only account that emphasizes the future relationship between the business firm and the individuals.

Personal accounts can be classified into three categories:

- **Persons of Nature:** Persons who are nothing but outcome of nature i.e., the Almighty.
- **Persons of Artificial Relationship:** Persons who are made of artificial relationship through legal structure are known as—organisations, corporate, partnership firms and so on. The companies and partnership firms are governed by the Companies Act 1956 and the Partnership Act. The relationships among the owners of the company or partners of the firm are totally structured through respective laws.  
For example, LIC, SBI, etc., companies are the most important examples of the entities governed by the artificial relationship among the members through LIC Act, SBI Act and the Companies Act and so on.
- **Persons of Representations:** This classification represents the amount outstanding or prepaid in connection with the individual transactions.

### **Receiver of the Benefits**

For example, the credit sale of the goods worth of ₹ 1,500 to Mr. X. In this transaction, Mr. X is the receiver of the benefits through the credit sale of the firm.

Till the collection of the benefits of the sale, the firm should maintain the relationship of business with Mr. X in the book of accounts.

#### *Giver of the Benefits*

For example, the credit purchase of the goods worth of ₹ 3,000 from Mr. Y. The giver of the goods is nothing but the supplier of the goods. Mr. Y should be recorded in the books of the firm till the payment of dues of the credit purchase. The future relationship is maintained in the book of the accounts till the payment process is over.

Debit the Receiver Credit the Giver
--

#### *Impersonal Accounts*

Impersonal accounts are all accounts other than the personal accounts. In the accounts of the nominal ledger, we have different types of expenses for different purposes like rent, insurance, telephone and others. As these expenses are related NOT to the person to whom the money is paid and more concerned towards the reason for payment these are known as IMPERSONAL accounts.

#### *Real Accounts*

It is a major classification that highlights the real worth of the assets. This is an account that specially deals with the movement of the assets. It is an account that reveals the value and movement of the assets taking place between the firm and other parties due to any transactions.

The movement of the assets can be classified into two categories, viz.: the assets which are coming into the firm and the assets which are going out of the firm.

Whenever any movement of the assets take place with reference to any transactions either coming into the firm or going out of the firm, they should be recorded in accordance with the set golden rules of this account.

Debit What comes in Credit What goes out
---

#### *Nominal Accounts*

This is an account that deals with the amount of expenses incurred or incomes earned. It includes all expenses and losses as well as incomes and gains of the enterprise. This nominal account records the expenses and incomes which are not carried forward to near future.

Debit all the expenses and losses Credit all incomes and gains
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## 1.13 BASIS OF ACCOUNTING

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The basis of accounting systems is discussed below:

- **Cash Basis of Accounting:** Under this basis of accounting, actual cash receipts and actual cash payments are recorded. Cash basis is the method of recording transactions under which revenues, costs, assets and liabilities are reflected in the period in which actual receipt or actual payments are made.

*Example:* 'Receipt and payments account' in case of clubs, societies, hospitals, etc., of cash basis of accounting.

Thus, under the cash basis of accounting, revenues are recognised when cash is received, regardless of the fact whether the time services are provided or products are sold; and expenses are recognised when cash is paid, regardless of the time costs incurred.

- **Accrual or Mercantile Basis of Accounting:** This method of recording transactions records the revenues, costs, assets and liabilities in the period in which they accrue. This basis includes considerations related to outstanding, prepaid, accrued due and received in advance. In the accrual basis of accounting, the income whether received or not but has been earned or accrued during the period forms part of the total income of that period.

*Example:* Sales made on credit will be included in the total sales of the period irrespective of the fact when cash is actually realised.

Under the accrual basis accounting, revenues and expenses are recorded when earned and incurred, accordingly, regardless of time cash is exchanged (i.e., received or paid). Under the accrual basis accounting, revenue is recognised when it is (i) earned (i.e., products are delivered or services are provided), and (ii) realised (i.e., cash is received) or realisable (i.e., it is reasonable to expect that cash will be collected in the future). Under the accrual basis of accounting, expenses are recognised in the period when related revenues are recognised (i.e., the matching principle).

- **Hybrid or Mixed Basis of Accounting:** It is the combination of both the basis i.e., cash as well as mercantile basis. Incomes are recorded on cash basis but expenses are recorded on mercantile basis. Cash basis of accounting is the simplest system whereas accrual basis of accounting is scientific and reliable. Hybrid system of accounting is the most conservative basis of ascertaining income because all possible expenses related to the period, whether they are actually paid or not, are considered whereas income only received in cash is taken into consideration. When all the expenses are taken into account, there is reduction in taxable income. This system is very popular among professionals.

## 1.14 BASIC TERMS OF ACCOUNTING

The basic accounting terms are discussed below:

- **Assets:** Assets are economic resources of an enterprise that can be usefully expressed in monetary terms. Assets are things of value used by the business in its operations.
- **Fixed Assets:** These assets are held on a long-term basis, such as land, buildings, machinery, plant, furniture and fixtures. These assets are used for doing business and not for re-sale in normal course of operation.
- **Current Assets:** These assets are held on a short-term basis such as debtors (accounts receivable), bills receivable (notes receivable), and stock (inventory), temporary investment in securities, cash and bank balances. Normally, short-term refers to an accounting year.
- **Business Transactions:** Any exchange of money or money's worth as goods and services between two parties is called a transaction. A business transaction is an event, which can be expressed in terms of money.
- **Liabilities:** Liabilities are the obligations or debts that the enterprise must pay in money or services at some time in the future. They are as follows:
  - ❖ **Long-term Liabilities:** Liabilities that are usually payable after a period of one year are long-term liabilities.

*Example:* A term loan from financial institution or debentures (bonds) issued by the company.

- ❖ **Short-term Liabilities:** Liabilities that are obligations and payable within a period of one year are short-term liabilities.

*Example:* Creditors (accounts payable), bills payable (notes payable), and cash credit overdraft from a bank for a short period.

- **Capital:** Investment by the owners for the use in the business is known as capital. Owner's equity is the ownership claim on total assets. It is equal to total assets minus total external liabilities:

Equities = Assets – Liabilities.

This is also called residual interest. Owner's equity is equal to capital.

- **Creditors/Accounts Payable:** Creditors (accounts payable) are persons and/or other entities that have to be paid by an enterprise an amount for providing the enterprise goods and/or services on credit. The total amount standing due to such persons and/or entities on the closing date is shown on the balance sheet as sundry creditors (accounts payable) on the liability side. Thus, a person to whom money is owing or payable is called a creditor.
- **Debtors/Accounts Receivable:** Debtors (accounts receivable) are persons and/or other entities who owe to an enterprise an amount for receiving goods and services on the credit. The total amount due from such persons and/or entities on the closing date is shown in the balance sheet as the sundry debtors (account receivables) on the asset side. Thus, a debtor is a person who owes money. The amount due from him is called debt.
- **Drawings:** It is the amount of cash or other assets withdrawn by the owner for his/her personal use.
- **Equity:** It is the ordinary shares or risk capital of an enterprise. A claim, which can be enforced against the assets of the firm, is called equity.
- **Expenses:** These are costs incurred by a business in the process of earning revenues. Generally, expenses are measured by the cost of assets consumed or services used during an accounting period. The usual items of expenses are depreciation, rent, wages, salary, interest, costs of heat, light and water, telephone, etc.
- **Expenditure:** Expenditure is the amount of resources consumed. Usually, it is of long-term in nature. Therefore, its benefit is to be derived in future.  
*Example:* Capital expenditure
- **Gain:** Gain is the change in the equity (net worth) arising from change in the form and place of goods and holding of assets over a period whether realised or unrealised. It may be either of capital nature or revenue nature or both.
- **Income:** Income is the increase in the net worth of the organisation from either business activity or other activities. Income is a comprehensive term, which includes profit also. In accounting, income is the positive change in the wealth of the firm over a period. Thus, income is an inflow of assets, which results in an increase in the owner's equity.
- **Insolvent:** A person who cannot pay his debts is called insolvent. His assets are less than his liabilities.

- **Loss:** Loss is the gross decrease in the assets or gross increase in the liabilities. It is the excess of expenses over revenues. It represents reduction in owners' equity due to inability of the firm to recover the assets used in the business.

*Example:* A firm spends ₹80,000 and generates revenue of ₹70,000; there is a loss of ₹10,000, which represents non-recovery of assets consumed in doing business.

- **Net worth:** It is total assets minus total liabilities. Net worth is seldom the true value of a company. Profits of a business increase the net worth whereas losses reduce the net worth of a business.
- **Profit:** Profit is the excess of revenues over expenses during an accounting year. It increases the owner's equity.
- **Purchases:** Purchases are total amounts of goods procured by a business on credit and for cash, for use or sale. In a trading concern, purchases are made of merchandise for resale with or without processing. In a manufacturing concern, raw materials are purchased, processed further into finished goods and then sold. Purchases may be cash purchases or credit purchases.
- **Revenues:** Revenues are the amounts the business earns by selling its products or providing services to customers. These are called 'sales revenues.' Other items and sources of revenues common to many businesses are sales, fees, commission, interest, dividends, royalties, rent received, etc.
- **Stock:** Stock (inventory) is a measure of something on hand—goods, spares and other items in a business.

It is called stock in hand. In a trading concern, the stock in hand is the amount of goods, which have not been sold on the date on which the balance sheet is prepared. This is also called closing stock (ending inventory). In a manufacturing company, closing stock comprises raw materials, semi-finished goods and finished goods on hand on the closing date. Similarly, opening stock (beginning inventory) is the amount of stock at the beginning of the accounting year.

- **Sales:** Sales are the amounts received or due for goods or services sold to customers. Gross sales are total sales before any returns or adjustments. Net sales are after accounting for returns and adjustments. Sales are total revenues from goods sold and/or services sold or provided to customers. Sales may be cash sales or credit sales.

### Check Your Progress

Fill in the blanks:

1. \_\_\_\_\_ is the process of recording financial transactions and keeping financial records.
2. Users of financial information may be both \_\_\_\_\_ and external to the organisation.
3. Under \_\_\_\_\_ the analysis and interpretation of the accounts, prepared by financial accounting, are done in a manner so that the managers may forecast, plan for future and frame the policy.
4. Now-a-days \_\_\_\_\_ has been replaced by prudence which means the principle of conservatism is applied by the accountants only in case of doubts or uncertainties with prudence.
5. \_\_\_\_\_ enables the comparison of the profit or performance of a business in a year with the performance of another year for example the depreciation methods.

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## 1.15 LET US SUM UP

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- Accounting is an extension of bookkeeping. Where bookkeeping ends, accounting begins. Bookkeeping records the business transactions in account books, accounting aims at recording, classifying and summarizing the business transactions in a useful manner.
- Accounting is a base and with its help, various returns, documents, statements, etc., are prepared.
- The main objective of accounting is to maintain a complete and systematic record of business transactions.
- Accounting provides useful and meaningful information to those who have interests in the business.
- A proper accounting system is essential to any business whether big or small in order to manage its daily functions and keeps the business running successfully.
- Accounting information helps users to make better financial decisions. Users of financial information may be both internal and external to the organization.
- Accounting Information System (AIS) is the collection, storage, processing of financial, and accounting data that are used by decision makers. An accounting information system is generally a computer-based method for tracking accounting activity in conjunction with information technology resources.
- The matching concept suggests that the revenue earned in an accounting year is matched with the expenses incurred during the same period to generate that revenue.
- Human Resource Accounting means the accounting for human being as now in organisations human beings are treated as an asset like other physical assets.
- Double entry system is a system wherein every transaction is being recorded in two different ledgers account.
- All accounts of the enterprise are broadly classified into two categories, viz., Personal accounts and Impersonal accounts. Impersonal accounts are further classified into two categories, viz. Real accounts and Nominal accounts.

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## 1.16 LESSON END ACTIVITY

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When financial accounts records all transactions related to a business then why there are different branches of accounts? Prepare a report stating the importance of branches of accounting and give a presentation on it.

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## 1.17 KEYWORDS

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**Accounting Process:** It includes the recording of financial transactions, ledger posting, preparation of financial statements and analyzing and interpretation of them.

**Cost Accounting:** Accounting relating to the ascertainment of cost of the product.

**Management Accounting:** Presenting of accounting information in such a way as to assist the management in taking the important decisions and making the policies.

**Accounting Conventions:** Customs and traditions which guide the accountants to record the financial transactions.

**Hybrid Accounting:** It is the combination of both the basis i.e., cash as well as mercantile basis.

**Accrual Accounting:** It is an accounting method, which measures the performance and position of a company by recognizing economic events regardless of when cash transactions occur.

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## 1.18 QUESTIONS FOR DISCUSSION

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1. Define accounting. What is the need of accounting?
2. What are the basic concepts of accounting?
3. What are the key conventions of accounting?
4. Describe the objectives of accounting.
5. What are the different types of accounts?
6. What are the different branches of accounting?
7. Discuss the concept of double entry system of accounting.

### Check Your Progress: Model Answer

1. Bookkeeping
2. Internal
3. Management Accounting
4. Conservatism
5. Horizontal Consistency

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## 1.19 SUGGESTED READINGS

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- M. P. Pandikumar, *Accounting & Finance for Managers*, Excel Books, New Delhi.
- R. L. Gupta and Radhaswamy, *Advanced Accountancy*.
- V. K. Goyal, *Financial Accounting*, Excel Books, New Delhi.
- Nitin Balwani, *Accounting & Finance for Managers*, Excel Books, New Delhi.



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## LESSON

# 2

## JOURNAL

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- 2.0 Aims and Objectives
- 2.1 Introduction
- 2.2 Journalisation
  - 2.2.1 Characteristics of Journal
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  - 2.7.1 Non-cash Transaction
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- 2.9 Lesson End Activity
- 2.10 Keywords
- 2.11 Questions for Discussion
- 2.12 Suggested Readings

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### 2.0 AIMS AND OBJECTIVES

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After studying this lesson, you should be able to:

- Explain the meaning of journal and its need
- Describe the basic rules for journalisation
- Understand the format and process of journalisation
- Identify the subdivision of journal

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### 2.1 INTRODUCTION

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The first thing that the accounting system takes on is the financial transactions. A transaction is defined as an external event or internal event which gives rise to a change affecting the operations or finances of an organisation. There should be

evidence that a transaction has taken place. This evidence comes from the documents that are used to support a transaction/like invoices, receipts, cheques, bank statements, etc. For recording a transaction, it must be analysed to determine its effects on the two (or more) accounts and the reason why it affects those accounts. As the original document cannot be used to write these details, a standard document known as a voucher is used to accompany the original document. Voucher is therefore the basic unit of an accounting transaction. Every voucher mentions the two (or more) accounts that are being affected, the amount with which each account is affected and the reason for the transaction (known as narration). Each voucher is numbered and dated, that makes referencing easier. Once, the vouchers are made for the day, they are entered into the primary book known as journal. Vouchers are normally recorded in the order in which they occur. Journal entries contain all relevant information pertaining to a transaction. This data from the journal has to be rearranged to assist in analysis.

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## 2.2 JOURNALISATION

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Journal is the book of original entry in which business transactions are recorded date-wise and serial-wise. The word Journal has been derived from the French word 'jour' that means 'day'. Hence, it is a book for recording daily business transactions, according to the double entry system. In order to provide a chronological record of business transactions, where each transaction is set down with relevant supplementary information, it becomes necessary to have some preliminary book, i.e., journal. The process of recording transactions in a journal is called journalising. The form or manner in which transactions are recorded in the journal is called 'journal entry'. Journal is also called a book of original entry because various ledger accounts are recorded and/or posted from this book. In other words, as transactions occur they are recorded first in the journal.

According to Carter, "The journal or daily record as originally used is a book of prime entry in which transactions are copied in order of date from a memorandum or waste book. The entries as they copied are classified into debits or credits, to facilitate there being correctly posted afterwards in the ledger."

According to L.C. Cropper, "A journal is a book, employed to classify or sort out transactions in a form convenient for their subsequent entry in the ledger".

### 2.2.1 Characteristics of Journal

The following are the characteristics of journal:

1. Journal is a book of original entry.
2. It keeps a chronological record of the transactions i.e., according to occurrence of the transactions.
3. It helps the ledger, which is the principal book of accounts.
4. Journal gives a complete picture of each transaction, which helps in maintaining the identity of the transaction.
5. It tells the true nature of every transaction with the help of narration.
6. It is also known as daybook.

### 2.2.2 Advantages of Journal

Journal has the following merits:

- **To understand double entry system:** Journal is an important part of the double entry system. The study of journal helps in understanding the double entry system. without journal, it is difficult to get knowledge of the double entry system.

- **Date-wise accounting:** It provides a chronological (or in order of date) record of all transactions and hence provides permanent record. This also helps in location of any transaction.
- **Proof:** Journal can be presented as a proof in court, in case of a default in future.
- **Helpful in formation of ledger:** After formation of the journal, the ledger can be formed easily and in an errorless way.
- **Less possibility of errors:** It reduces the possibility of errors as both the aspects of every transaction are written side by side. If transactions are recorded directly in ledger then there is a possibility of errors of more or less debit or credit.
- It also eliminates the need for a reliance on memory of the accounts keeper. Some transactions are of complicated nature and without the journal entries may be difficult, though not impossible.

### 2.2.3 Limitations of Journal

The following are the limitations of the journal:

- **Limited use:** The practical use of the journal is limited. In this, all transactions are not recorded but only those transactions are recorded, which are limited in numbers and which are not written in subsidiary books.
- **More useful for small business:** It is not useful for large businesses, because large organisations have more number of transactions, if all are recorded in one journal then the size of the journal will become big and this will be difficult for one person to maintain.
- **Lack of business information:** In journals, transactions are kept at one place. Therefore, business information can't be received easily. If traders want information about the cash, bank, stock, creditors, debtors, income and expenses, then with the help of the journal, such information cannot be provided.

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## 2.3 FORMAT OF JOURNAL

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The pro forma of a journal is given below and its various columns are also discussed below:

Date	Particulars	Ledger folio	Amount (Dr)	Amount (Cr)
(1)	(2)	(3)	(4)	(5)

**Note:** The columns have been numbered only to make them clearly understandable to the readers otherwise in practice they are never numbered.

1. **Date of Transaction:** With every entry, date is written, on which the transaction has occurred. Year and month is written at the beginning of every page, when the month is changed, then the name of the changed month is written again.
2. **Particulars:** It is an important part of the journal. Debit and Credit side of every transaction is written in this. Firstly, the account is written which is to be debited and the account to be credited is written below the debit entry. Every debit aspect is written in the first line and the word 'Dr' is written at the end of column. In second line, credit aspect is written and the word 'To' is written as few space. After writing of debit and credit of accounts, narration of transaction (in brief) is written in the column of particular.

3. **Ledger Folio or L.F.:** This column contains the page number of the ledger where the account has been opened. It is useful for reference purposes.

It serves the following purposes:

- (a) By writing the page number of L.F. It shows that on which page of ledger the entry has been posted. It provides convenience in any posting in future.
  - (b) For writing of page number, it shows that which entries have been posted. Those entries, which have been posted, their page number will be written in parallel to them.
  - (c) If for any reason, the trial balance is not matched then posting can be verified with the help of these page numbers.
4. **Debit Amount:** The amount of debit is written against the debited account.
  5. **Credit Amount:** The amount of credit is written against the credited account.

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## 2.4 JOURNALISATION RELATED TERMS

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Some terms related to journalising are discussed below:

1. **Source Documents:** These documents always help in recording the transactions in the books of accounts. These are cash memo, invoice, receipt, pay-in-slip, cheque, debit and credit note, etc.
2. **Cash Memo:** The seller issues it to the buyer when goods are sold on cash basis. Cash memo is a printed document, which contains information regarding the name of seller, date, description of goods sold including quantity and rate at which goods were sold. It provides details about cash transactions, which become the basis for recording these transactions.
3. **Invoice:** An invoice is a document, which is prepared when goods are sold or purchased on credit. A sale invoice is prepared to record credit sales. It contains information such as name of the party to whom goods are sold, total amount of sales and description of goods sold. It is prepared in triplicate by the seller. The original copy is sent to the buyer, second copy is sent to the accounts section and the sales department for future retains third copy.
4. **Cheque:** It is a written document drawn upon a specified banker and payable on demand. The name of the party to whom the payment is to be made should be written clearly after the words 'pay to'. The details of the payment through the cheque are also recorded on the counterfoil, which forms the source document regarding payments.
5. **Receipt:** It is issued by the firm who receives cash from customers. It is prepared in duplicate, the original copy is given to the person making payment and the duplicate is kept as record for future. Receipt contains date of issue, amount received, name of the paying party, nature of payment.
6. **Pay in Slips:** This is the standard form issued by the banks for depositing cash or cheque in a bank account. It consists of two parts. The cashier returns one part to the depositor after his signatures while the other part is kept by the bank.
7. **Debit and Credit Notes:** When goods are returned to the supplier or an additional amount is recoverable from a customer, then these notes are prepared. The document becomes debit note for the party from whom money is recoverable and it becomes the credit note for the party who is to recover the amount. Thus, a proper credit note should be sent in case a customer returns the goods.

8. **Account:** It is a statement, which records all transactions related to a particular person or particular asset or a particular head of income or expense at one place. It is in 'T' shape having two sides, left side is debit side and right side is credit side. There are three types of account.

- (a) **Personal Account:** These represent the accounts related to individuals. firms, societies, hospitals, clubs, company, corporation, etc.
- (b) **Real Account:** These accounts record the transactions relating to the assets (tangible or intangible) of business such as Cash A/c, Furniture A/c, Goods A/c, etc.
- (c) **Nominal Account:** Accounts related to incomes expenses, profits, losses are called as nominal accounts such as Interest A/c, Discount A/c, Sales A/c, Wages A/c, etc.

## 2.5 RULES FOR JOURNALISING

Journalising is an act of recording the debit and credit aspects of a business transaction in journal, together with an explanation of the transaction, known as narration. This recording is made according to certain rules, which are called rules of journalising. Two accounts are affected from each transaction in a double entry system. One account is debited and the other account is credited.

### 2.5.1 Traditional Approach

This method is based on the classification of accounts as per double entry system. The rules are:

1. **Personal Account:** The persons receiving the goods or cash are debited, i.e., Debit the receiver, such as ₹ 12,000 were paid to Bawa, then the journal entry will be:

#### Journal

Date	Particulars	L.F.	Amount (Dr) (₹)	Amount (Cr) (₹)
	Bawa Dr To Cash A/c (Being cash paid to Bawa)		12,000	12,000

Similarly, the persons giving goods or cash are credited, i.e., Credit the giver, such as ₹ 25,000 received from Raphel, the journal entry will be:

#### Journal

Date	Particulars	L.F.	Amount (Dr) (₹)	Amount (Cr) (₹)
	Cash A/c Dr To Raphel (Being cash received from Raphel)		25,000	25,000

2. **Real Accounts:** In case of real accounts, anything or cash which is coming to business is always debited and anything or cash which is going out from the business is always credited. i.e., 'Debit is what comes in and Credit is what goes out.'

For instance, if furniture is purchased for cash ₹ 40,000; the entry will be:

**Journal**

Date	Particulars	L.F.	Amount (Dr) (₹)	Amount (Cr) (₹)
	Furniture A/c To cash A/c (Being furniture purchased)	Dr	40,000	40,000

3. **Nominal Accounts:** In this case, all expenses and losses are debited and all incomes and gains are credited, i.e., Debit all expenses and losses, credit all incomes and gains. For example, if wages are paid at ₹ 4200; the entry will be:

**Journal**

Date	Particulars	L.F.	Amount (Dr) (₹)	Amount (Cr) (₹)
	Wages A/c To Cash A/c (Being wages paid)	Dr	4,200	4,200

Similarly, all incomes and gains are credited.

For example, ₹ 15,000 received for commission, the entry will be:

**Journal**

Date	Particulars	L.F.	Amount (Dr) (₹)	Amount (Cr) (₹)
	Cash A/c To Commission A/c (Being commission received)	Dr	15,000	15,000

In brief, the rules of Journalising are:

**For Personal Accounts:**

- Debit the receiver
- Credit the giver

**For Real Accounts:**

- Debit what comes in
- Credit what goes out

**For Nominal Accounts:**

- Debit all expenses and losses
- Credit all incomes and gains

The traditional method suffers from the following defects:

The classification of accounts into personal or real or nominal is rigid to some extent.

There are some accounts, which cannot be conveniently put under any of the categories, e.g., provision for depreciation, provision for bad debts, etc.

It does not give proper explanation for a debit or a credit. For example, a debt of ₹ 500 due from Raphael (a customer) is to be written off as bad.

The entry will be:

	₹	₹
Bad Debts A/c Dr	500	
To Raphel		500

### 2.5.2 Modern Approach

This method is based on accounting equation. Under this method, the accounts are divided into five categories, viz. (1) Assets, (2) Liabilities, (3) Capital, (4) Expenses and Losses and (5) Revenue (i.e., gains and incomes).

Thus, the accounting equation will be:

$$\text{Assets} = \text{Liabilities} + \text{Capital} + \text{Incomes} - \text{Expenses}$$

Or

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

#### Rules under Modern Approach

S. No.	Name of the Account	Debit	Credit
1.	Assets Account	Increase	Decrease
2.	Liabilities Account	Decrease	Increase
3.	Capital	Decrease	Increase
4.	Revenue	Decrease	Increase
5.	Expenses and Losses	Increase	Decrease

This method does not suffer from any shortcoming.

**Example:** From the following particulars, analyse with reason, giving the accounts to be debited and credited by modern approach:

1.	Banji started business with	80,000
2.	Purchased machinery	10,000
3.	Paid wages	800
4.	Received commission	900
5.	Paid telephone bills	1,200
6.	Deposited cash into bank	2,000
7.	Cash sales to Raphel	7,500
8.	Withdrew cash for personal use	2,200

**Solution:**

#### Analysis of Transaction

S. No.	Transaction	Accounts Involved	Account Classification	Increase or Decrease	Debit or Credit
1.	Banji started business with cash	Cash	Asset	Increase	Debit
		Capital	Capital	Increase	Credit
2.	Purchased machinery for cash	Machinery	Asset	Increase	Debit
		Cash	Asset	Decrease	Credit

*Contd...*

3.	Paid wages	Wages	Expense	Increase	Debit
		Cash	Asset	Decrease	Credit
4.	Received commission	Cash	Asset	Increase	Debit
		Commission	Income	Increase	Credit
5.	Paid Telephone bill	Telephone Bill	Expense	Increase	Debit
		Cash	Asset	Decrease	Credit
6.	Deposited cash into Bank	Bank	Asset	Increase	Debit
		Cash	Asset	Increase	Credit
7.	Cash sales to Raphael	Cash	Asset	Increase	Debit
		Sales	Revenue	Increase	Credit
8.	Withdraw cash from business for personal use	Cash	Asset	Decrease	Credit
		Drawings	Capital	Decrease	Debit

Thus, when only two accounts are involved in a transaction, the entry passed to record (such transaction) is called a simple journal entry.

### **Compound Journal Entry**

When there are two or more transactions of similar nature occurring on the same day and either 'Dr' or 'Cr' account in common, such transactions can be recorded in the form of one journal entry instead of making a separate entry for each transaction. Such entry is known as 'Compound Journal Entry'.

For example, on 31<sup>st</sup> March, ₹ 2,500 is paid for salaries and ₹ 1,000 is paid for rent, the following entry will be:

		₹	₹
Salaries A/c	Dr	2,500	
Rent A/c	Dr	1,000	
To Cash A/c			3,500
(for expenses paid)			

Compound entries may be recorded by any of the three ways:

1. One particular account may be debited while several other accounts may be credited.
2. Several accounts may be debited while one particular account may be credited.
3. Several accounts may be debited and several other accounts may be credited, e.g., opening entry.

### **Discount**

It means a deduction, which reduces the received or paid amount from purchases.

For example, Mr. A went to a shop for purchasing a fan whose print rate was ₹ 1,500 and the shopkeeper takes from him ₹ 1,350, then ₹ 150 less received by the shopkeeper from Mr. A is called discount. Discount may be of two types:

1. **Trade Discount:** Trade discount is that discount which is given for promoting sales at a certain percentage on sales, such as discount on clothes, discount on shoes, discount on books, etc. It is not recorded in the books at all; it is deducted from invoice price.



For instance, if a trader sells goods for ₹ 20,000 at 10% discount then the entry will be:

**Journal**

Date	Particulars	L.F.	Amount (Dr) (₹)	Amount (Cr) (₹)
	Cash A/c To Sales A/c (Being goods sold less trade discount)	Dr	18,000	18,000

2. **Cash Discount:** Cash discount is the discount, which is given to debtors by the trader for early payment of price of goods. It is given only when the customer paid the balance in a certain period. As the discount is allowed at the time of making payment, so the cash discount will be recorded in the books. Discount account is nominal account in nature. When discount is allowed at receiving of cash, then discount is debited because it is a loss and when discount is received at payment of cash, then discounted is credited because it is profit.

For example, received cash from Chabala ₹ 37,500 and discount allowed to him ₹ 500. The entry will be:

**Journal**

Date	Particulars	L.F.	Amount (Dr) (₹)	Amount (Cr) (₹)
	Cash A/c Discount A/c To Chabala (Being cash received and discount allowed)	Dr Dr	37,500 500	38,000

Similarly, paid to Banji ₹ 19,750 in full settlement of ₹ 20,000. The entry will be:

**Journal**

Date	Particulars	L.F.	Amount (Dr) (₹)	Amount (Cr) (₹)
	Banji To Cash A/c To Discount A/c (Being cash paid to Banji and discount received)	Dr	20,000	19,750 250

**Table 2.1: Differences between Trade Discount and Cash Discount**

S. No.	Basis of Difference	Trade Discount	Cash Discount
1.	Meaning	Trade discount is given by seller at the time of selling goods at a certain percentage to the customers.	Cash discount is given to customers for immediate or early payment.
2.	Object	The purpose of this discount is to increase in selling.	The purpose of this discount is encouraging early payment.
3.	Treatment	Trade discount is not recorded in the books of accounts.	Cash discount is recorded in the books of accounts.
4.	Allowance	It is an allowance off the selling price.	It is an allowance off the amount due.
5.	Reduction from Invoice	It is deducted from invoice amount.	It is not deducted from invoice amount.

If both the discounts are allowed to a customer, then firstly trade discount is deducted from price of goods. Then cash discount is computed on the balance amount.

**Meaning of Goods**

Goods mean the things, which are bought by trader for the purpose of resale at a profit. In other words, we can say that goods mean those goods in which a trader deals. For instance, books for a bookseller, furniture for a furniture dealer, etc. Goods account can be classified in the following four parts:

1. **Purchases Account:** When goods are purchased then purchases account is debited instead of goods account. It records all the purchases of goods.
2. **Sales Account:** When goods are sold then sales account is credited instead of goods account. It records sales of the goods.
3. **Purchases Return Account:** If goods purchased are returned, then it is called purchases return. This account is credited.
4. **Sales Return Account:** If goods sold are returned then it is called sales return. This account is always debited.

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**2.6 DETERMINATION OF THE NATURE OF TRANSACTIONS WHETHER CREDIT OR CASH**

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Whether a particular transaction is made for cash or credit in case of purchase and sale of goods, it should be determined. Cash transaction is to be treated when the word 'cash' is mentioned and credit when only the name of the person is given but the same will also be treated as cash transaction when neither cash nor name of the person is written therein.

**Example:**

Transaction	Cash or Credit	Reason
Goods sold for ₹ 15,000 in cash	Cash	The word 'cash' is given
Goods sold for ₹ 20,000 in cash to Mr X.	Cash	The word 'cash' is given
Goods sold for ₹ 35,000 to John	Credit	The name of person is given

**Special Transactions**

**Drawings:** When goods or cash are taken/withdrawn by the owner for personal use from the business, then the entry will be:

Drawings A/c To Cash A/c Or To Bank A/c Or To Purchases A/c	Dr	(if cash is withdrawn)   (If withdrawal is from bank)   (If goods are withdrawn)
--	----	--

**Bad Debts:** Sometimes, a certain amount is not realised, or partially, on account of credit sales. The amount, which is not realised, is treated as bad debt. It is a loss, which is debited. The entry will be:

Bad Debts A/c                      Dr  
    To Debtors A/c

**Bad Debts Recovered:** If the debt or an amount which is written off as bad is recovered later on, it becomes a gain for the business and is credited to a newly-opened account called bad debts recovered account. The entry will be:

Cash A/c                              Dr  
    To Bad Debts Recovered A/c

**Life Insurance Premium Paid:** If the insurance premium is paid from his pocket for the life of the proprietor or for the life of any of his family members in case of insurance, then no entry will be passed in the books of the business. But if the insurance premium has been paid out of business money, then the entry will be:

Drawings A/c                        Dr  
    To Cash/Bank A/c

**Income Tax Paid:** Income tax is a tax on the income of the owner/proprietor or partners in case of sole proprietorship and partnership firms. It is the personal liability of the businessman. The entry will be:

Drawings A/c                        Dr  
    To Cash A/c

**Interest on Capital:** It is allowed on capital, the entry is:

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

In fact, it is an expense for the business and, hence, debited. The capital account has been credited because the amount has become due to the proprietor.

**Interest on Drawings:** It is charged from the proprietor on the drawings made by him. The entry will be:

Capital A/c                            Dr or Drawings A/c            Dr  
    To Interest on Drawings A/c

**Interest charged by Bank:** It is an expense and the amount due to bank on this account is a liability. The entry will be passed in the books of the firm:

Interest A/c                            Dr  
    To Bank A/c

**Depreciation:** Depreciation means reduction in the value of an asset due to wear and tear. The entry will be:

Depreciation A/c                    Dr  
    To Asset A/c

(Being depreciation charged on asset)

**Goods given away as charity:** If some goods from the business are given away as charity to any person or institution, it should be debited to charity account and credited to Purchases Account.

**Goods lost by fire or stolen:** If stock is lost by fire, it should be debited to loss of stock by fire and credited to purchases account. However, in case, any part of such loss is recoverable from the insurance company, it should be debited to insurance claim account and credited to loss of stock by fire account.

The entries are:

- (a) Goods lost by Fire/Stolen A/c      Dr  
       To Trading/Purchases A/c  
 (For the original loss)
- (b) Insurance claim A/c                      Dr  
       To Goods Lost by Fire/Stolen A/c  
 (When fully admitted by the insurance company) Or  
 Insurance Claim A/c                      Dr (Admitted portion)  
 Profit and Loss A/c                      Dr (Net loss)  
       To Goods Lost by Fire/Stolen A/c                      or Profit and Loss A/c  
       To Goods Lost by Fire/Stolen A/c  
 (When not admitted by the insurance company)
- (c) When Cash is realised from the insurance company  
 Bank A/c                                      Dr  
       To Insurance Claim A/c

**Purchase of Shares:** When shares or securities are purchased, the entry is made at market value and not at the face value. An expense such as brokerage paid on such investment is also added for investment.

For instance, if shares of ₹ 60,000 are purchased at ₹ 90 and ₹ 300 is paid as brokerage, the purchase price would be ₹ 54,300 (i.e.  $60,000 \times \frac{90}{100} + 300$ ). It is debited to Investment Account and credited to Cash Account. However, in case of sale of shares, the entry should be passed at market value less brokerage, if any, paid.

**Example:** Enter the following transactions in journal of Bbalo:

2015	₹
March 1    Bbalo started business with cash	60,000
March 1    Bought goods for cash	10,000
March 3    Purchased furniture for cash	25,000
March 4    Purchased goods from Peter	15,000
March 5    Sold goods for cash	20,000
March 7    Paid cash to Raphel	14,500
March 9    Received cash from Bbalo	12,000
March 15   Paid wages of ₹ 1,300 and salaries of ₹ 2,200	
March 20   Received commission	850
March 22   Withdrew cash from office for personal use	2,500
March 26   Paid rent	900
March 31   Received Interest	300

**Solution:**

**Journal of Raphel**

Date	Particulars	L.F.	Amount (Dr) (₹)	Amount (Dr) (₹)
2015 March 1	Cash A/c Dr Purchases A/c Dr To Capital A/c (Being business started with cash and goods)		60,000 10,000	70,000
March 3	Furniture A/c Dr To Cash A/c (Being furniture purchased)		25,000	25,000
March 4	Purchases A/c Dr To Peter (Being goods purchased from Peter)		15,000	15,000
March 5	Cash A/c Dr To Sales A/c (Being goods sold for cash)		20,000	20,000
March 7	Raphel Dr To Cash A/c (Being cash paid to Raphel)		14,500	14,500
March 9	Cash A/c Dr To Bbalo (Being cash received from Bbalo)		12,000	12,000
March 15	Wages A/c Dr Salaries A/c Dr To Cash A/c (Being wages and salaries paid)		1,300 2,200	3,500
March 20	Cash A/c Dr To Commission A/c (Being Commission received)		850	850
March 22	Drawings A/c Dr To Cash A/c (Being cash withdrawn for personal use)		2,500	2,500
March 26	Rent A/c Dr To Cash A/c (Being rent paid)		900	900
March 31	Cash A/c Dr To Interest A/c (Being interest received)		300	300

**Example:** Journalise the following transactions:

- Goods worth ₹ 4000 given as charity.
- Received ₹ 7850 from Banji in full settlement of his account for ₹ 8000.

- iii. Sold to Amar worth ₹ 12,000 less 3% cash discount and received ₹ 11,640 net on account by cheque.
- iv. Paid ₹ 450 in cash as wages on installation of machine.
- v. Goods worth ₹ 1000 were damaged in transit; a claim was made on the railway authorities for the same.
- vi. Goods costing ₹ 2500 were supplied to Raphel, issued invoice of 20% above cost less 5% trade discount.
- vii. Purchased 1000 shares in X Ltd. @ ₹ 15 per share, brokerage paid ₹ 150.
- viii. Cash received from the railway in full settlement of claim for damaged in transit.
- ix. Goods worth ₹ 3000 were used by the owner for his personal use.
- x. Received a first and final dividend of 70 paise in a rupee from the official receiver of Mr X. who owed him ₹ 10,000.
- xi. One month's interest on Abale's loan of ₹ 10,000 @ 12% p.a. became due but could not be paid.
- xii. Goods uninsured worth ₹ 6500 were destroyed by fire.

**Solution:**

S. No.	Particulars	L.F.	Amount (Dr) (₹)	Amount (Dr) (₹)
i.	Charity A/c To Purchases A/c (Being goods given as charity)	Dr	4,000	4,000
ii.	Cash A/c Discount A/c To Banji (Cash received and discount allowed)	Dr Dr	7,850 150	8,000
iii.	Bank A/c Discount A/c To Sales A/c (Being goods sold & cheque received after allowing discount)	Dr Dr	11,640 360	12,000
iv.	Machinery A/c To Cash A/c (Being wages paid on installation of machine)	Dr	450	450
v.	Railway Claim A/c To Purchases A/c (Being claim sent to railways for goods damaged in transit)	Dr	1,000	1,000
vi.	Raphel To Sales A/c (Being goods of ₹ 2500 supplied to Raphel at 20% above cost less 5% trade discount)	Dr	2,850	2,850
vii.	Investment in Shares A/c To Cash A/c (Being purchase of 1000 shares in X Ltd. @ ₹ 15 per share plus brokerage ₹ 150)	Dr	15,150	15,150

Contd..

viii.	Cash A/c To Railway Claim A/c (Being cash received in full settlement of claim for damages from railway)	Dr		1000	1000
ix.	Drawings A/c To Purchases A/c (Being goods used by the owner for his personal use)	Dr		3,000	3,000
x.	Cash A/c Bad Debts A/c To Mr X (Being 70% cash received and balance treated as bad debts)	Dr Dr		7,000 3,000	10,000
xi.	Interest A/c To Abale's Loan A/c (Being interest payable on Abale's loan ₹ 10,000 @ 12% p.a. per month)	Dr		100	100
xii.	Goods Lost by Fire A/c To Purchases A/c (Being goods of ₹ 6500 destroyed by fire)	Dr		6,500	6,500

**Recording of Banking Transactions:**

Transaction	Entry
1. Cash deposited into bank	Bank A/c To Cash A/c Dr
2. Cash withdrawn from bank	Cash A/c To Bank A/c Dr
3. Amount withdrawn from bank for personal use	Drawings A/c To Bank A/c Dr
4. When cheques, drafts, etc., received from customers are deposited into bank on the same day	Bank A/c To Personal A/c Dr
5. When cheques, drafts, etc., received from customers are not deposited into bank on the same day	(a) Cash A/c To Customer's A/c Dr (b) Bank A/c To Cash A/c
6. Expenses paid through cheque	Expenses A/c To Bank A/c Dr
7. When the amount is deposited directly by the customers in the bank account	Bank A/c To Personal A/c Dr
8. When received cheque is endorsed	Creditor's A/c To Cash A/c Dr
9. Cheques already deposited into bank. is dishonoured.	Customer's A/c To Bank A/c Dr
10. Payments made through cheque	Personal A/c To Bank A/c Dr

11. (a) Interest charged by bank	Interest A/c	Dr
	To Bank A/c	
(b) Interest allowed by bank	Bank A/c	Dr
	To Interest A/c	
12. When bank charges some amount for the services rendered	Bank Charges A/c	Dr
	To Bank A/c	

**Opening Entry:** Every businessman maintains his books of accounts on a yearly basis. In running a business, the previous year's balance of assets and liabilities will have to be brought forward to the current year's new books of accounts. This is done by means of a journal entry, which is termed as 'opening entry'. Such entry is made on the basis of accounting equation, i.e., by debiting all assets and crediting liabilities and capital account. If the amount of capital is not given in the question, the balancing figure will depict capital, i.e., Assets – Liabilities.

**Example:** From the following particulars of Mr A, pass opening entry as on January 1, 2002:

Cash ₹ 6,000; Bank Loan ₹ 15,000; Capital ₹ 75,000; Building ₹ 50,000; Debtors ₹ 12,000; Furniture ₹ 18,000; Creditors ₹ 7,000; and Stock ₹ 13,000.

**Solution:**

#### Journal

Date	Particulars	L.F.	Amount (Dr) (₹)	Amount (Dr) (₹)
	Building A/c	Dr	50,000	
	Debtors A/c	Dr	12,000	
	Furniture A/c	Dr	18,000	
	Stock A/c	Dr	13,000	
	Cash A/c	Dr	6,000	
	To Creditors A/c			7,000
	To Bank Loan A/c			15,000
	To Capital A/c			75,000
	(Being assets and liabilities brought in new accounting year)			

**Example:** Enter the following transactions in the journal of Mr Bawa.

**Assets:** Cash in hand ₹ 10,000; Cash at bank ₹ 1,200; Stock ₹ 15,000; Debtors ₹ 12,000 (Chabala ₹ 4,600; Raphel ₹ 5,800; Banda ₹ 1,600)

**Liabilities:** Creditors ₹ 3,500 (Raphel ₹ 2,000; Chakwe ₹ 1,500); Bank Loan ₹ 7,000.

Following transactions took place during the month of June 2015:

June 2 Goods sold to Chabala ₹ 2,000.

June 3 Purchased goods from Abale for ₹ 8,000, at a discount of 15% and cash discount of 2.5%, paid 50% amount immediately.

June 4 Received a cheque from Chabala for ₹ 6,500 (discount allowed ₹ 100); cheque deposited into bank.

June 7 Received a cheque from Raphel for ₹ 5,600 in full settlement of his account. This cheque was immediately deposited into the bank.

June 12 Cheque of Raphel dishonoured.

June 16 Deposited into bank ₹ 2,200 for cash sales.



- June 19 Paid Life insurance premium of ₹ 3,500 and insurance premium of office building of ₹ 1,500 by cheque.
- June 21 Banda became insolvent and for 0.6 per dollar could be recovered from his estate.
- June 24 Purchased goods from Tom for ₹ 1,400 and paid by cheque.
- June 27 Sold half of the above goods at a profit of 25% on cost to Jon.
- June 28 Paid interest on loan of ₹ 500.
- June 30 Income tax paid by cheque of ₹ 1,200.

**Solution:**

**Journal of Mr Bawa**

S. No.	Particulars	L.F.	Amount (Dr) (₹)	Amount (Dr) (₹)
2015	Cash A/c	Dr	10,000	
June 1	Cash at bank A/c	Dr	1,200	
	Stock A/c	Dr	15,000	
	Chabala	Dr	4,600	
	Raphel	Dr	5,800	
	Banda	Dr	1,600	
	To Raphel			2,000
	To Chakwe			1,500
	To Bank Loan A/c			7,000
	To Capital A/c (Balancing figure)			27,700
	(Being assets and liabilities brought forward)			
June 2	Chabala	Dr	2,000	
	To Sales A/c			2,000
	(Being goods sold to Chabala)			
June 3	Purchases A/c	Dr	6,800	
	To Cash A/c			3,315
	To Discount A/c			85
	To Abale			3,400
	(Being goods purchased and discount received)			
June 4	Bank A/c	Dr	6,500	
	Discount A/c	Dr	100	
	To Chabala			6,600
	(Being cheque received and discount allowed)			
June 7	Bank A/c	Dr	5,600	
	Discount A/c	Dr	200	
	To Raphel			5,800
	(Being cheque received & discount allowed)			
June 12	Raphel	Dr	5,800	
	To Bank A/c			5,600
	To Discount A/c			200
	(Being Raphelan's cheque dishonoured)			

Contd.

June 16	Bank A/c	Dr	2,200	
	To Sales A/c			2,200
	(Being cash received from sales, deposited into bank)			
June 19	Drawings A/c	Dr	3,500	
	Insurance Premium A/c	Dr	1,500	
	To Bank A/c			5,000
	(Being payment of life insurance and insurance premium by cheque)			
June 21	Cash A/c	Dr	960	
	Bad debts A/c	Dr	640	
	To Banda			1,600
	(Being cash received and bad debts written off)			
June 24	Purchases A/c	Dr	1,400	
	To Bank A/c			1,400
	(Being goods purchased by cheque)			
June 27	Jon	Dr	875	
	To Sales A/c			875
	(Being goods sold on credit i.e. 700 + 25% on 700)			
June 28	Interest on Loan A/c	Dr	500	
	To Cash A/c			500
	(Being interest paid)			
June 30	Drawings A/c	Dr	1,200	
	To Bank A/c			1,200
	(Being income tax paid by cheque)			

## 2.7 SUBDIVISION OF JOURNAL

Journal is an important book for accounting in every business. In a small-sized business, the number of transactions is less; hence, it is appropriate to do accounting in a journal. But in large-scale operations, the number of transactions is more, and then it is not possible to record every transaction in the journal. Moreover, the recording of all the transactions in the journal may lead to delay in getting information. Hence, for convenience, the journal is divided into many books. Each transaction is recorded in a special book according to its nature.

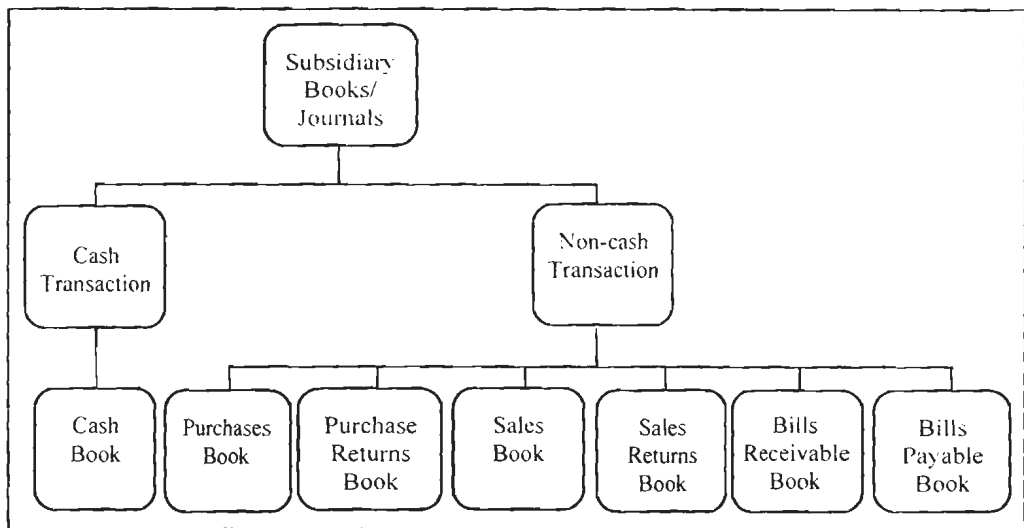
Subdivisions of journal are the division of journal in parts. Subdivisions of journal are beneficial because it reduces the pressure on other journals. The journal can be divided into the following:

- **Cash Book:** In this book, transactions of all cash receipts and cash payments are recorded. All banking transactions are also recorded in this book.
- **Purchases Book:** Goods purchased on credit are recorded in this book.
- **Sales Book:** Goods sold on credit are recorded in this book.
- **Purchases Return Book:** If goods purchased on credit are returned, then they are recorded in this book.
- **Sales Return Book:** If goods sold on credit are returned by customers, then these are recorded in this book.

- **Bills Receivable Book:** Bills of exchanges, promissory notes, and hundis, received from customers are recorded in this book.
- **Bills Payable Book:** Bills of exchanges, promissory notes, and hundis, issued by the business are recorded in this book.
- **Journal Proper:** Any transaction, which is not recorded in the above books, is recorded in this book.

### Classification of Journal

The following are the subsidiary books/journals on the major frequent occurrence of transactions.



**Figure 2.1: Classification of Subsidiary Books**

Subsidiary books are classified on the basis of transactions viz. Cash transactions and Non-cash transactions.

First, let us discuss the Non-cash transactions.

A Non-cash transaction is a transaction in terms of credit and conditions of the enterprise.

The Non-cash transactions shall include the following transactions of the enterprise, which do not involve any cash; they are as follows:

- Credit Sales Book
- Credit Purchases Book
- Credit Sales Return Book
- Credit Purchases Return Book
- Bills Payable Book-Outcome of Credit Transaction and
- Bills Receivable Book-Outcome of Credit Transaction

### 2.7.1 Non-cash Transaction

#### **Purchases Book**

The purchases book is also known as purchase journal. It is a book meant for credit purchases only for resale.

### Pro Forma of the Purchases Book

Date	Name of the Supplier	Ledger Folio	Inward Invoice No.	Amount (₹)

The purchase book usually contains various components viz.:

**Name of the supplier:** From whom the raw material was procured on credit.

**Ledger folio:** It is the number of the page where the journal entry is transacted.

**Inward Invoice No:** This book contains the invoice number of the credit purchase of the goods from the supplier.

**Amount (₹):** The book contains the value of credit purchase transactions from the supplier.

Steps involved in posting the entries:

- Posting the entries pertaining to the individual accounts into the purchase journal.
- The total of the purchase journal is determined monthly and finally should be posted into debit side of the purchase account – to satisfy the rule of Real Account; which not only contains the cash purchase but also the credit purchase of the firm during the year.

### Purchase Returns Book

This is a book of goods returned to the supplier which are out of credit purchases. The return of goods out of the credit purchase is due to non-confirmation with the specification mentioned in the order.

### Pro Forma of the Purchase Returns Book

Date	Name of the Supplier	Ledger Folio	Debit Note No.	Amount (₹)

The purchase returns book consists of various components, viz.:

- **Name of the supplier:** To whom the goods/raw material purchased were returned.
- **Ledger folio:** It is the number of the page where the journal entry is posted.
- **Debit Note No:** It is the page number on the original copy of the document sent to the firm to whom the goods are sent, back/returned.
- **Amount (₹):** The book should illustrate the value of goods/raw materials returned out of credit purchase.

Steps involved in the purchase returns book:

- Posting the entries of the purchase returns to the individual suppliers' account into the purchase return journal.
- The monthly total of the purchase return journal is credited into the purchase return account.

### Sales Book

It is a book maintained by the enterprise only during the moment of selling the goods on credit. It is known in other words as a sales journal.

### Pro Forma of the Sales Book

Date	Name of the Customer	Ledger Folio	Outward Invoice No.	Amount (₹)

The sales book normally contains the following components:

- **Name of the customer:** The sales book usually records the name of the buyer who has been sold the goods or raw materials on credit.
- **Ledger Folio:** The page number where the journal entry is posted/ transacted.
- **Outward Invoice No:** This book registers the invoice number of the goods/raw materials sold out to the buyers on credit.
- **Amount (₹):** It is a fundamental document to earmark the value of the goods/raw materials sold out on credit to the various buyers. It aids the firm in identifying the amount of sales transacted on credit as well as in collecting the amount of dues from the buyers.

Steps involved in the sales book:

- Sales of the goods/raw materials to the individual buyers are entered on a daily basis.
- The monthly total of sales book is credited into the sales account of the firm which includes both the sale transactions of cash as well as credit.

### Sales Returns Book

It is a book that registers the goods sold on credit and received from the buyers. The sales return from the buyers is due to not confirming to the specifications mentioned at the moment of placement of the order. It is known as sales return journal.

### Pro Forma of the Sales Returns Book

Date	Name of the Customer	Ledger Folio	Credit Noted No.	Amount (₹)

The following are the various components dealt in the design of the book:

- **Name of the customer:** It includes the most important information about the buyer who returned the goods/raw materials, because of non-confirmation to specifications of the placed order.
- **Ledger Folio:** It contains the page number of the journal entry posted.
- **Credit Note No.:** It is a number on the original copy of the document sent to the firm from whom the goods are received i.e., the buyer.

Steps involved in the sales returns book:

- Sales returns of the enterprise from the individual buyers are recorded immediately after the transactions.
- The monthly total of the sales return is posted into the debit side of the sales return account in accordance with the rule of real account.

### Trade Bills Book

The trade bills book can be classified into two categories, viz. Bills receivable book and Bills payable book.

1. **Bills Receivable Book:** It is a book maintained especially for promissory notes and bill of exchanges accepted by the customers out of their dues, as an outcome

of credit sale of the enterprise. The bills receivable and promissory notes are nothing but the resultant of the credit sale transactions of the enterprise not only to safeguard the interest of enterprise, but also to collect the dues from the customers as per the terms of the trade agreed earlier.

#### Pro Forma of Bills Receivable Book

Sl. No	Date	From whom Received	Acceptor	Date of the Bill	Term	Date of the Maturity	Where Payable	Amt. (₹)	How Disposed

The various components of the bills receivable book are as follows:

- ❖ *From Whom Received:* Either the bill or promissory received from whom? The name of the party should be entered at the moment of receiving the negotiable instruments of the trade.
- ❖ *Acceptor:* The person/institution who/which accepts the terms of the bill to make the payment.
- ❖ *Date of the Bill:* When the bill is drafted/drawn for obtaining the acceptance of the buyer; who bought the goods on credit.
- ❖ *Term:* Modalities involved in the process of payment of the dues mentioned in the bill.
- ❖ *Date of Maturity:* Date at which the bill is to be presented for collection from the customer.
- ❖ *Where Payable:* The place of amount payable by the customers or buyers who bought the goods on credit.
- ❖ *Amount (₹):* It reveals the amount how much to be collected from the customer through either bill receivable or promissory note.
- ❖ *How Disposed:* The process of the collection done should be recorded for future verification in settling the dues of the customer.

2. **Bills Payable Book:** It is a book of bills payable or promissory notes accepted by the enterprise to the suppliers at the moment of carrying out the credit purchase.

#### Pro Forma of Bills Payable Book

Sl. No.	Date	Name of the Drawer	Payee	Date of the Bill	Term	Date of the Maturity	Where Payable	Amt. (₹)	Remarks

The following are the some of the important components normally included in the book:

- ❖ *Name of the Drawer:* Name of the person or concern, who or which draws the bill. This is nothing but either the name of the seller or manufacturer or supplier of the goods or raw materials.
- ❖ *Payee:* To whom the payment has to be paid.
- ❖ *Date of the Bill:* Normally included to know the date at which the bill was drafted which is under the possession of the seller or supplier.
- ❖ *Date of Maturity:* It is the date at which the payment has to be made as per the terms of trade.
- ❖ *Where Payable:* The place where the amount of the bills is to be paid.

## 2.7.2 Cash Transaction

### Cash Book

Cash transaction is a transaction carried out only in terms of cash. The cash transactions are recorded in the subsidiary book known as the cash book. The cash book can be classified into following categories:

- Single Columnar Cash Book
- Double Columnar Cash Book
- Three Columnar Cash Book
- Petty Cash Book

#### Single Columnar Cash Book

It is a book that generally records the transactions into two classifications, viz. Payments and Receipts. The receipts and payments are recorded in the debit and credit side of the cash book respectively. The debit and credit side transactions of the cash book are prefixed with "To" and "By" respectively.

#### Pro Forma of the Single Columnar Cash Book

Dr.		Cr.	
Date	Receipts (₹)	Date	Payments (₹)
	To Opening Balance B/d		By Closing Balance B/d

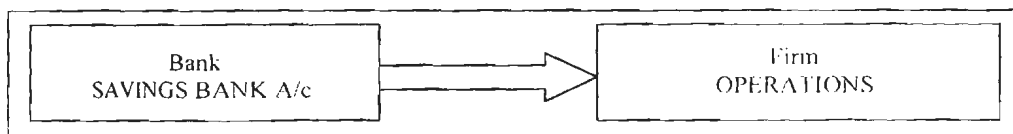
#### Double Columnar Cash Book

It is another kind of cash book which is nothing but an extension of the single columnar cash book. The double columnar cash book includes the operations of the enterprise into two different categories viz. transactions through Cash and Bank. It means that the entire receipts and payments of the business routed through cash and bank. The transaction of the business with the bank either at the moment of cash withdrawal or cash deposit leads to registering the movement of cash from one entity to another through the contra entries.

The contra entries are posted in two different occasions viz. cash withdrawal and cash deposit.

During the cash withdrawal, the movement of cash is depicted below for easier understanding, which is nothing but the movement of the asset from bank to firm.

#### Cash Withdrawal



#### Transaction No. 1

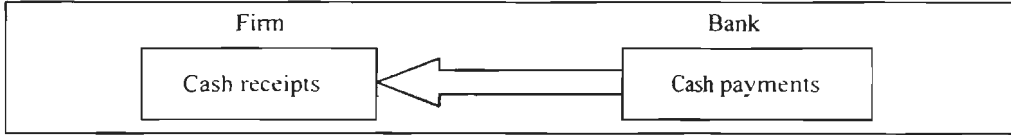
Jan. 5, 2016, Cash withdrawal ₹ 10,000 from the bank is having the following journal entry:

Cash A/c	Dr	₹ 10,000
To Bank A/c		₹ 10,000

(Being cash withdrawn from the bank A/c)

From the above entry, it is obviously understood that the bank is the giver of the cash resources from the savings bank A/c and cash receipts are made only due to withdrawal of cash from the bank

There are two different angles of cash withdrawal; one is in the dimension of firm and another is bank.

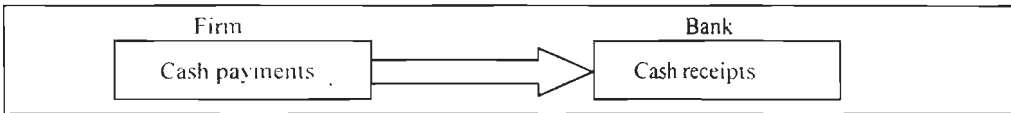


**Transaction No. 2**

Jan 20, 2016: Cash deposit has a similar kind of process to post a contra entry, just opposite to the entry of cash withdrawal. Cash deposit of ₹ 5,000 in the bank account. The following is the journal entry for the cash deposit:

Bank A/c	Dr	₹ 5,000
To Cash A/c	Cr	₹ 5,000

(Being cash deposited into the bank account)



**Pro Forma of Double Columnar Cash Book**

Dr.				Cr.			
Date	Receipts	Bank	Cash	Date	Payments	Bank	Cash
Jan 5	To Balance B/d			Jan 5	By Balance c/d*		
	To Bank C1		10,000		By cash C1	10,000	
Jan 20	To Cash C2	5,000		Jan 20	By Bank C2		5,000
					By Balance B/d		

\* Bank overdraft

The above table of double columnar cash book clearly elucidates the contra entry process taking place between the two entities, viz. firm and bank.

**Three Columnar Cash Book**

It is another dimension of cash book which has three components of operations of the enterprise viz. cash, bank and discount. This cash book is an extension of the early one, not only allows and incorporates the receipts and payments of the firm through cash and bank, but also discount allowed and received.

**Pro Forma of Three Columnar Cash Book**

Dr.					Cr.				
Date	Receipts	Bank	Cash	Discount Allowed	Date	Payments	Bank	Cash	Discount Received
	To Balance b/d					By Balance c/d			
						By Balance b/d			



**Why is discount allowed brought under the debit side?**

The discount is allowed at the time of receipts out of sale. The discounts are categorized into two categories, viz. cash discount and trade discount.

Cash discount is the discount allowed by the firm, only at the moment of making the payment within the stipulated time frame. 7% @ 10 days means that 7% discount will be given to the parties who are able to make the payment of dues within 10 days of the stipulated time period.

Trade discount is the discount allowed by the firm to encourage the regular customers to buy more and more. This type of discount is allowed by the firm only on the total value of the invoice. The discount is granted on the gross value of the goods purchased by the regular customer from the enterprise.

**Why is discount received brought under the credit side?**

The reason for showing the discount received under the credit side of the cash book is that the amount of discount received is availed only during the moment of payment of overdues only due to credit purchase.

**Petty Cash Book**

It is a book maintained by the petty cashier who is especially appointed for the purpose of assisting the cashier of the business enterprise in order to meet the day to day expenses that are meager in volume. The cashier normally hands over a certain sum of money to the petty cashier to meet tiny expenses of the enterprise based on the early estimation on the daily requirement e.g., postage, refreshment charges. The meagre amount that is given by the cashier is known in other words as petty cash or float. The vouchers and receipts are finally examined by the cashier based on the presentation of petty cash book balance.

Given below is the pro forma of petty cash book:

**Analytical Petty Cash Book**

Receipts (₹)	Date	Particulars	Voucher No.	Total Amount (₹)	Printing and Stationery	Cartage	Postage

**Example:** From the following particulars, write up the Cash Book of M/s K.K. of Chennai with Cash and Bank columns and bring down the final balance:

2016		₹
Oct. 1	Cash in hand	100
Oct. 1	Cash at bank	3,500
Oct. 5	Paid salary by cheque	250
Oct. 7	Paid to K.K. & Co. by cheque	260
Oct. 9	Received a cheque from B & Co.	2,500
Oct. 12	Bought goods for cash paid by cheque	750
Oct. 15	Received cash from M/s S. Chand	1,500
Oct. 17	Deposited cash into bank	1,450
Oct. 18	Sundry creditors were paid by cheque	1,250
Oct. 19	Received from debtors by cheque which could not be sent to bank	1,780
Oct. 20	B & Co. cheque dishonoured	2,500
Oct. 22	B & Co. paid cash	2,500
Oct. 24	R & Co. issued a cheque for ₹ 470 in full satisfaction of his account for	500
Oct. 27	Shyam Lal was paid ₹ 395 in full settlement of his A/c amounting to	400
Oct. 31	Deposited into the Bank	2,200

**Solution:**

**Three Columns Cash Book**

Date	Particulars	L.F.	Discount (₹)	Cash (₹)	Bank (₹)	Date	Particulars	L.F.	Discount (₹)	Cash (₹)	Bank (₹)
2016						2016					
Oct. 1	To Balance b/d			100	3,500	Oct. 5	By Salaries A/c			—	250
Oct. 9	To B & Co.			—	2,500	Oct. 7	By K & Co.			—	260
Oct. 15	To S Chand			1,500		Oct. 12	By Purchase A/c			—	750
Oct. 17	To Cash A/c	(C)		—	1450	Oct. 17	By Bank A/c	(C)		1450	—
Oct. 19	To Debtors A/c			1,780	—	Oct. 18	By S. Creditors			—	1250
Oct. 22	To B & Co			2,500	—	Oct. 20	By B & Co			—	2,500
Oct. 24	To R & Co		30		470	Oct. 27	By Shyam Lal		5	395	
Oct. 31	To Cash A/c	(C)			2,200	Oct. 31	By Bank A/c	(C)		2,200	
							By Balance c/d			1,835	5,110
			30	5,880	10,120				5	5,880	10,120

**Example:** Enter the following transactions in Analytical Petty Cash Book:

2016		₹
Jan. 1	Received cheque from head cashier	100.00
Jan. 2	Paid for postage	15.00
Jan. 3	Stationery purchased	5.00
Jan. 14	Paid for cartage	8.00
Jan. 18	Paid for travelling	7.00
Jan. 27	Tea for guests	6.00
Jan. 29	Office cleaning charges	12.00
Jan. 30	Paid for carriage	4.00
Jan. 31	Extra postage charges	8.00

**Solution:**

**Analytical Petty Cash Book (2016)**

Receipts	Date	Particulars	Voucher No.	Total Amount	Postage	Stationery	Cartage Travelling	Tea & office expenses (₹)
100.00	Jan. 1	To cash a/c		—				
	Jan. 2	By Postage		15.00	15.00	—	—	—
	Jan. 3	By Stationery		5.00	—	5.00	—	—
	Jan. 14	By Cartage		8.00	—	—	8.00	—
	Jan. 18	By Travelling		7.00	—	—	7.00	6.00
	Jan. 27	By Tea for guest		6.00	—	—	—	12.00
	Jan. 29	By office cleaning charges		12.00	—	—	—	—
	Jan. 30	By Carriage		4.00	—	—	—	—
	Jan. 31	By Extra postage		8.00	8.00	—	4.00	—
				65.00	23.00	5.00	19.00	18.00
		By Balance c/d		35.00				
		Total		100.00				
100.00	Feb. 1							
35.00	Feb. 1							
65.00		To Balance b/d						
100.00		To Cash						

**Check Your Progress**

Fill in the blanks:

1. Journal is also called a book of \_\_\_\_\_ entry because various ledger accounts are recorded and/or posted from this book.
2. After writing of debit and credit of accounts, \_\_\_\_\_ of transaction (in brief) is written in column of particulars.
3. An \_\_\_\_\_ is a document, which is prepared when goods are sold or purchased on credit.
4. Accounts related to incomes expenses, profits, losses are called as \_\_\_\_\_ accounts.
5. \_\_\_\_\_ of Journal is beneficial because it reduces the pressure on other journals.

**2.8 LET US SUM UP**

- Journal entries contain all relevant information pertaining to a transaction.
- The process of recording transactions in a journal is called journalising. The form or manner in which transactions are recorded in the journal is called 'journal entry'.
- Journal gives a complete picture of each transaction, which helps in maintaining the identity of the transaction.
- Cash memo is a printed document, which contains information regarding the name of seller, date, description of goods sold including quantity and rate at which goods were sold.
- In case of real accounts, anything or cash which is coming to business is always debited and anything or cash which is going out from the business is always credited.
- When there are two or more transactions of similar nature occurring on the same day and either 'Dr' or 'Cr' account in common, such transactions can be recorded in the form of one journal entry instead of making a separate entry for each transaction. Such entry is known as 'Compound Journal Entry'.
- Trade discount is that discount which is given for promoting sales at a certain percentage on sales, such as discount on clothes, discount on shoes, discount on books, etc.
- Cash discount is the discount, which is given to debtors by the trader for early payment of price of goods. It is given only when the customer paid the balance in a certain period.
- Subdivisions of journal are the division of journal in parts. Subdivisions of journal are beneficial because it reduces the pressure on other journals.
- Subsidiary books are classified on the basis of transactions viz. Cash transactions and Non-cash transactions.
- The purchases book is known in other words as purchase journal. It is a book meant for credit purchases only for resale.

## 2.9 LESSON END ACTIVITY

To increase the balance in the following accounts, would you debit the account or would you credit the account? Give the reason for your answers.

Accounts Name	Debit	Credit	Reason
Accounts Payable			
Cash			
Land			
Notes Payable			
Accounts Receivable			
Mary Smith Capital			
Supplies			
Supplies Expense			
Prepaid Insurance			
Service Revenue			
Mary Smith Drawing			
Equipment			
Unearned Revenue			

## 2.10 KEYWORDS

**Journal:** The primary book in which the transactions are recorded first time.

**Subsidiary Book:** It is a book maintained for routine transactions of the enterprise.

**Purchase Book:** It is known in other words as purchase journal. It is a book meant for credit purchases only for resale.

**Sales Book:** It is a book maintained by the enterprise only during the moment of selling the goods on credit. It is known in other words as a sales journal.

**Sales Return Book:** Sales return is a book that registers the goods sold on credit and received from the buyers.

**Non-cash Transaction:** A non-cash transaction is a transaction in terms of credit and conditions of the enterprise.

## 2.11 QUESTIONS FOR DISCUSSION

- Journalise the following transactions:
  - Started business with cash ₹3,00,000.
  - Bought Goods on credit for ₹5,000.
  - Sold Goods for cash ₹12,000 and on credit ₹8,000.
- Discuss the process of journalising the transactions with suitable examples.
- Explain the nature of petty cash book.
- What is the difference between a petty cash book and a simple cash book?

5. Prepare a Cash Book from the transactions given below:

2016	₹
July 1 Balance at bank	10,000
July 4 Received a cheque from Pankaj	5,000
July 7 Issued a cheque to Rakesh	6,000
July 10 Received dividend by bank draft	2,000
July 15 Mukesh was paid by issuing a cheque	1,500
July 20 Deposited into bank	7,000
July 24 Interest collected by bank	200
July 28 Dividend collected by bank	500
July 31 Bank charges debited	800

6. What are the different types of trade bills books?

7. Enter the following transactions in Analytical Petty Cash Book:

2016	
Jan. 1 Received cheque from head cashier	100.00
Jan. 2 Paid for postage	15.00
Jan. 3 Stationery purchased	5.00
Jan. 14 Paid for cartage	8.00
Jan. 18 Paid for travelling	7.00
Jan. 27 Tea for guests	6.00
Jan. 29 Office cleaning charges	12.00
Jan. 30 Paid for carriage	4.00
Jan. 31 Extra postage charges	8.00

8. Make the pro forma of purchase return book and sales return book and explain it.

9. Explain the significance of preparing subsidiary books of accounts.

#### **Check Your Progress: Model Answer**

1. Original
2. Internal
3. Invoice
4. Nominal
5. Subdivision

### **2.12 SUGGESTED READINGS**

- M. P. Pandikumar, *Accounting & Finance for Managers*, Excel Books, New Delhi.
- R. L. Gupta and Radhaswamy, *Advanced Accountancy*.
- V. K. Goyal, *Financial Accounting*, Excel Books, New Delhi.
- Nitin Balwani, *Accounting & Finance for Managers*, Excel Books, New Delhi.

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## LESSON

# 3

## LEDGER AND TRIAL BALANCE

### CONTENTS

- 3.0 Aims and Objectives
- 3.1 Introduction
- 3.2 Overview of Ledger
  - 3.2.1 Characteristics of Ledger
  - 3.2.2 Merits of Ledger
- 3.3 Format of Ledger
- 3.4 Rules for Posting
- 3.5 Posting of Compound Journal Entries
- 3.6 Closing and Balancing of Accounts
- 3.7 Posting of Opening Entry
- 3.8 Significance of Ledger
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  - 3.12.5 Advantages of Trial Balance
  - 3.12.6 Limitations of Trial Balance
- 3.13 Let Us Sum Up
- 3.14 Lesson End Activity
- 3.15 Keywords
- 3.16 Questions for Discussion
- 3.17 Suggested Readings

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### 3.0 AIMS AND OBJECTIVES

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After studying this lesson, you should be able to:

- Understand the ledger need and its characteristics
- Describe ledgers rules for posting the transactions
- Discuss the trial balance and its importance
- Explain the working of trial balance

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### 3.1 INTRODUCTION

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In accounting, all the transactions are recorded in the journal, thereafter; these are recorded in the ledger under the double entry principle. This is called ledger posting. Ledger is a book, which contains various accounts where similar transactions related to a particular person or thing are recorded. This is the main book of account and contains all information needed for preparing financial statements. Therefore, it is also called as 'Book of Principal Entry.' In this book, separate accounts are opened for every person, asset, income and expenses.

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### 3.2 OVERVIEW OF LEDGER

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Journal of a business is very useful but it does not reply the different queries as how much amount is due from debtors, how much is to be paid to creditors and what is the balance of a particular account, etc. For the reply of all these queries, the ledger is prepared from the journal entries. Ledger is the set of accounts in which all types of account (personal, real or nominal) are kept.

According to L.C. Cropper, The book in which a trader's transactions are recorded in a classified permanent record, is called the ledger.

There can be two forms of ledger:

- (a) Bound Ledger
- (b) Loose Leaf Ledger

A ledger in traditional way is normally kept in the form of bound note books. In bigger business enterprises, it is not easy to maintain a large and variety of transaction in a single book.

To overcome this difficulty, loose leaf shuts took the place of bound books.

Under loose leaf ledger, appropriate sheets are introduced. Additional pages may be added to any extent, completed account may be removed to reduced volume, and any account may be rearranged so as to suit the needs of the enterprises. This mode of maintaining ledger in the form of loose sheets is called loose leaf ledger.

#### 3.2.1 Characteristics of Ledger

The following are the features/characteristics of ledger:

- It is the principal book of accounts.
- It is prepared with the help of data provided by the journal.
- The balances of all nominal accounts are transferred to the Trading/Profit & Loss Account at the end of the period.
- The balances of real and personal accounts are shown in the Balance Sheet.

- Trial balance is prepared with the help of the closing balances of all accounts maintained in it.
- It depicts the present position of the accounts.

### 3.2.2 Merits of Ledger

As ledger is a book of final entry, so it has an important place in accounting. The following are the merits of the ledger:

1. **Knowledge of business results:** From the ledger, all transactions related to one item are written at one place. And all the important information related to business can be obtained easily from this.
2. **Helpful in preparation of trial balance:** Trial balance is prepared from ledger. And Arithmetic accuracy can be checked with the help of trial balance.
3. **Helpful in preparation of final accounts:** Ledger provides all information for the preparation of final accounts. Hence, these can be easily prepared to ascertain the gross profit, net profit as well as the financial position of the business at the end of the year.
4. **To overcome the limitations of journal:** The main limitation of the journal is that from this the complete information related to any transaction cannot be obtained. However, from the ledger, the complete information about any item can be obtained easily.

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## 3.3 FORMAT OF LEDGER

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It is like a register. Its every page is divided into two parts. Left part is called debit part and right part is called credit part. Every part has four columns. The format is shown below:

Specimen of Ledger

Dr				Cr			
Date	Particulars	J.F.	Amount (₹)	Date	Particulars	J.F.	Amount (₹)

Details of the above columns are as follows:

- **Date:** Those page numbers are written in this column, which are written in journal.
- **Particulars:** The name of the other account, which is affected by the transaction, is written in this column. In debit 'To' and in credit 'By' words are used.
- **Journal Folio No.:** In this column, that number of journal is written from where the transaction is posted.
- **Amount:** The amount related to transaction is written.

Thus, ledger is a set of books or accounts where different types of accounts are maintained. It is not possible to estimate the business performance from the journal only. Final accounts are prepared from the ledger account balances to know the financial position of the business. Therefore, the performance of the business can't be



measured without taking the help of ledger accounts and this is the reason due to which it is called the main book of accounts.

Ledger contains all types of accounts except the debtors and creditors, for example, assets accounts, goods accounts, capital and drawings accounts.

### 3.4 RULES FOR POSTING

Posting means recording the transaction in ledger from journal or other subsidiary books. The following rules should be observed while positing entries in the ledger.

The name of account should be written on the top of the account firstly. It is called opening of an account. For example, wages account, furniture account, etc.

Write the date in the account on the proper side. Date should be noted from journal or subsidiary book.

All transactions related to one account should be written in one page.

As 'Dr' is written on the top corner of debit side and 'Cr' is written on the top corner of the credit side, so all the debit entries are written with 'To' and all the credit entries are written with 'By'.

The amount written in the debit side of one account should be same as written in the credit side of other account.

Folio column is meant for writing the page no. of journal or subsidiary book, from where positing is being done. Therefore, it should be filled by the page no. of source book.

**Example:** Soyi commenced a business on 1<sup>st</sup> January 2009 for ₹ 8,00,000 then its journal entry will be as follows:

#### Journal

Date	Particulars	L.F.	Amount Dr (₹)	Amount Cr (₹)
2009 Jan 1	Cash A/c Dr To Capital A/c (Being business started with cash)		8,00,000	8,00,000

The above entry from journal to ledger will be posted as follows:

#### Cash A/c

Dr				Cr			
Date	Particulars	J.F.	Amount (₹)	Date	Particulars	J.F.	Amount (₹)
2009 Jan 1	To Capital A/c		8,00,000				

#### Capital A/c

Dr				Cr			
Date	Particulars	J.F.	Amount (₹)	Date	Particulars	J.F.	Amount (₹)
				2009 Jan 1	By Cash A/c		8,00,000

### 3.5 POSTING OF COMPOUND JOURNAL ENTRIES

Sometimes two or more than two accounts are involved in a transaction, it is recorded as a single entry and called compound journal entry. For posting of this entry as many accounts will be opened as shown in the entry.

**Example:** On 12<sup>th</sup> June 2008, ₹ 10,500 paid to Moray and discount of ₹ 500 was received.

#### Journal

Date	Particulars	L.F.	Amount Dr (₹)	Amount Cr (₹)
2008 June 12	Raphel Dr To Cash A/c To Discount A/c (Being cash paid to Raphel, discount received)		11,000	10,500 500

The posting of above entry will be:

#### Moray Account

Dr				Cr			
Date	Particulars	J.F.	Amount (₹)	Date	Particulars	J.F.	Amount (₹)
2008 June 11	To Cash A/c		10,500				
June 12	To Discount A/c		500				

#### Cash Account

Dr				Cr			
Date	Particulars	J.F.	Amount (₹)	Date	Particulars	J.F.	Amount (₹)
				2008 June 12	By Moray		10,500

#### Discount Account

Dr				Cr			
Date	Particulars	J.F.	Amount (₹)	Date	Particulars	J.F.	Amount (₹)
				2008 June 12	By Moray		500

It is clear from the above example that for posting of compound journal entry, the same amount will be recorded in the concerned account as shown in the journal against that account. Such as cash A/c ₹ 10,500, Discount A/c ₹ 500 and Moray account ₹ 11,000 have been recorded because the same amount has been shown against the accounts in journal.

### 3.6 CLOSING AND BALANCING OF ACCOUNTS

Balancing of accounts is compulsory because the businessman has to prepare final accounts. Accounts are mostly closed at the end of the year and their balances are found out, but they may be closed at any time as per the requirements of the business. For this, totalling of debit and credit sides of account is done and the difference is calculated. If debit side is more than credit side, then it is called debit balance and if credit side is more than debit side, then it is called credit balance. If the sum of the two sides is equal, no balance is taken out.

The following are the rules for closing of different types of accounts:

- **Closing and Balancing of Personal Accounts:** If the sum of debit side is more than credit side, the difference is put on credit side by writing the word 'By Balance c/d' in particular column. After this, account will be closed by totalling both sides. On the first day of the next month, closing balance will be brought forward as opening balance by writing the word 'To Balance b/d' on debit side. Similarly, if the sum of credit side of this account is more than the debit side, then the amount of difference is written in the debit side by writing the word 'To Balance c/d'. After this, the account will be closed by totalling of both sides. On the first day of the next month, the closing balance will be brought forward to opening balance by writing the word 'By Balance b/d' on the credit side. In fact, these accounts are prepared with the aim to know whether the amount owes from or the amount is owed to. If this account shows the debit balance, the amount is owed or it may be said to be a debtor and if this account shows credit balance, the amount is owed or it may be said to be a creditor.
- **Closing and Balancing of Real Account:** These accounts are prepared with the objective to know the net balance of cash and assets. Cash account, Assets account and Goods accounts are included in real accounts. Assets accounts are closed like personal accounts. If depreciation is given on assets accounts, then the account is balanced by deducting depreciation. Cash account has always debit balance. Purchases A/c, Sales A/c, Purchase Return A/c and Sales Returns A/c are included in Goods Account. These accounts are not balanced rather these are closed by transferring the balance to Trading A/c.
- **Closing and Balancing of Nominal Accounts:** All the incomes and expenses accounts of business are included in nominal accounts. Therefore, the balance of each of these accounts is transferred either to trading account or to profit and loss account as the case may be. For closing these accounts, the expenses, which are related to manufacturing or purchasing of goods, are transferred to Trading A/c. These are closed by writing the word 'By Trading A/c' on the credit side of these accounts. All other expenses accounts are transferred to profit and loss account. For this, these accounts are closed by writing the word 'By Profit and loss A/c' on the credit side.

Similarly, all income accounts are transferred to profit and loss account. For this, these accounts are closed by writing the word 'To Profit and loss A/c' on debit side. In fact, these accounts have no balance at the end of the year because the payments of these indicate that the services of these expenses have been received and there is no need of balancing of these accounts.

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### 3.7 POSTING OF OPENING ENTRY

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In the beginning of every accounting period, a journal entry is passed to record the opening balances of all the accounts, which is called opening entry. In this entry, all assets are debited and all the liabilities are credited. The word 'To Balance b/d' is written in debit in the ledger for the accounts, which have debit balances and the word 'By Balance b/d' is written in credit in the ledger for the accounts, which have credit balances. This has been explained by following the example:

**Example:** Mr A has the following balances as on 1<sup>st</sup> April 2000; cash in hand ₹ 12,000, cash at bank ₹ 10,000; Due from Katty ₹ 7,000; Furniture ₹ 8,000; Loan from K ₹ 11,000; Due to Amy ₹ 8,500; Due to Arish ₹ 6,500.

You are required to pass the opening entry and post it into ledger.

**Solution:**

**Journal**

Date	Particulars	L.F.	Amount Dr (₹)	Amount Cr (₹)
2000 April 1	Cash A/c	Dr	12,000	
	Bank A/c	Dr	10,000	
	Katty	Dr	7,000	
	Furniture A/c	Dr	8,000	
	To K's loan A/c			11,000
	To Amy			8,500
	To Arish			6,500
	To Capital A/c			11,000
	(Being the opening entry for balances brought forward from the last year)			

**Ledger  
Cash Account**

Dr				Cr.			
Date	Particulars	J.F.	Amount (₹)	Date	Particulars	J.F.	Amount (₹)
2000 April 1	To Balance b/d		12,000				

**Bank Account**

Dr				Cr.			
Date	Particulars	J.F.	Amount (₹)	Date	Particulars	J.F.	Amount (₹)
2000 April 1	To Balance b/d		10,000				

**Katty**

				₹			
2000 April 1	To Balance b/d		7,000				

**Furniture Account**

				₹			
2000 April 11	To Balance b/d		8,000				

**K's Loan Account**

				₹			
				2000 April 1	By Balance b/d		11,000

**Amy**

				₹			
				2000 April 1	By Balance b/d		8,500

**Arish**

							₹
					2000		
					April 1	By Balance b/d	6,500

**Capital Account**

							₹
					2000		
					April 1	By Balance b/d	11,000

**Example:** The following appeared in the books of Razor on 1<sup>st</sup> January 2002:

Assets: Cash ₹ 40,000; Stock ₹ 25,000; Debtors ₹ 40,000, and Machinery ₹ 50,000.

Liabilities: Creditors: Williams ₹ 30,000.

Following transactions took place in January 2002:

Jan 3: Sold goods for cash ₹ 6,000 and on credit of ₹ 3,000 to Ashley.

Jan 5: Ashley returned goods for ₹ 1,500.

Jan 9: Purchased goods from Williams of the list price ₹ 10,000 valued at ₹ 9,000.

Jan 13: Purchased goods of list price of ₹ 15,000 from Razor less 10% trade discount and 5% cash discount and paid 40% price immediately.

Jan 19: Paid to Williams ₹ 38,600 in full settlement of his account

Jan 23: Paid ₹ 700 for the life insurance premium of the proprietor

Jan 30: Received for commission ₹ 2,500

Pass journal entries in journal and post it in ledger.

**Solution:**

**Journal of Razor**

Date	Particulars	L.F.	Amount Dr (₹)	Amount Cr (₹)
2002 Jan 1	Cash A/c           Dr Stock A/c           Dr Debtors A/c        Dr Machinery A/c     Dr To Williams To Capital A/c (Being opening balances of assets and Liabilities recorded)		40,000 25,000 40,000 50,000	30,000 1,25,000
Jan 3	Cash A/c           Dr Ashley             Dr To Sales A/c (Being goods sold)		6,000 3,000	9,000
Jan 5	Sales Returns A/c Dr To Ashley (Being goods purchased)		1,500	1,500
Jan 9	Purchases A/c     Dr To Williams (Being goods purchased)		9,000	9,000

Contd...

Jan 13	Purchases A/c	Dr		13,500	
	To Cash A/c				5,130
	To Discount A/c				270
	To Razor				8,100
	(Being goods purchased and discount received)				
Jan 19	Williams	Dr		39,000	
	To Cash A/c				38,600
	To Discount A/c				400
	(Being goods purchased and discount received)				
Jan 23	Drawings A/c	Dr		700	
	To Cash A/c				700
	(Being Life Ins. Premium paid)				
Jan 30	Cash A/c	Dr		2,500	
	To Commission A/c				2,500
	(Being commission received)				

### Ledger Cash A/c

Dr				Cr			
Date	Particulars	J.F.	Amount (₹)	Date	Particulars	J.F.	Amount (₹)
2002				2002			
Jan 1	To Balance b/d		40,000	Jan 13	By Purchases A/c		5,130
Jan 3	To Sales A/c		6,000	Jan 19	By Williams		38,600
Jan 30	To Commission A/c		2,500	Jan 23	By Drawings A/c		700
				Jan 31	By Balance c/d		4,070
			48,500				48,500
Feb 1	To Balance b/d		4,070				

### Stock A/c

Dr			Cr		
2002			2002		
Jan 1	To Balance b/d	25,000	Jan 31	By Balance c/d	25,000
		25,000			25,000
Feb 1	To Balance b/d	25,000			

### Debtors A/c

Dr			Cr		
2002			2002		
Jan 1	To Balance b/d	40,000	Jan 31	By Balance c/d	40,000
		40,000			40,000
Feb 1	To Balance b/d	40,000			

**Machinery A/c**

Dr			Cr		
2002			2002		
Jan 1	To Balance b/d	50.000	Jan 31	By Balance c/d	50.000
		50.000			50.000
Feb 1	To Balance b/d	50.000			

**Williams**

Dr			Cr		
2002			2002		
Jan 19	To Cash A/c	38.600	Jan 1	By Balance b/d	30.000
Jan 19	To Discount A/c	400	Jan 9	By Purchases A/c	9.000
		39.000			39.000

**Capital A/c**

Dr			Cr		
2002			2002		
Jan 31	To Balance c/d	1.25.000	Jan 1	By Balance b/d	1.25.000
		1.25.000			1.25.000
			Feb 1	By Balance b/d	1.25.000

**Ashley**

Dr			Cr		
2003			2003		
Jan 3	To Sales A/c	3.000	Jan 5	By Sales Return A/c	1.500
			Jan 31	By Balance c/d	1.500
		3.000			3.000
Feb 1	To Balance b/d	1.500			

**Sales A/c**

Dr			Cr		
2002			2002		
Jan 31	To Balance c/d	9.000	Jan 3	By Cash A/c	6.000
			Jan 3	By Ashley	3.000
		9.000			9.000
			Feb 1	By Balance b/d	9.000

**Sales Returns A/c**

Dr			Cr		
2002			2002		
Jan 5	To Ashley	1.500	Jan 31	By Balance c/d	1.500
		1.500			1.500
Feb 1	Balance b/d	1.500			

**Purchases A/c**

Dr			Cr		
2002			2002		
Jan 9	To Williams	9,000	Jan 31	Balance c/d	22,500
Jan 13	To Cash A/c	5,130			
Jan 13	To Discount A/c	270			
Jan 13	To Razor	8,100			
		22,500			22,500
Feb 1	To Balance b/d	22,500			

**Razor**

Dr			Cr		
2002			2002		
Jan 31	To Balance c/d	8,100	Jan 13	By Purchases A/c	8,100
		8,100			8,100
			Feb 1	By Balance b/d	8,100

**Discount A/c**

Dr			Cr		
2002			2002		
Jan 31	To Balance c/d	670	Jan 13	By Purchases A/c	270
			Jan 19	By Williams	400
		670			670
			Feb 1	By Balance b/d	670

**Drawing A/c**

Dr			Cr		
2002			2002		
Jan 23	To Cash A/c	700	Jan 31	By Balance c/d	700
		700			700
Feb 1	To Balance b/d	700			

**Commission A/c**

Dr			Cr		
2002			2002		
Jan 31	To Balance b/d	2,500	Jan 30	By Cash A/c	2,500
		2,500			2,500
			Feb 1	By Balance b/d	2,500

**3.8 SIGNIFICANCE OF LEDGER**

Ledger is the most important book used by the businessmen as it provides a detailed record of all the financial transactions.

It is very useful in any business organisation because it provides a permanent record of all the transactions. No business can run without the ledger. In journal, all the transactions are recorded date-wise at one place in lieu of recording of transactions of similar nature at one place. If we want to know amounts to be received from Moray, then we have to see the journal of complete duration. If we use subsidiary books, then firstly we will have to go through the sales book for knowing the amount of goods



sold to Moray on different dates. After this, the amount of sales returns from sales return book has to be obtained. Then the amount received from Moray on different dates will be obtained from cash book. At the end, we will be able to ascertain the amount due from Moray.

Ledger is framed to avoid this difficulty. With the help of ledger all information related to one account is obtained at one place. Every businessman wants to know profit and loss and financial position of the business at the end of the year, which is possible only with the help of ledger because it provides ground work for their preparations. Similarly, trial balance can be framed only from the ledger. In fact, ledger is the life blood of accounting records that fulfils different objectives. The accounting process cannot be completed without the ledger.

### 3.8.1 Differences between Journal and Ledger

Journal and Ledger are two important books of accounts in the double entry system of accounting. However, they differ from each other in various aspects. The prominent differences in these accounting books are given below:

**Table 3.1: Differences between Journal and Ledger**

S. No.	Journal	Ledger
1.	Transactions are recorded in the chronological order as and when they occur. This process is termed as 'Journalising'.	Ledger is the book in which entries are recorded in different accounts by transferring from journal. This process is termed as 'posting'.
2.	The journal is a book of original entry.	Ledger is a book of final entry.
3.	Journal is not prepared on the basis of ledger.	Ledger is prepared on the basis of journal.
4.	Narration is written with every entry in the journal.	Narration is not written in the ledger.
5.	Balancing is not done in the journal.	In the ledger, all the accounts are balanced.
6.	Final accounts are not prepared with the help of the journal.	Final accounts are prepared with the help of the ledger.
7.	Recording is made date-wise in it.	Recording is done account-wise in it.
8.	Journal has more evidential value in case of disputes, as it is a book of first entry.	Ledger has less evidential value.

## 3.9 TRIAL BALANCE

The fundamental principle of double entry system of accounting is that for every debit, there must be a corresponding credit. Hence, in the preparation of journals as well as ledgers, both aspects of a transaction are taken into account. For this verification, a statement is prepared which is called trial balance. If the totals of the debit and credit amount columns of the trial balance are equal, it is presumed that the postings to the ledger in terms of debit and credit amounts are accurate. In other words, trial balance is a statement in which debit and credit balances of all the accounts of ledger including cash and bank balances (taken from cash book) are shown to test the arithmetical accuracy of the books of accounts. As every debit has a corresponding credit, hence total of debit balances of trial balance is always equal to total of its credit balances.

Trial balance is a statement, which is prepared at a certain interval of period i.e., financial year. If the trial balance does not agree, it shows that there are some errors, which must be detected and rectified if the correct final accounts are to be prepared.

According to **J R Batliboi**, *Trial balance is a statement prepared with the debit and credit balances of ledger accounts to verify the arithmetical accuracy of the books.*

**Spicer and Pegler** state that, *A trial balance is a statement, a list of all the balance standing on the ledger account and cash book of a concern at any given time.*

According to **M S Gosav**, *Trial balance is a statement containing the balances of all ledger accounts, as at any given date, arranged in the form of debit and credit columns placed side by side and prepared with the object of checking the arithmetical accuracy of ledger positing.*

#### Format of Trial Balance

Name of the Firm...  
Trial Balance  
as on...

S. No.	Name of Ledger Accounts	L.F.	Dr Balances (₹)	Cr Balances (₹)

### 3.9.1 Objectives of Preparing Trial Balance

The objectives of preparing trial balance are as follows:

- It provides a basis on which the final accounts are prepared (i.e., Trading Account, Profit and Loss Account and Balance Sheet). In fact, it forms a connecting link between the ledger accounts and final accounts.
- To check or ascertain the arithmetical accuracy of ledger accounts. If the total of the debit balances agrees with the total of credit balances, it is a proof that the ledger accounts have been correctly written up. However, if the trial balance totals do not agree, it shows that there are some errors, which must be detected and rectified before the preparation of final accounts.
- The balances of all the accounts of ledger can easily and conveniently known by the trial balances, which supplies useful information to the management.
- It serves as a summary of what is contained in the ledger.

## 3.10 METHODS OF PREPARATION OF TRIAL BALANCE

There are three methods of preparation of trial balances:

- **Total method:** In this method, debit total and credit total of each account of ledger are recorded in trial balance. This method is simple but it has some limitations. Firstly, the totalling of large amount is difficult and more time consuming. Secondly, balancing is necessary for preparation of final accounts. Hence, this method is not used in practice.
- **Balance method:** In this method, only the balances of the accounts of ledger either debit or credit, as the case may be, are recorded. This method is the most common and considered as the best method of preparation of trial balance: (a) as small amounts are totalled in lieu of large amounts, which is very easy, (b) balancing of accounts helps in preparation of final accounts. The balance method is also known as net trial balance. One important point is that if an account shows no balance, it is ignored.

- **Compound method:** It is a combination of the above two methods, i.e., under this method, both debit and credit totals of each account are shown under respective totals columns. Similarly, debit and credit balances are shown under respective balances columns. There will be different totals according to different methods but the total of debit and credit of each method will be equal.

### 3.10.1 Points to be Kept in Mind While Preparing Trial Balance

The following points should be kept in mind in this respect:

- All assets show debit balance. Thus, these balances are shown in the debit side of trial balance viz. cash, bills receivable, debtors, furniture, goodwill, prepaid expenses, etc.
- All liabilities show credit balances. Thus, these balances are shown in the credit side of trial balance viz.: creditors, bills payable, bank overdraft, outstanding expenses, etc.
- Drawings account shows debit balance while capital account shows credit balance.
- All expenses and losses show debit balance while all incomes and gains show credit balance.
- All provisions or reserves have a credit balance.
- Purchases account shows debit balance while purchases returns account shows credit balance.
- Sales account shows credit balance while sales returns account shows debit balance.
- All the personal accounts showing debit balances are put together and are collectively shown under debit balances in the trial balance as 'Sundry Debtors'.
- Similarly, all the personal accounts showing credit balances are put together and collectively shown under credit balances in the trial balance as 'Sundry Creditors'.
- Generally, closing stock does not appear in the trial balance because it is not an account extracted from ledger.

Only if the entry for closing stock is passed before the preparation of trial balance, it can be shown inside the trial balance. The trial balance is a part of the double-entry bookkeeping system and uses the classic 'T' account format for presenting values.

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## 3.11 CORRECTION OF A WRONG TRIAL BALANCE

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Sometimes, a trial balance is given in which some of the balances are mentioned in the wrong side. In such a case, students are required to correct the trial balance. The rules given above should be applied to know which of the balances are given in the right side and which of them are given in the wrong side. After that, the corrected trial balance should be formed. This can be understood by the following example.

**Example:** The following trial balance has been prepared wrongly. You are required to prepare it in correct form as on 31<sup>st</sup> March 2002:

Heads of Account	Dr Balances (₹)	Cr Balances (₹)
Building	6,350	
Purchases	12,500	
S. Debtors	5,000	

Contd...

Opening Stock		3,500
Sales		23,000
Carriage Outwards		900
Salaries	2,000	
Rent & Taxes	500	
S. Creditors		4,000
Capital	5,000	
Furniture		2,950
Bank Loan	2,000	
Interest on Loan	60	
Discount Allowed		70
Wages	480	
Sales Returns		700
Purchases Returns	1,000	
Discount Received	120	
Cash in Hand	110	
<b>Total</b>	<b>35,120</b>	<b>35,120</b>

**Solution:**

**Corrected Trial Balance  
as on 31<sup>st</sup> March, 2002**

S. No.	Name of Ledger Accounts	L.F.	Balance Dr (₹)	Balances Cr (₹)
1.	Building		6,350	
2.	Purchases		12,500	
3.	S. Debtors		5,000	
4.	Opening Stock		3,500	
5.	Sales			23,000
6.	Carriage Outward		900	
7.	Rent and Taxes		500	
8.	Salaries		2,000	
9.	S. Creditors			4,000
10.	Capital			5,000
11.	Furniture		2,950	
12.	Bank Loan			2,000
13.	Interest on Loan		60	
14.	Discount Allowed		70	
15.	Wages		480	
16.	Sales Returns		700	
17.	Purchases Returns			1,000
18.	Discount Received			120
19.	Cash in Hand		110	
	<b>Total</b>		<b>35,120</b>	<b>35,120</b>

**Example:** The accountant of a firm wrongly prepared the following trial balance. You are required to draw up correctly.

S. No.	Name of Ledger Accounts	L.F.	Balance Dr (₹)	Balances Cr (₹)
1.	Capital			70,000
2.	Opening Stock		25,000	
3.	Fixed Assets			34,000
4.	Purchases			28,000
5.	Sales		25,500	
6.	Discount Allowed		300	
7.	Commission Received		610	
8.	Returns Outwards		1,500	
9.	Returns Inwards			2,500
10.	Bills Receivable			29,500
11.	Cash		16,000	
12.	Interest Paid		360	
13.	Loan Taken		26,000	
14.	Bills Payable		13,000	
15.	Bad Debts		1,800	
16.	Wages & Salary		2,500	
17.	Carriage Inwards		1,550	
18.	Carriage Outwards		1,600	
19.	Debtors		18,500	
20.	Creditors			25,000
21.	Stock at the End		25,000	
22.	Suspense Account		29,780	
	<b>Total</b>		<b>1,89,000</b>	<b>1,89,000</b>

**Solution:**

**Trial Balance**  
as on ...

S. No.	Head of Accounts	L.F.	Balance Dr (₹)	Balances Cr (₹)
1.	Capital			70,000
2.	Opening Stock		25,000	
3.	Fixed Assets		34,000	
4.	Purchases		28,000	
5.	Sales			25,500
6.	Discount Allowed		300	
7.	Commission Received			610
8.	Returns Outwards			1,500
9.	Returns Inwards		2,500	
10.	Bills Receivable		29,500	
11.	Cash		16,000	
12.	Interest Paid		360	

*Contd*

13.	Loan Taken			26,000
14.	Bills Payable			13,000
15.	Bad debts		1,800	
16.	Wages & Salary		2,500	
17.	Carriage Inwards		1,550	
18.	Carriage Outwards		1,600	
19.	Debtors		18,500	
20.	Creditors			25,000
	<b>Total</b>		<b>1,61,610</b>	<b>1,61,610</b>

Closing stock is not an account. It has no balance, so it does not find a place in trial balance. Only when it is adjusted against purchases, it appears in trial balance.

## 3.12 ERRORS AND TRIAL BALANCE

Is trial balance a conclusive proof of the accuracy of books of accounts? The agreement of a trial balance is not a conclusive proof as to the absolute accuracy of the books. There is always a possibility of some mistakes being committed while writing up the books of accounts. This is because it only indicates that equal debits and credits have been recorded in the ledger accounts and the balance of accounts is correctly calculated. In other words, it is only a *prima facie* proof. Accounting errors have been categorised under two headings:

1. Errors not disclosed by trial balance
2. Errors disclosed by trial balance

### 3.12.1 Errors not Disclosed by Trial Balance

The trial balance is not an absolute proof of the accuracy of ledger accounts. It is a proof only of the arithmetical accuracy of the postings.

The following errors are not disclosed by a trial balance even when it tallies:

- **Errors of Omission:** If a transaction is completely omitted, there will be no effect on the trial balance. When a transaction is not recorded in the journal or subsidiary books or a transaction after being recorded in the books of prime entry is not at all posted in the ledger, the error is an error of omission.

For example, goods purchased for ₹ 1,15,000 from Bandaon credited and omitted to be recorded in the books. This has neither been recorded in the journal and is not posted in the ledger; hence, the trial balance will be tallied.

- **Errors of Commission:** If a wrong amount is entered in the journal or in the subsidiary books, the trial balance will tally because the same amount (though wrong) will be posted in both the accounts affected by the transaction.

For example, goods worth ₹ 350 have been purchased from R, but the entry in the journal is made of ₹ 530, which is an incorrect amount. It means that purchase account is being debited with ₹ 530 and Raphael is being credited with ₹ 530. In spite of the error in both the accounts, the trial balance will tally.

- **Errors of Principles:** When an accounting principle is violated and recording a transaction, then it is called error of principle.

For example, purchase of furniture is debited to purchase account, instead of furniture account; wages paid for the erection of plant is debited to wages account,

instead of plant account, etc. It means that these errors may be of two types: (a) when a capital expenditure is treated as revenue expenditure, (b) when revenue expenditure is treated as capital expenditure. Such errors are not disclosed by the trial balance.

- **Wrong entries in the books of original records:** If we make wrong entries in the original books of accounts, then many times, the trial balance will be agreed.

For example, goods sold to Abale for ₹ 20,000 were wrongly written in the account of Banda. There will be no effect in trial balance for such type of errors.

- **Compensating Errors:** Compensating errors are those, which cancel themselves out. In other words, such errors occur when two or more errors are committed in such a way that the net effect of these errors on the debits and credits of accounts is nil.

For example, D has been credited with ₹ 11,800 instead of crediting of ₹ 18,100 and S has been credited with ₹ 18,100 instead of crediting ₹ 11,800. Therefore, by making the above recording, the effect of error in D's account has become ineffective by making another mistake in S's account.

### 3.12.2 Errors Disclosed by Trial Balance

If the trial balance does not agree, there must have been some errors, which can be detected.

- **Posting on the wrong side:** If an item is by mistakenly posted on the wrong side of the ledger account, then the trial balance does not tally.

For example, if ₹ 250 has been allowed as discount and while positing into discount account, the amount has been credited to discount account. It will result in a difference of ₹ 250 on two sides of the trial balance.

- **Wrong totalling:** Sometimes, the total of any subsidiary book is wrongly cast; it would result in disagreement of a trial balance.

For example, if the total of sales return book was under cast by ₹ 1,250, then the sum of debit side of trial balance will be less by ₹ 1,250 and it will not tally.

- **Posting of the wrong amount:** If wrong amount is posted in one of the two accounts, the trial balance disagrees.

For example, cash received in the cash book but posted to Mr A account ₹ 2,050. Due to this mistake, cash balance will reduce. This will affect the trial balance.

- **Wrong totalling or balancing of ledger account:** If any account in the ledger is wrongly totalled or balanced, then the trial balance shall not agree.

- **Double posting:** If, while making postings, a posting is made twice in an account, then such errors are disclosed by the trial balance, as the totals of the trial balance will not tally.

- If balance of an account is not recorded in the trial balance, the two sides of the trial balance shall not agree.

- Errors made in carrying forward the total from one page to another page.

- Omission of an account from trial balance (cash, bank, etc.).

- Wrong totals of the total balance.

### 3.12.3 Location of Errors

If the trial balance does not agree, it indicates that there are errors in the books of account. These are the steps, which should be taken into account while locating the errors:

- First of all, re-total the debit and credit columns of the trial balance and ascertain the difference.
- Divide the difference of the trial balance by two and see the similar amount appears in the trial balance. If the similar figure exists, see whether it is in the correct column. It is also possible that such a balance will have been recorded on the wrong side, causing a difference of double the amount.
- If mistake remains undetected, divide the difference by 9. If the difference is evenly divisible by 9, the error may be due to transposition or trans-placement figures. Transposition occurs when 89 is written as 98, 231 as 132 and so on. And a trans-placement occurs when the digits of the numbers are moved to the left or right. For example, when ₹ 8494 is written as ₹ 84.94 or ₹ 849.4. If there is such a problem, the search can be narrowed down to numbers where these errors have been made.
- See the cash balance and bank balance are properly listed in the trial balance.
- Confirm that the opening balances have been correctly brought forward in the current year's books.
- See the totals in the list of S. Debtors and S. Creditors.
- Recheck the balances extracted from the ledger.
- Check the casting and carry forward of all the subsidiary books.
- Verify the posting of individual items from the subsidiary books.
- Recompute the account balances.
- Recheck the discount columns.
- If the difference is a round sum, it is advisable to check totalling and carry forwards. However, if the difference is an odd sum, the balancing should be checked.

### 3.12.4 Suspense Account

If the trial balance does not tally after proper checking then it is tallied by transferring the difference to suspense account. Later on, when the errors will be located, they will be rectified through the suspense account. The suspense account will automatically be closed when all the errors will be located.

### 3.12.5 Advantages of Trial Balance

The following are the advantages of trial balance:

- It provides a basis on which the final accounts can be prepared.
- It summarises the results of all the transactions during a period.
- It proves the arithmetical accuracy of accounting entries in the ledger.
- It provides information of all the balances of various accounts of ledger in one place.
- If any error is found, it can easily be rectified.



### 3.12.6 Limitations of Trial Balance

The following are the limitations of trial balance:

- Though trial balance gives arithmetical accuracy of the books of accounts but there are certain errors, which cannot be detected. Hence, trial balance is not a conclusive proof of the accuracy of the books of accounts.
- Preparation of trial balance is a time-consuming and costly affair. It is prepared only by those concerns, where double entry system of accounting is adopted. It is very costly and cannot be adopted by the small concerns.
- The final accounts prepared will not reflect the true and fair view of the state of affairs, if the trial balance is not prepared correctly.

#### Check Your Progress

Fill in the blanks:

1. A ledger in \_\_\_\_\_ way is normally kept in the form of bound note books.
2. Final accounts are prepared from the ledger account \_\_\_\_\_ to know the financial position of the business.
3. \_\_\_\_\_ column is meant for writing the page no. of journal or subsidiary book, from where posting is being done.
4. As every debit has a corresponding credit, hence total of debit balances of trial balance is always \_\_\_\_\_ to total of its credit balances.
5. The trial balance is not an absolute proof of the \_\_\_\_\_ of ledger accounts. It is a proof only of the arithmetical accuracy of the postings.

### 3.13 LET US SUM UP

- The General Ledger contains all of the balance sheet accounts of an accounting system. The balance sheet accounts are the assets, liabilities, and fund balance accounts of the school district.
- Values in General Ledger are expressed as debits or credits. The ledger page is actually a T-account in a more detailed format. It has the account title and its corresponding account number on top. It also has two sides, namely, the debit side and the credit side.
- A basic rule of double-entry accounting is that for every credit there must be an equal debit amount. From this concept, one can say that the sum of all debits must equal the sum of all credits in the accounting system. If debits do not equal credits, then an error has been made. The trial balance is a tool for detecting such errors.
- The trial balance is calculated by summing the balances of all the ledger accounts. The account balances are used because the balance summarizes the net effect of all of the debits and credits in an account.
- If you have an unbalanced trial balance, then you have an error somewhere in the accounting process. If all of your journal entries were posted properly (and error-free) in the general ledger, your debit grand total and credit grand total should balance, and you can move on in the accounting cycle. If the debit and credit grand totals do not balance, then you have an error to find somewhere in your transaction posting process (journal to general ledger to trial balance).

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### 3.14 LESSON END ACTIVITY

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Make a presentation on Ledger and Trial balance, and show their role and discuss the importance with examples.

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### 3.15 KEYWORDS

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**Ledger:** A ledger is the principal book or computer file for recording and totalling economic transactions measured in terms of a monetary unit of account by account type, with debits and credits in separate columns and a beginning monetary balance and ending monetary balance for each account.

**Trial balance:** A trial balance is a list of all the General ledger accounts (both revenue and capital) contained in the ledger of a business.

**Subsidiary books:** Subsidiary books refer to books meant for specific transactions of similar nature. Subsidiary books are also known as Special journals or daybooks.

**Journalising:** Transactions are recorded in the chronological order as and when they occur. This process is termed as Journalising.

**Posting:** Ledger is the book in which entries are recorded in different accounts by transferring from journal. This process is termed as posting.

**Suspense Account:** A suspense account is an account used temporarily to carry doubtful receipts and disbursements or discrepancies pending their analysis and permanent classification.

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### 3.16 QUESTIONS FOR DISCUSSION

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1. What is ledger? Why is it necessary?
2. Define ledger. Give its format. Also, explain the different rules of posting in it.
3. Describe the difference between journal and ledger.
4. Discuss the posting of an opening journal entry.
5. Explain the posting of compound journal entry.
6. What do you understand by ledger? Explain the significance of ledger.
7. What do you mean by balancing of accounts? Explain the procedure of balancing of accounts.
8. What is trial balance? State the objectives of trial balance.
9. Explain the different methods of preparing trial balance.
10. Discuss the various kinds of errors committed in writing up a set of books.
11. State the errors that cannot be detected even when matching the trial balance. Explain with examples.
12. What is trial balance? Why is it prepared? Explain the advantages and limitations of trial balance.
13. "Trial balance is not a conclusive proof of accuracy in the books of accounts." Do you agree with this statement?

14. From the following balances extracted from the books of Mr X, prepare his trial balance as on 31<sup>st</sup> March 2003.

	(₹)		(₹)
Building	67,000	Cash in hand	1,880
Machinery	53,000	Stationery	500
Furniture	5,000	Mis. Expenses	1,600
Debtors	18,400	Goodwill	10,000
Capital	1,20,000	Bank Overdraft	1,000
Drawings	15,000	Purchases	42,000
Freight	12,800	Provision for Bad debts	1,000
Carriage Outward	2,700	Postage	300
Opening Stock	21,300	Interest on loan	900
Wages	50,000	Loan from Sem	32,000
Salaries	1,800	Sundry Creditors	12,000
Sales	1,35,000	Prepaid Wages	420
General Reserve	4000	Charity Fund	2,000

(Total of trial balance 3,10,000)

15. Give journal entries of the following transactions and post them into ledger:

2013

Sept 1	Bret started business with cash	15,000
Sept 2	Paid into bank	8,000
Sept 4	Purchased furniture for office use	1,300
Sept 7	Purchased goods for cash	600
Sept 11	Drew from bank for office use	1,000
Sept 13	Goods sold to Pret	700
Sept 16	Purchased goods of Trex	410
Sept 20	Paid trade expenses	100
Sept 22	Received cash from Pret	680
	Allowed him discount	20
Sept 24	Paid rent	200
Sept 28	Paid Trex in full settlement	400
Sept 29	Interest on capital	100
Sept 30	Paid wages	100

**Check Your Progress: Model Answer**

1. Traditional
2. Balances
3. Folio
4. Equal
5. Accuracy

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### 3.17 SUGGESTED READINGS

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M. P. Pandikumar, *Accounting & Finance for Managers*, Excel Books, New Delhi.

R. L. Gupta and Radhaswamy, *Advanced Accountancy*.

V. K. Goyal, *Financial Accounting*, Excel Books, New Delhi.

Nitin Balwani, *Accounting & Finance for Managers*, Excel Books, New Delhi.



## UNIT II



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# LESSON

# 4

## FINAL ACCOUNTS

### CONTENTS

- 4.0 Aims and Objectives
- 4.1 Introduction
- 4.2 Overview of Financial Statements
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  - 4.6.5 Differences between Trading Account and Profit and Loss Account
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- 4.8 Let Us Sum Up
- 4.9 Lesson End Activity
- 4.10 Keywords
- 4.11 Questions for Discussion
- 4.12 Suggested Readings

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### 4.0 AIMS AND OBJECTIVES

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After studying this lesson, you should be able to:

- Understand the concept of financial statements
- Discuss income statement and trading account
- Describe the profit and loss account and balance sheet
- Explain how to treat various adjustments



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## 4.1 INTRODUCTION

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Every business entrepreneur is interested to know the ultimate results of his business enterprise, i.e., whether he/she has earned profits or suffered losses in the accounting period. In order to achieve these objectives of accountancy, final accounts are prepared after trial balance. Trial balance indicates that all the transactions have been duly entered, posted and balanced. And final accounts are prepared to ascertain the profit or loss and the financial position of the business.

The term 'Final Account' is a broader term. It refers to trading account, profit and loss account and balance sheet. These are called final accounts because they are the last accounts, prepared at the end of the year. Final Accounts are those accounts and statements, which are prepared to represent the financial position of the business at the end of the financial year to cater to the needs of the users of the accounting information. The preparation of financial statements is not the first step in the accounting process but they are the products of the accounting process, which give concise accounting information of the accounting period after the accounting period is over.

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## 4.2 OVERVIEW OF FINANCIAL STATEMENTS

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Financial statements mean the two statements, which are prepared at the end of the year. These are (a) Income statement or Trading and Profit and Loss Account, which is prepared to ascertain the profit earned and loss suffered during a specified period; (b) Position Statement or Balance Sheet, which is prepared to know the financial position on a particular date.

According to American Institute of Certified Public Accountants, "Financial Statements are prepared for the purpose of presenting a periodical review or report on the progress by the management and deal with the (i) status of the investment in the business and; (ii) results achieved during the period under review."

### 4.2.1 Objectives of Financial Statements

The main objectives of preparing financial statements are as follows:

- To provide a true and fair view of all the affairs of business.
- To show the net financial results of the business.
- To give adequate, timely and accurate information for decision-making.
- To provide information that assist in estimating the earning potentials of a business.

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## 4.3 INCOME STATEMENT

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This statement is a measure of financial performance and is divided into two parts. The first part is called the trading account and the second part is called profit and loss account.

### 4.3.1 Trading Account

Trading account is the first part of the financial statements and is prepared to know the trading results, i.e., the gross profit or gross loss. A trading account is an account, which contains, "in summarised form, all the transactions, occurring, throughout the trading period, in commodities in which trader deals" and which gives the gross trading result. In short, trading account is the account, which is prepared to determine the gross profit or the gross loss of a business enterprise. In the trading account,

the cost of goods sold is shown on the left-hand side and the sales on the right-hand side. If the sales are more than the cost of goods sold, the difference is called gross profit, and, in the reverse case, there will be a gross loss.

**Debit Side Items**

They are listed below:

- The value of opening stocks of goods (i.e., the stock of goods with which the business was started)
- Net purchase made during the year (i.e., purchases less returns)
- Direct expenses, if any

**Credit Side Items**

They are as follows:

- Total sales made during the period less the value of returns, i.e., net sales.
- The value of closing stock of goods.

The difference between the two sides of the trading account represents either gross profit or gross loss. The balance of trading account, which represents either gross profit or gross loss, is transferred to profit and loss account.

**Format for Trading Account**

**Trading Account  
for the year ended 20.....**

Particulars	Amount (₹)	Particulars	Amount (₹)
To opening stock		By sales	
		Less: Sales returns	
To purchases		By closing stock	
Less: Purchase returns			
To wages		By Gross Loss (transferred to profit and loss account)	
To carriage inwards			
To cartage			
To dock dues			
To manufacturing expenses			
To duty			
To freight			
To motive power			
To consumable stores			
To coal, gas and oil			
To packaging expenses			
To Gross Profit (transferred to profit and loss account)			

**Trading Accounts Items**

The explanation of items to be included in Trading Account is as under:

- **Opening Stock:** It refers to the opening goods in hand, i.e., goods at the beginning of the year. In case of trading concerns, it will consist of only finished goods or goods to be sold without alteration. In manufacturing concerns, the opening stock

will consist of three parts (a) Stock of raw materials; (b) Stock of partly completed goods or work-in-progress; and (c) Stock of finished goods. In case of new business, there will be no opening stock.

- **Purchases:** This item includes both cash and credit purchases of goods, purchased with the objective for sales. In trading account, net purchases are shown. To get net purchases, goods returned to suppliers (i.e., purchase returns) are deducted from gross purchases. In certain cases, goods that are distributed as free samples or those which are used by the proprietors for personal use are to be deducted from purchases.
- **Discount on Purchases:** It is also shown by way of deduction from purchases in the trading account.
- **Sales:** This item includes the total of both cash and credit sales of goods in which a businessman deals in. It is credited to trading account. In trading account, net sales are shown. To get net sales, goods returned from customers (i.e., sales returns) are deducted from gross sales. Sales of any fixed assets or other items wrongly included in sales are to be eliminated.
- **Returns Inwards or Sales Returns:** Goods returned to a trader by his customers is known as returns inwards or sales returns. It is shown by way of deduction from sales on the credit side, of the trading account.
- **Discount on Sales:** It is always a debit balance and is shown by deduction from sales in the trading account.
- **Direct Expenses:** Direct expenses are those expenses which are incurred to convert raw materials into finished goods or which may be regarded as a part of the cost of purchasing the goods, e.g., expenses incurred to bring goods from the place of purchase to the business place of the trader, etc. All the direct expenses are charged to the trading account. The items usually included in the direct expenses are:
  - ❖ **Wages:** Wages paid to the workers, who are directly engaged in the production, are direct expenses. This item usually signifies some hourly, daily or piecework remuneration paid to labourers. It is direct expenditure and it should be charged to trading account. However, wages and salaries paid in manufacturing of an asset is excluded from wages and salaries account. It will be added to the asset concerned on the asset side of the Balance sheet. Wages paid for installation of plant and machinery is an example of capital expenditure, and they are added to the plant and machinery on the asset side. It will be deducted from wages on the debit side of the trading account.
  - ❖ **Manufacturing or Productive Wages:** This item usually signifies the wages of factory workmen actually engaged in making or producing something. It is a direct charge on the cost of manufacturer. It is debited to the manufacturing account or the trading account.
  - ❖ **Carriage, Cartage or Freight:** Carriage inward is the conveyance expenses incurred to bring the goods purchased in the godown or shop. These are the expenses incurred on purchase of goods and are direct in nature. Thus, these are debited to trading account. If carriage is paid on purchase of some fixed assets or other items excluding goods, then it is not to be considered in the trading account.
  - ❖ **Customs Duty, Octroi Duty, etc.:** When goods are purchased from a foreign country, import duty, dock charges will be payable. When goods are received from another city, the municipal corporation may charge Octroi duty. All duties on goods purchased should be debited to the trading account.

- ❖ *Excise Duty*: It is a tax levied by the government. If the duty is levied on production, it will be treated as manufacturing expenses and debited to the trading account.
- ❖ *Manufacturing Expense*: All other expenses such as factory rent, factory insurance, factory repair, etc., are direct expenses and should be charged to trading account.
- ❖ *Stores Consumed*: This item denotes lubricating oil, tallow, grease, cotton and jute waste, etc., required for running the machinery of a manufacturing concern. The amount, stores consumed is a direct expense and should be charged to trading account. Expenses of consumable stores will be calculated as under:

	₹
Opening stock of stores	-----
Add: Purchase of stores during the year	-----
Less: Closing stock of stores	-----
Stores Consumed during the year	-----
	-----

- ❖ *Motive Power*: This item includes coke, gas, water or electric energy consumed in propelling the machinery. It is debited to the manufacturing account, in the absence of a manufacturing account; it is debited to the trading account.
- ❖ *Packing Expenses*: If packing is done at the time of production, it is included in direct expenses. However, if it is done at the time of sale, it is an indirect expense and is included in indirect expenses.
- ❖ *Royalty*: Royalty is an amount paid to a person for exploiting rights possessed by him. It is usually paid to a patentee, author, or landlord for the right to use his/her patent, copyright or land. If they are productive expenses, they are debited to manufacturing account; but in the absence of a manufacturing account, they are debited to a trading account.

### ***Closing Stock and its Valuation***

Closing stock represents the value of goods lying unsold in the hands of a trader at the end of a trading period. It is credited to the trading account. While valuing the closing stock, conservative principle is followed. As per this, the closing stock is valued at cost or market price, whichever is lower. As this item materially affects the gross profit (or gross loss), it is essential that all possible care should be taken to calculate the closing stock at a proper value.

The value of closing stock is taken into consideration only at the time of preparing the trading account and not before. The trial balance is prepared before the preparation of the trading account. Hence, the closing stock does not appear in a trial balance. It is brought into account by means of a journal entry debiting stock account and crediting the trading account. Generally, closing stock is not shown in the Trial Balance, but when adjusted purchases or materials consumed are given, then closing stock is shown in the Trial Balance.

### ***Closing Entries for Trading Account***

Closing entries are those, which are passed at the end of each financial period for transferring the various revenues items to the trading and profit and loss account and thus the nominal accounts are closed. While preparing a trading account, the opening

stock, purchases, and sales, both inwards and outwards, direct expenses and closing stock are transferred to it by means of journal entries as follows:

1. Trading Account Dr  
     To Opening Stock Account  
     To Purchases Account  
     To Sales Returns Account  
     To Direct Expenses Account (wages, carriage, etc.)  
     (Being the balances transferred to trading account)
2. Sales Account Dr  
     Purchases Returns Account Dr  
     Closing Stock Account Dr  
     To Trading Account  
     (Being the balances transferred to trading account)
3. (a) For Gross Profit (b) For Gross Loss  
     Trading Account Dr      Profit & Loss Account Dr  
     To Profit & Loss Account To Trading Account

**Advantages of Trading Account**

The advantages of the trading account are as follows:

- Trading account helps to know gross profit or loss so that the profitability of the business can be evaluated. The percentage of profit a businessman has earned on the cost of goods sold may serve as his ready guide for the adjustment of future sale price.
- Trading account provides information about the direct expenses.
- Gross Profit ratio can be calculated with the help of trading account. The formula is:

$$\text{Gross Profit Ratio} = \frac{\text{Gross Profit}}{\text{Sales}} \times 100$$

Trading account provides safety against possibilities of loss.

- Trading account helps in comparison of the closing stock with the last year's stock, which further helps in avoiding overstocking.
- Comparison of trading account details with previous years' details help to draw better administrative policies.

**Example:** Based on the following balances, prepare the trading account for the year ending on 31<sup>st</sup> December 2005:

	₹		₹
Opening Stock	15,000	Sales	40,000
Purchases	20,000	Sales return	1,800
Carriage	12,000	Purchases Return	1,200
Power	800	Wages	2,200
Freight	2,500		

The value of closing stock at the end of year is ₹ 26,000.

**Solution:**

**Trading Account  
for the year ending 31<sup>st</sup> December 2001**

Dr				Cr			
Date	Particulars	L.F.	Amount (₹)	Date	Particulars	L.F.	Amount (₹)
	To Opening stock		15,000		By Sales		40,000
	To Purchases	20,000			Less: Sales return		1,800
	Less: Purchase Return	1200	18,800		By Closing stock		26,000
	To Wages		2,200				
	To Carriage		12,000				
	To Power		800				
	To Freight		2,500				
	To Gross Profit c/d		12,900				
			64,200				64,200

**Importance of the Trading Account**

The importance of trading account can be judged from the following advantages:

- It provides information regarding gross profit or gross loss so that profitability of the business can be evaluated.
- Gross profit ratio is also calculated with the help of the trading account.
- This ratio further tells about the ratio of direct expenses to sales, which gives us the limits within which expenses are to be kept. Higher the gross profit ratio, the better it is. After every year, gross profit ratio can be calculated and comparison of performance of year after year can be made. A low ratio indicates reduction in sales or increase in cost of production.
- The progress of the business can also be known with the help of increasing or decreasing sales trend.
- Comparison of stock figures of one period with another period will be helpful in avoiding overstocking.
- Trading account also helps to determine the cost of goods sold, which can be helpful to fix fair selling price for future.

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**4.4 PROFIT AND LOSS ACCOUNT**

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Profit and Loss account is the second part of the income statement, which is prepared to ascertain the net profit of the business. Trading account reveals Gross Profit or Gross Loss. Gross Profit is transferred to credit side of Profit and Loss A/c. Gross Loss is transferred to debit side of the Profit Loss Account. Every businessman has to spend expenses other than on manufacture or purchase of goods, which are called indirect expenses. There are other incomes except sales. So gross profit or loss is adjusted keeping in view these indirect expenses and other incomes to find out the net profit or net loss. Thus, it is an account in which all gains and losses are collected, in order to ascertain the excess of gains over the losses or vice versa.

#### 4.4.1 Format of the Profit and Loss Account

The format of the profit and loss account is given below:

##### Profit and Loss Account for the year ended ...

Particulars	Amount (₹)	Particulars	Amount (₹)
To Gross Loss b/d		By Gross Profit b/d	
To Office and Management Expenses:		By Commission Received	
Office Salaries		By Discount Received	
Rent, rates and taxes		By Income from investment	
Printing and Stationery		By Interest Received	
Heating and Lighting		By Interest on Debentures	
Telephone Charges		By Dividend Received	
Audit Fees		By Apprenticeship premium	
Postage		By Rent from tenets	
Legal Charges		By Reserve for discount on creditors	
General Charges		By Miscellaneous receipts	
To Selling & Distribution Charges:		By Net loss transferred to capital account	
Advertisement			
Selling Commission			
Bad Debts			
Travelling Expenses			
Godown Rent			
Brokerage			
Packing Charges			
Carriage Outwards			
Upkeep of Motor Lorries			
To Depreciation & Maintenance:			
Depreciation on Furniture, Machinery, Building			
Repairs to Machinery, Building, Furniture			
To Financial Expenses:			
Interest on Capital			
Interest on Loan			
Bank Charges			
Discount Allowed			
Discount on Bills Discounted			
To Losses and Miscellaneous:			
Loss by Fire			
Loss on sale of fixed assets			
Charity, Donations			
To Net profit transferred to capital account			

Indirect expenses can be divided into two categories, i.e., (i) operating expenses and (ii) non-operating expenses. Operating expenses are those expenses, which are incurred to run the business efficiently such as administration, selling, and distribution expenses. Non-operating expenses are those expenses, which are not required to be incurred for efficient operation of the business but are shown on the debit side of the profit and loss account. These are loss on sale of fixed assets, writing off tangible assets and intangible assets, etc.

Trading and profit and loss account/income statement may be prepared either in account form (T form) or in report form (statement form). Trading and profit and loss account in both the forms give the same information. The account or T form is traditional and is used widely but in the recent years, many business houses prefer to present the profit and loss account/income statement in the report form. Modern trend is to present Trading and Profit and Loss account or Income Statement in the form shown as under:

**Format of Profit and Loss Account/Income Statement in Statement Form**

**Trading, Profit, and Loss Account/Income Statement  
for the year ended 31<sup>st</sup> December 2007**

Income From Sales:			
Sales		-----	
Less: Sales returns	-----		
Sales discount	-----	-----	
	-----	-----	
Net Sales			-----
Cost of Goods Sold:			
Merchandise in stock on 1 January		-----	
Purchases	-----		
Less: Purchases returns	-----		
	-----		
Net purchases		-----	
		-----	
Cost of goods available for sale		-----	
Less merchandise in stock on 31 December		-----	
		-----	
Cost of goods sold			-----
			-----
<b>GROSS PROFIT</b>			-----
Operating Expenses:			
<i>Selling Expenses:</i>			
Sales salaries	-----		
Advertising expenses	-----		
Insurance expense – selling	-----		
Store supplies expenses	-----		

*Contd*



Sundry selling expenses	-----		
Total selling expenses	-----		
		-----	
<i>General Expenses:</i>			
Office salaries	-----		
Taxes	-----		
Insurance expenses general	-----		
Office supplies expenses	-----		
Sundry general expenses	-----		
	-----		
Total general expenses		-----	
		-----	
Total operating expenses			-----
			-----
Net profit from operations			-----
	-----		
Other Income:			
Rent income		-----	
Other Expenses:			
Interest expenses		-----	
		-----	
			-----
			-----
NET PROFIT			-----
			-----

#### ***Important Points in Profit and Loss Account***

- **Salaries:** When the words 'wages and salaries' are given, it is written on the debit side of the trading account because it is a direct expense but if the first word is salaries i.e., 'salaries and wages' are given, then it is written on the debit side of the profit and loss account because it is an indirect expense. If any salary has been paid to proprietor or partners, it should be shown separately because it requires special treatment at the time of income tax assessment.
- **Rent:** Rent of the office, shop, showroom, or godown is an indirect expense and so is debited to the profit and loss account. However, rent of the factory is debited to the trading account. When a part of the building has been sublet, the rent received should be shown on the credit side of the profit and loss account as a separate item.
- **Rates and Taxes:** The local authorities to meet public expenditure levy these. Being an indirect expenditure it is shown on the debit side of the profit and loss account. If rent and rates are related to factory building, then they are recorded on the debit side of the trading account.
- **Interest:** Interest on loan, overdraft or overdue debts is payable by the firm. It is an indirect expense so debited to profit and loss account. Interest on loan advanced by the firm on depositor investments is an income of the firm and so is

credited to the profit and loss account. If business has paid any interest on capital to its proprietor or partners, it should also be debited in the profit and loss account but separately because this item needs special treatment at the time of income-tax assessment.

- **Apprentice Premium:** This is the amount charged from persons, to whom training is imparted by the business. It is an income and is credited to profit and loss account. In case apprentice premium is charged in advance for two or three years, then the amount is distributed over a number of years and each year's profit and loss account is credited with its share of income.
- **Commission:** In business, sometimes, agents are appointed to effect sales and are paid commission as their remuneration. Thus, a being selling expenses are shown on the debit side of the profit and loss account. Sometimes, commission is also paid on the purchase of goods; such an expense should be debited in the trading account. At times, the firm can also act as an agent to the other business houses, and in such cases, it receives commission from them. Commission so received is shown on the credit side of the profit and loss account.
- **Trade Expenses:** They are also termed as 'sundry expenses'. Trade expenses represent expenses of such a nature for which it is not worthwhile to open separate accounts. Trade expenses are not taken to the trading account.
- **Repairs:** Repairs to the plant, machinery, and building are indirect expenses, are treated as expenses, and are debited to profit and loss account.
- **Travelling Expenses:** Unless mentioned otherwise, travelling expenses are treated as indirect expenses and are debited to profit and loss account.
- **Bad debts:** It is the amount, which could not be recovered by the trader because of credit sales. It is a business loss, so is debited in the profit and loss account.
- **Life Insurance Premium:** If the premium is paid on the life policy of the proprietor of the business, it is treated as his drawings and is shown by the way of deduction from the capital account. It should not be taken to the profit and loss account.
- **Insurance Premium:** If insurance premium account appears in the trial balance, it stands for the insurance of the business. This is taken to the profit and loss account. Insurance premium on goods purchased, factory building, and factory machines are treated as direct expenses and are taken to the trading account.
- **Income Tax:** Income tax paid is treated as a personal expense and is shown by way of deduction from capital account. It is not recorded in the profit and loss account. Income tax in case of companies is treated differently.
- **Discount allowed and received:** Discount is a reward for prompt payment. It is a trend to show discount received and discount allowed separately on the credit and debit side of profit and loss account, respectively, instead of showing the net balance of this account.
- **Domestic and Household Expenses:** These expenses are not shown in the profit and loss account, as these are the personal expenses of the proprietor and should be treated as drawings.
- **Depreciation:** Depreciation is a loss incurred on the account of use of fixed assets in the business. Generally, it is charged from the profit and loss account at a fixed percentage. If rate is without words 'per annum', then the rate will be taken irrespective of the period of accounts. This is very important when the period of accounts is less than a year. On the other hand, if the rate of depreciation is

'per annum' the depreciation should be calculated on the assets with due consideration to the period for which the asset has been used in business during the year. In case of additions to assets during the year, it is advisable to ignore depreciation on additions if the date of additions is not given.

- **Rebate:** If rebate is given, it is shown on the debit side of profit and loss account, if it is received, it is shown on the credit side of profit and loss account.

### ***Closing Entries for Profit and Loss Account***

The following usual entries are passed at the end of each trading period.

Transferring all expenses or losses:

Profit and loss account	Dr
To Various expenses or losses	

(This entry will close the expenses accounts)

Transferring all items of gains, etc.:

Various income accounts (representing gains)	Dr
To Profit and loss account	

(This entry will close all the remaining nominal accounts)

Transferring net gain to capital account:

Profit and loss account	Dr
To Capital account	

(This entry closes the P & L account)

Transferring net loss to capital account:

Capital account	Dr
To Profit and loss account	

(This entry closes the P & L account)

### ***Advantages of Profit and Loss Account***

- Profit and loss account gives the actual information about the net profit or the net loss of the business for an accounting period, which helps us to evaluate the performance of a business.
- Profit and loss account gives the actual information about indirect expenses. Expenses of the current year can be compared with the expenses of the previous year, which help in taking effective steps to control such expenses.
- Profit and loss account serves to determine the ratio between net profits to sales.
- Profit and loss account helps in tax assessment because the net profit disclosed by the profit and loss account is the basis for determining business income for tax purposes.
- Profit and loss account helps in determining the ratio between net profits to operating expenses.
- Balance sheet cannot be prepared without preparing profit and loss account.
- Future planning can be made easily with the help of information provided by the profit and loss account.

**Example:** From the following balances extracted at the close of the year ended 31<sup>st</sup> March 2006, prepare profit and loss account of Mr Alex:

	₹		₹
Discount (Dr)	650	Apprentice Premium (Cr)	1,200
Gross Profit	98,000	Carriages Outward	1,800
Printing & Stationery	350	Salaries	5,200
Income Tax Paid	2,150	Rates & Taxes	300
Rent	3,800	Fire Insurance Premium	750
Bad Debts	1,700	Travelling Expenses	150
Rent received	1,200		

**Solution:**

**Profit & Loss Account of Mr Abale  
for the year ended 31<sup>st</sup> March 2006**

	₹		₹
To Carriage Outward	1,800	By Gross Profit b/d	98,000
To Salaries	5,200	By Apprentice Premium	1,200
To Rent	3,800	By Rent Received	1,200
To Rates & Taxes	300		
To Fire Insurance Premium	750		
To Printing & Stationery	350		
To Discount	650		
To Travelling Expenses	150		
To Net Profit c/d	87,400		
	1,00,400		1,00,400

Income tax paid being personal expense of the proprietor has not been debited to Profit and Loss Account. This is to be taken as drawings and deducted from Capital Account.

## 4.5 MANUFACTURING ACCOUNTS

The concerns, which convert raw materials into finished goods, are required to ascertain the cost of goods manufactured besides gross and net profits. Such concerns are known as manufacturing cum trading concerns. Manufacturing account is prepared before the trading account. The debit side of the manufacturing account shows the cost of materials consumed, i.e., opening stock of raw material plus net purchases less closing stock of the raw materials. Procurement cost, e.g., custom duty, excise duty, landing charges should also be included with the cost of raw materials. Closing stock is then deducted from the sum of the opening stock and purchases. Thereafter, productive wages and direct expenses are listed. Then, indirect factory expenses, e.g., rent, salaries of superiors, power, light, heat and fuel, depreciation on factory plant, building are listed. Total of materials, productive wages, and direct expenses should be adjusted for opening and closing stock of partly finished goods or work in progress, etc. On the credit side, closing stock of raw materials and work in progress can also be placed, if not adjusted in the debit side. The net amount will represent the cost of production. Sale of scrap, if any, will be adjusted from the cost of production. The cost

of goods manufactured during the year will be transferred to the trading account. A specimen of manufacturing account and trading account is as follows:

#### Manufacturing Account

Particulars	Amount (₹)	Particulars	Amount (₹)
To Opening Stock		By Closing stock:	
Raw Materials		Raw Materials	
Work-in Progress		Work-in Progress	
To Purchase of raw		By Sale of scrap (if any)	
Materials		By Cost of production	
Less returns		(transferred to trading account)	
To Direct Wages		(Balancing figure)	
To Direct Expenses			
(as carriage on purchases)			
To Factory Expenses			
Rent and taxes			
Lighting & heating			
Motive power			
Fuel			
Factory insurance			
To Depreciation on			
Factory			
Building			
Plant			
To Store consumed			
To Repairs to plant			
To Factory supervisor's salary			
To Opening stock of finished goods		By Sales	
To Cost of goods manufactured b/d		By Closing stock of finished goods	
(from manufacturing account)		By Gross Loss A/c	
To Purchase of finished goods			
To Gross profit – A/c			

**Example:** From the following balances, prepare the manufacturing account of Mr X for the year-ended March, 2015.

Work in Progress	₹
April 1, 2014	8,500
March 31, 2015	7,800
Materials Consumed	1,10,000
Sale of Scrap	1,800
Cost of scrap in words	1,750
Productive wages	26,000
Power	4,200
Other factory expenses	8,800

**Solution:**

**Manufacturing Account of Mr X  
for the Year Ended March 31, 2015**

Dr		Cr	
Particulars	Amount (₹)	Particulars	Amount (₹)
To Work in progress at the beginning	8,500	By Sale of scrap	1,800
To Materials consumed	1,10,000	By Work in progress at the end	7,800
To Carriage in words	1,750	By Cost of goods manufactured (transferred to trading account)	1,48,650
To Productive wages	26,000		
To Power	4,200		
To Other factory expenses	7,800		
	1,58,250		1,58,250

## 4.6 BALANCE SHEET

The balance sheet presents a company's financial position at the end of a specified date. Some describe the balance sheet as a "snapshot" of the company's financial position at a point (a moment or an instant) in time. The balance sheet is also referred to as the statement of financial position. A balance sheet is a statement prepared at the end of a financial year to know the true financial position of the business. It is not an account but only a statement that represents the closing assets and liabilities of the business on a certain date. In fact, it is a summary of whole of the accounting record. The Balance Sheet or Position Statement is based on fundamental accounting equation, i.e.,  $Assets = Liabilities + Capital$ . It has two sides. Left hand side shows liabilities and Right hand side shows assets. If assets are more than liabilities, the business is said to be solvent and if liabilities are more than assets, the business is said to be insolvent. There are generally three major categories of account classification on a balance sheet:

- **Assets:** Assets are economic resources owned by business. Two major asset classes are tangible assets and intangible assets.
- **Liabilities:** This includes all debts and obligations owed by the business to outside creditors, vendors, or banks.
- **Equity:** Stockholders, partners' or owners' equity is made up of the owner/investor investment in the business as well as any retained earnings that are reinvested in the business.

*The Balance Sheet, sometimes called the statement of financial position, shows the economic resources of the business at a point in time and the sources of these resources at a point of time.*

*—Smith and Keith*

A balance sheet is a statement of the financial position of a business, which states the assets, liabilities, and owners' equity at a particular point in time. In other words, the balance sheet illustrates the business' net worth. A specimen of a balance sheet is given below.

**Balance Sheet  
as on...**

Liabilities	Amount (₹)	Assets	Amount (₹)
Sundry Liabilities	-----	Sundry Assets	-----
Capital	-----		
	-----		-----

#### **4.6.1 Advantages of Balance Sheet**

The advantages of a balance sheet are as follows:

- It helps to know the amount of capital employed in business.
- It helps in ascertaining the financial position at the end of the accounting period.
- Solvency of the business can be judged from the total amount of assets available for the payment of liabilities.
- It helps in comparison of assets and liabilities of business on two dates for ascertaining their progress.
- Various ratios can also be calculated which help in better management of the business.

#### **4.6.2 Limitations of Balance Sheet**

Though the balance sheet is prepared at the end of each accounting period, yet it suffers from the following limitations:

- Balance Sheet cannot reflect those assets, which cannot be expressed in monetary terms such as honesty, skill, loyalty of workers.
- Balance Sheet does not reflect the true value of assets because fixed assets are shown at the original cost less depreciation up-to-date.
- It is prepared on a historical cost basis and changes in prices are not taken into account.
- Intangible assets such as goodwill are shown as imaginary figures having no relationship with the market value.

#### **4.6.3 Differences between Trial Balance and Balance Sheet**

The differences between trial balance and balance sheet are as follows:

- Trial Balance is a list of balances – debit and credit from the ledger accounts whereas balance sheet is a statement of assets and liabilities.
- Trial Balance may be prepared at regular intervals, e.g., quarterly, monthly whereas balance sheet is prepared at the end of the accounting period.
- Trial Balance contains balances of all personal, real and nominal accounts. Balance Sheet contains only those personal and real accounts, which represent assets and liabilities.
- The aim of preparing the trial balance is to check the arithmetical accuracy of the accounts whereas the main objective of preparing the balance sheet is to know the financial position of the business.
- Trial Balance is prepared before preparation of trading and profit and loss account. Balance sheet is prepared after the preparation of the trading and profit and loss account.
- Trial Balance does not show closing stock whereas it is shown on the asset side of the balance sheet.
- Trial Balance is prepared from the ledger accounts and the balance sheet is prepared from the trial balance.
- The preparation of the trial balance is not compulsory but the preparation of the balance sheet is compulsory.

- Opening stock is shown in the trial balance whereas it is not shown in the balance sheet.
- Trial balance is not a part of the final accounts whereas balance sheet is an important part of the final account.
- The accountants use Trial Balance only. Various parties like creditors, tax authorities, investors, bankers, etc., use Balance Sheet.
- It is not compulsory to prepare the trial balance but the preparation of the balance sheet is compulsory.
- There is no order for writing the items in the trial balances. However, the items of assets and liabilities may be written in order of liquidity or permanence.

#### 4.6.4 Similarities in Trial Balance and Balance Sheet

The similarities between trial balance and balance sheet are as follows:

- Both are statements and not ledger accounts.
- Both are prepared on a particular date.
- Both do not use the words 'To' and 'By'.
- Both are prepared from the balances of the ledger.

#### 4.6.5 Differences between Trading Account and Profit and Loss Account

The differences between Trading Account and Profit and Loss Account are listed in the following table.

**Table 4.1: Differences between Trading Account and Profit and Loss Account**

S. No.	Trading Account	Profit and Loss Account
1.	The trading account shows gross profit or gross loss.	Profit and loss account shows net profit or net loss.
2.	It is prepared before the profit and loss account is made.	It is prepared after the trading account is made.
3.	Trading account deals with purchasing and manufacturing costs of goods.	It deals with selling, administration and distribution expenses, etc.
4.	It is prepared to know the trend of the business for a period.	It is prepared to know the ultimate result of the business for a period.
5.	It considers only direct expenses and incomes.	It considers indirect expenses, losses, income gains, etc.
6.	Balance of this account is transferred to profit and loss account.	The balance of profit and loss account is transferred to capital account.

#### 4.6.6 Differences between Profit and Loss Account and Balance Sheet

The differences between Profit and Loss Account and Balance Sheet are listed in the following table.

**Table 4.2: Differences between Profit and Loss Account and Balance Sheet**

S. No.	Profit and Loss Account	Balance Sheet
1.	It is an account.	It is a statement.
2.	The aim of preparing this account is to find out net profit or net loss.	The objective of preparing this is to know the financial position of business.
3.	All nominal accounts are recorded here.	Real and personal accounts are recorded in balance sheet.

*Contd...*



4.	It is prepared for a certain period.	It is prepared on a particular date.
5.	It has debit side and credit side like an account.	It does not have debit or credit side but it has liabilities on the left side and assets on the right side.
6.	The difference of credit and debit is either net profit or net loss.	Balance Sheet does not show any balance. The total of assets side is always equal to the total of liabilities side.
7.	The word 'To' is used in debit side and 'By' in the credit side.	The words 'To' and 'By' are not used while preparing the balance sheet.

#### 4.6.7 Classification of Assets and Liabilities

##### *Assets*

Assets are the properties and possessions, which benefit the future. Assets are what the business owns, i.e., land, building, stock, cash, bills receivable, etc. The classification of assets is as follows:

- **Fixed Assets:** Fixed assets are acquired and intended to be retained permanently for carrying on the business. Assets, which are of durable nature and not intended for sale such as plant, building, machinery, furniture and fixtures, etc., are fixed assets. Fixed assets may be tangible or intangible. Tangible assets are those assets, which have physical existence those can be seen, touched and felt, like-building, machinery, plant, cash, stock, etc. Intangible assets are those assets, which cannot be seen, touched but have some value and also contribute to the profits, such as trademarks, etc.

According to schedule VI of the Companies Act, 1956, these tangible and intangible assets have been treated as fixed assets and are placed in the list of fixed assets of this schedule.

- **Current Assets:** These are in the form of cash or such other assets that can be converted into cash within a short period. Cash in hand, cash at bank, debtors, and bills receivable, temporary investments, etc., are the examples. These are also known as circulating assets because their amounts are subject to constant change.
- **Fictitious Assets:** These assets are fictitious in nature. These are not real assets. There are unwritten losses or non-recoupable costs. For example, brokerage, underwriting commission, heavy advertisement expenses, research and development expenditure, market research, debit balance of profit and loss account, discount on issue of shares or debentures, etc. All such expenses have debit balances and are to be written off through profit and loss account, slowly during future years an unwritten off portion of such expenses appear in the balance sheet.
- **Wasting Assets:** The assets, which are exhausted completely by use, or lose their value through wear and tear and cannot be replaced in the normal way are called wasting asset. e.g., quarries, mines, etc. Natural resources like mineral deposits, oil reserves, etc., can be called wasting assets.
- **Contingent Assets:** These are the assets whose existence and ownership depends on the happening or non-happening of a specified event. For example, a right to file a suit for claiming a certain amount. If this suit is won, the amount will be received. These assets are not shown in the balance sheet, because of the convention of accountancy, which states that provision for future losses is made but no consideration is made for uncertain future property or income.

## Liabilities

Every business is bound to pay an amount, a debit, i.e., liability is a debit, or an amount owned to anybody who has a right of claim at law. Liabilities may be internal or external. All amounts, which a business has to pay to the proprietor or owners, are internal liabilities; these include capital and un-distributed profits. All amounts, which a business has to pay to outsiders, are known as external liabilities; these liabilities include creditors, long-term loans, bills payable, etc. The classification of liabilities is as follows:

- **Fixed Liabilities:** All long-term liabilities are treated as fixed liabilities whether they are payable to the proprietor or to the outsiders.

For example, capital, long-term loans and debentures, debentures of a company, etc.

- **Current Liabilities:** All short-term liabilities, i.e., the amounts that are payable within one year and are paid out of current assets. These include bank loans, trade creditors, bills payable, short-term loans, outstanding expenses, etc.
- **Contingent Liabilities:** These are not actual liabilities, i.e., these are not the liabilities of the business on the date of balance sheet but may become liabilities in future on happening of an uncertain event are called contingent liabilities. In other words, they would become liabilities in the future provided the contemplated event occurs. If it does not occur, no liability is incurred. It is not shown in the balance sheet. Usually, it is mentioned in the form of a footnote. Bill discounted with bank is an example of a contingent liability. Other examples of such liabilities are:
  - ❖ Liability of a case pending in the court.
  - ❖ Claim against the companies not acknowledged as debts.
  - ❖ Bills of exchange, guarantees given against a particular firm or person.

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## 4.7 MARSHALLING OF BALANCE SHEET

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‘Marshalling’ means the order or sequence in which assets and liabilities are recorded in balance sheet. There are no statutory guidelines for the order or sequence of assets and liabilities for the preparation of the balance sheet of sole proprietorship and partnership firm. However, there is a specific pro forma prescribed by the Companies Act in case of balance sheet of joint stock companies. Most of the sole proprietorship and partnership firms prepare balance sheet according to their nature of business and suitability. There are two methods to prepare the balance sheet of sole proprietorship and partnership firms. These are:

- Liquidity Method
- Permanence Method

### 4.7.1 Liquidity Method

When assets and liabilities are arranged according to their reliability and payment preference, such an order is called liquidity order. In other words, cash, bank or other assets, which can be converted into cash easily, will be shown first and fixed assets will be shown later on.

Similarly, current liabilities will be followed by long-term liabilities and fixed liabilities. The specimen of this method is as follows:

**Balance Sheet (Liquidity Order)**

Liability	Amount (₹)	Assets	Amount (₹)
<b>Current Liabilities:</b>		<b>Current Assets:</b>	
Bills payable		Cash in hand	
Bank overdraft		Cash at bank	
Sundry creditors		Debtors	
Outstanding expenses		Bills receivable	
Short-term loans		Investment	
Fixed Liabilities		Closing stock	
Long-term loans		(i) Raw materials	
Debentures/Public deposits		(ii) Work in progress	
Capital		(iii) Finished goods	
Add: Net profit or loss		Prepaid expenses	
Net loss		Accrued incomes	
Less: Drawings		<b>Fixed Assets:</b>	
		Loose Tools	
		Furniture	
		Plant & Machinery	
		Motor Vehicles	
		Land & Building	
		Patents	
		Goodwill	
		Fictitious Assets	

#### 4.7.2 Permanence Method

Under this, the balance sheet will be prepared just opposite of the first possibility. Order of assets and liabilities (both) will be reversed. In other words, fixed assets will be followed by the current assets. Similarly, capital and long-term liabilities will be followed by the current liabilities. The specimen is as follows:

**Balance Sheet (Order of Permanence)**

Liabilities	Amount (₹)	Assets	Amount (₹)
Capital		Fixed Assets	
Add: Net profit		Current Assets	
Less: Drawings		Liquid Assets	
Fixed Liabilities			
Current Liabilities			

**Example:** From the following particulars, prepare a balance sheet as on 31<sup>st</sup> December 2012.

	Dr (₹)	Cr (₹)
Drawings	5,000	–
Capital	–	60,000
Debtors and Creditors	6,200	4,500
Cash at bank	8,200	–
Cash in hand	1,400	–
Plant	10,600	–
Furniture	21,000	–
Net Profit	–	2,200
General Reserve	–	1,500
Bills Receivable	15,800	–
	68,200	68,200

**Balance Sheet**  
**as on 31<sup>st</sup> December 2012 (Order of liquidity)**

Liabilities	Amount (₹)	Assets	Amount (₹)
Sundry creditors	4,500	Cash in hand	8,200
General Reserve	1,500	Cash in Bank	1,400
Capital 60,000		Bills Receivable	15,800
Add: Profits 2,200		Furniture	21,000
<u>62,200</u>		Plant	10,600
Less: Drawings 5,000	57,200		
	63,200		63,200

**Balance Sheet**  
**as on 31<sup>st</sup> December 2012 (Order of Permanence)**

Liabilities	Amount (₹)	Assets	Amount (₹)
Capital 60,000		Plant	10,600
Add: Profits 2,200		Furniture	21,000
<u>62,200</u>		Bills Receivable	15,800
Less: Drawings 5000	57,200	Debtors	6,200
		Cash in Bank	1,400
General Reserve 1,500		Cash in hand	8,200
Sundry creditors 4,500			
	63,200		63,200

**Adjustments:** As per the objectives of accounting convention of disclosure and the accrual concept, the final accounts are required to be prepared in such a way that the trading and profit and loss account and balance sheet represent a “true and fair” view of the profits earned and its true state of affairs at the end of the period. Sometimes, it is seen that after preparation of trial balance, but prior to preparation of final accounts, it may be noticed that some business transactions have been, completely or partially, omitted to be recorded or entered wrong. Besides this, there are some incomes or expenses, which are related to the next year but have been received or paid during the current year.

Trading and Profit and Loss and Balance sheet, together, are called as final accounts. Item appearing in the trial balance appears only once in the final accounts, either on the debit or credit. Any adjustment entry requires two postings, debit and credit for the same amount. Hence, before preparing final accounts, adjustment entries should be made to ensure that final accounts depict a true and fair view. Some important adjustments, which are to be made at the end of the accounting year, are discussed as under:

**Closing Stock:** Closing stock represents the unsold stock at the end of the year. It is valued at the cost price or market price whichever is lower. Normally, closing stock appears as an adjustment entry in the problem and is given at the end of the trial balance.

For example, if the value of stock at the end of the period is ₹ 30,000 and is shown below the trial balance, then the following adjusting entry will be passed:

Closing Stock A/c     Dr   30,000  
    To Trading Account                      30,000

The two-fold effect of this entry will be:

- (i) Stock will have a debit balance. Being a real account, it will be shown on the assets side of the Balance Sheet.
- (ii) Closing stock will be shown on the credit side of the Trading Account.

Sometimes, opening and closing stock are adjusted through purchases. In this case, closing stock (debit balance) appears in the Trial Balance. Closing stock, under this case, will not be shown on the credit side of the Trading Account but will be shown on the assets side of the Balance Sheet only.

**Outstanding Expenses:** Outstanding means dues that are not paid. There are certain expenses, which have been incurred but not paid. These expenses are called outstanding expenses. For example, salary of ₹ 12,000 is due to be paid to the clerk for the month of December. Books are closed at the end of December. In order to bring this transaction into accounts, the following adjustment entry will be passed:

Salary Account	Dr	₹ 12,000
To Outstanding Salary A/c		₹ 12,000

The two-fold effect of this entry will be:

- (i) Outstanding salary will be added to salary, if any, on the debit side of Profit and Loss Account.
- (ii) Outstanding Salary Account, being personal and having credit balance, will be shown on the liabilities side of the Balance Sheet.

**Prepaid Expenses (Unexpired expenses):** Prepaid expenses are paid in advance, i.e., not due but paid. When expenditure related to the next year but paid in the current year, i.e., whose benefit will be available in the future are called prepaid or unexpired expenses. For example, annual premium ₹ 8,000 is paid on 1<sup>st</sup> July, whereas the accounting year closes on 31<sup>st</sup> December. ₹ 4000 will be insurance paid in advance. To bring this into account, the following adjusting entry will be passed:

Prepaid Insurance Premium Account	Dr	₹ 4,000
To Insurance Premium		₹ 4,000

The double effect of this adjusting entry will be:

- (i) Prepaid insurance will be deducted from the insurance premium on the debit side of the Profit and Loss Account.
- (ii) Prepaid insurance, being personal account and having debit balance, will be shown on the assets side of the balance sheet.

**Accrued Income:** When an income is due or accrued but not received during the accounting year, it is known as an accrued income. For example, if a business has invested ₹ 15,000 in 5% gilt-edged securities on 1<sup>st</sup> January 2009 but during the year, ₹ 400 has been received as interest on securities. Then ₹ 350 interest on securities earned up to 31<sup>st</sup> December 2009 but not received will be accrued interest for the year 2009. The following adjustment entry will be passed:

Accrued Interest on Investments Account	Dr	₹ 350
To Interest on Investment Account		₹ 350

The two-fold effect of this entry will be:

- (i) Interest on Investment account (accrued interest) will be added to the interest account on the credit side of the profit and loss account.
- (ii) Accrued interest, being personal account and having debit balance, will be shown on the debit side of the balance sheet.

**Income Received in Advance:** When an income is not due or accrued but is received, then the income received for the subsequent year is known as income received in advance. As it is related to the next year, so it should not be included in the income of the current year. For example, rent ₹ 3600 (@₹ 1200 per month) is received in advance for three months. The adjustment entry will be passed:

Rent Account	Dr	₹ 3,600	
	To Rent Received in Advance Account		₹ 3,600

The two-fold effect of this entry will be:

- (i) It is shown on the credit side of the profit and loss account by the way of deduction from the income.
- (ii) It is shown on the liabilities side of the balance sheet.

It is important that when outstanding expenses a/c, prepaid expenses a/c, accrued income and unearned income a/c or income received in advance are given in the trial balance, then no adjustment entries are made and these accounts are shown in the balance sheet only.

**Depreciation:** Depreciation is the permanent reduction in the value of fixed assets because of wear, tear and efflux of time. This reduction or fall in the value should be treated as a loss or expense, to be considered before profit or loss is ascertained. When an asset is used for earning purposes, it is necessary that reduction due to its use should be charged to the profit and loss account. Depreciation is usually computed on the basis of the life of the assets. For example, a machine costs ₹ 50,000 and has a life of 5 years. Then, each year  $1/5^{\text{th}}$  of the cost, i.e., ₹ 10,000 should be treated as an expense; only the remaining amount is to be shown in the balance sheet. The entry is:

Depreciation Account	Dr	10,000	
	To Machinery Account		10,000

Depreciation is debited to the profit and loss account. It is deducted from the concerned asset, in the asset side of the balance sheet.

When depreciation appears in the trial balance, it will be recorded on the debit side of the profit and loss account only.

**Interest on Capital:** Interest on capital is an appropriation of profit payable to the partners or to the proprietor; it is not business expenditure. It is allowed at a certain rate for the full year on capital in order to see whether the business is really earning profit or not. For example, the capital is ₹ 1,00,000 and the rate of interest is 5%. Then, the interest will be ₹ 5,000. It will be treated like other expenses and debited to the profit and loss account; the amount will also be credited to the capital account. The entry is:

Interest on Capital Account	Dr	5,000	
	To Capital Account		5,000

The two-fold effect of this entry will be:

1. It is business expenditure; it should be debited to the profit and loss account.
2. It should be added in capital on liabilities side of the balance sheet, as it is not paid.

**Interest on Drawings:** Interest on drawings is not a business income, but it is charged on drawings in a partnership firm. The proprietor may also realise that when he draws money for private use, the firm loses interest as funds for business are reduced. Therefore, the proprietor's capital may be debited with the interest on the money

drawn by him. Interest will depend on the amount and the date of withdrawal concerned. Interest on drawings is again to the business and loss to the proprietor. For example, drawings are ₹ 15000 and interest on drawings is ₹ 750. The entry to be passed is:

Drawings Account	Dr	₹ 750	
	To Interest on Drawings Account		₹ 750

The two-fold effect will be:

1. Shown on the credit side of profit and loss account
2. Shown on the liabilities side of the balance sheet by way of additions to the drawings, which are ultimately deducted from the capital

**Interest on Loan:** Interest must be paid on loans, whether there is a profit or loss. It is an indirect expenditure. When such expenditure is due or accrued but not paid, the amount of such expenditure is to be shown in the debit side of the profit and loss account and in the liabilities side of the balance sheet as an outstanding liability.

If the firm has taken some loan, it has to pay interest thereon. Hence, when a loan account is given in the trial balance, it must be found out whether the interest due on the loan has been paid or not. The rate of interest and the date on which the loan was taken is usually given. If, however, the date on which the loan was taken is not given, it means that it is an old loan and the full year's interest is to be provided. So, note the amount of loan, the rate of interest and the period for which the interest is to be provided. Calculate the amount of interest and find out from the trial balance whether the same has been paid or not. Generally, the interest has been paid but it is less than what is due. In such a situation, the difference is regarded as an outstanding interest, and the same is adjusted at the time of preparing the final accounts. For example, there is an item of 10% loan (taken on April 1, 2007) ₹ 20,000 in the Trial Balance. Assuming the accounting year ends on December 31, the total interest on loan will work out as ₹ 1,500 (at 10% on ₹ 20,000 for nine months). Ongoing through the trial balance, the interest paid is ₹ 1,000 only. It means ₹ 500 (₹ 1,500 – ₹ 1,000) is the outstanding interest. Therefore, there is a need to make the necessary adjustment, i.e., add it to the interest paid on the debit side of the profit and loss account and show it as an outstanding interest under the current liabilities in the balance sheet. The entry is:

Interest on Loan Account	Dr	₹ 500	
	To Outstanding Interest Account		₹ 500

**Bad Debts:** Debts, which cannot be recovered or become irrecoverable, are called bad debts. It is a loss to the business. The entry will be:

Bad Debts Account	Dr	
	To Debtors Account	

The two-fold effect will be:

1. It will be shown on the debit side of the profit and loss account.
2. It will be shown as a deduction from debtors on the asset side of the balance sheet.

Sometimes, there are additional bad debts after the trial balance is prepared and before the final accounts are drawn. Such bad debts must be recorded with the same adjusting entry. If the bad debts are appeared inside the trial balance, these should not be deducted from sundry debtors in the balance sheet. In that case, these are only shown on the debit side of the profit and loss account.

For example, total debtors in trial balance are ₹ 20,000 and bad debts ₹ 900 are given. Suppose a further adjustment for bad debts of ₹ 650 are to be made. The effect of the same is shown in the profit and loss account as under:

**Profit and Loss Account**

	₹	₹
To Bad Debts	900	
Add: Additional bad debts	650	
	1,550	

**Balance Sheet**

Liabilities	Assets	(₹)
	Sundry Debtors	20,000
	Less: Bad Debts	650
		19,350

**Provision for Doubtful Debts:** Debtors from whom recovery of debts may be doubtful are treated as doubtful debts. These debts may or may not be realised in future. In other words, besides bad debts, the recovery of certain debts may seem to be doubtful. A bad debt is a known loss. However, a doubtful debt is only an expected loss. For such a loss, as expected, some provision is made in the form of provision for doubtful debts. The following journal entry is passed for creating a provision for bad debts.

Profit & Loss A/c      Dr

To Provision for Bad and Doubtful Debts

For example, sundry debtors on 31.03.2009 are ₹ 25,500. Further bad debts are ₹ 500. Provision of 5% is to be made on debtors. The amount for the provision for doubtful debts will be ₹ 1,250 i.e., 5% on ₹ 25,000 (₹ 25,500 – 500).

It is important to note that bad debts appeared in the trial balance are not deducted from debtors, while recording in the balance sheet because they have already been deducted.

The two-fold effect will be:

1. It will be shown on the debit side of profit and loss account or by way of addition to bad debts.
2. Provision for doubtful debts is shown on the assets side of the balance sheet by the method of deduction from the sundry debtors.

**Example:** Sundry debtors shown in the trial balance ₹ 50,000 and bad debts shown are ₹ 2,000, further bad debts of ₹ 800 are to be written off and also provision of 5% is to be made on debtors on 31<sup>st</sup> March 2012. The effect of this is shown below.

**Profit and Loss Account**

	₹	
To Bad Debts	2,000	
Add: Further bad debts	800	
	2,800	
Add: Provision for doubtful debts	2,460	
	5,260	



### Balance Sheet

	Assets	₹
	Sundry Debtors	50,000
	Less: Bad Debts	800
		49,200
	Less: Provision for doubtful debts	2,460
		46,740

Some important points for the provision for bad debts:

- If opening balance is given, it should be shown on the credit side of the account.
- Total bad debts given in the trial balance and in adjustments are transferred by debit to the provision for doubtful debts account.
- New provision required must be debited to provision for doubtful debts account by putting it as a closing balance.
- If there is a balance, that balancing figure will be credited to this account by debiting to profit and loss account. It will be the amount transferred from profit and loss account to provision for doubtful debts.

**Provision for Discount on Debtors:** Every firm or businessman has to allow cash discount at the time of prompt payment from customers or debtors. As the debtors in the end of a year make payments in the next years, so the provision for such discount has to be made in the current year. This discount is a loss to the business. Hence, provision for discount on debtors must be created to meet out such loss to the business in the future. Treatment is same as provision for doubtful debts with the difference that provision for discount is always calculated on good debtors. That means, bad debts are written off and the new provision for doubtful debts is deducted from the debtors, and then the provision for discount will be calculated on the remaining debtors. The entry will be:

Profit & Loss Account      Dr  
     To Provision for discount on debtors Account

The two-fold effect will be:

1. It will be shown on the debit side of the profit and loss account.
2. It will be shown by the method of deduction from sundry debtors (after deducting bad debts and provision for doubtful debts) on the asset side of the balance sheet.

**Provision for Discount on Creditors:** If a businessman makes provision for discount on debtors, he can also make a provision for discount on creditors. Such discount increases his profit. While preparing final accounts at the end of the year, this provision/reserve is made as a percentage of the total creditors. For example, the creditors were ₹ 20,000 on 31<sup>st</sup> December 2015 and 2% reserve is to be made for discount on creditors. The following entry will be:

Provision/Reserve for Discount on Creditors Account      Dr      ₹ 400  
     To Profit and Loss Account      ₹ 400

The balance of provision for discount on creditors shall be carried forward to the next year.

**Loss of Stock by Fire:** Generally, there are the following three cases for such a condition:

**If the stock is fully insured:** In this case, the whole loss will be claimed from the insurance company. The following entry will be passed:

Goods lost by Fire Account      Dr  
    To Trading Account

The two-fold effect will be:

1. It will be shown on the credit side of the trading account.
2. It is shown on the asset side of the balance sheet.

**If the stock is partly insured:** Under such a case, the loss of stock covered by insurance policy will be claimed from the insurance company and the rest of the amount will be the loss for the business and is transferred to the profit and loss account. The claim admitted will be shown on the asset side of the balance sheet. The entry will be:

Insurance Company Account      Dr  
Profit & Loss Account              Dr  
    To Trading Account

The two-fold effect will be:

1. It will be shown on the credit side of the trading account with the value of stock and shown on the debit side of the profit and loss account for that part of the stock, which is not insured.
2. Amount realised from the insurance company is shown on the asset side of the balance sheet.

**If the stock is not insured at all:** In this case, the entire loss will be borne by the firm. Hence, it should be debited to the profit and loss account. The entry will be:

Profit and Loss Account              Dr  
    To Trading Account

The two-fold effect of this will be:

1. It will be shown on the credit side of the trading account.
2. It will be shown on the debit side of the profit and loss account.

**Deferred Revenue Expenditure:** Sometimes, there may be heavy expenditure on research, advertisement, etc. These are incurred in the initial stage or during the financial year, but the benefit of these will be available in the subsequent years. It is known as deferred revenue expenditure. A part of such expenditure will be written off in each year and the rest will be capitalised, i.e., the balance of expenditure carried forward will appear in the balance sheet as an asset until the entire amount has been transferred to profit and loss account. The entry for this (say advertisement of ₹ 1,500, which will be spend over 3 years) will be:

Profit and Loss Account              Dr      ₹ 500  
    To Advertisement Account                                      ₹ 500

The two-fold effect will be:

1. It will be shown on the debit side of the profit and loss account.
2. It will be shown on asset side by way of deduction from capitalised expenditure.

**Goods withdrawn for personal use:** If goods are withdrawn from the business for the personal use of the proprietor, then these are treated as drawings. The entry will be:

Drawings Account                      Dr  
    To Purchases Account

The two-fold effect of this entry will be:

1. It will be deducted from the purchases in the trading account.
2. The same amount will be deducted from the capital in the balance sheet.

**Goods Distributed as Free Samples:** When goods are distributed as free samples then these are to be treated as advertisement of the business. The entry will be:

Advertisement Account                 Dr  
    To Purchases Account

The two-fold effect of this will be:

1. It will be deducted from purchases.
2. It will be shown on the debit side of the profit and loss account as advertisement expenditure.

**Reserve Fund:** Reserve is created out of profit and loss account. For example, ₹ 1,200 are to be transferred to the Reserve Fund from the net profits, the entry will be:

Profit and Loss Account                Dr  
    To Reserve Fund Account

The two-fold effect of this will be:

It will be shown on the debit side of the profit and loss account along with the net profits.

It will be shown on the liabilities side of the balance sheet.

**Income Tax:** It is not business expenditure but it is a personal expenditure. Hence, it should be treated as a drawing and is to be deducted from the capital. When it is paid from the business and appears in the trial balance, it should be treated as under:

Drawings Account                      Dr  
    To Income Tax Account

**Interest on Investments:** Interest on investments is an indirect income. If such an income is due or accrued but is not received, the amount of such income is to be shown on the credit side of the profit and loss account and in the asset side as an accrued income. The entry will be:

Interest on Investment Account        Dr  
    To Profit and Loss Account

**Wages include installation charges of a machine:** Wages are generally direct expenses but when these are expended for installation of machines, then these are treated as a capital expenditure. Therefore, it will be deducted from wages account in the trading account and it will be added to the machinery account in the balance sheet. The entry will be:

Machinery Account                      Dr  
    To Wages Account

**Carriage includes carriage paid for purchase of assets:** Like wages, carriage inward is a direct expense, but when carriage is expended for the purchase of fixed assets, it will be treated as a capital expenditure. Hence, it will be deducted from the carriage account in the trading account and then it will be added to the fixed assets account in the balance sheet. The entry will be:

Fixed Assets Account                      Dr  
    To Carriage Account

**Dishonour of cheque/bill receivable but no entry has been made:** Sometimes, a cheque or a bill is dishonoured but no entry has been made in the books for such dishonour before the preparation of the trial balance. The entry for this will be:

Debtor's Account                          Dr  
    To Bank or Bills Receivable Account

The amount of the dishonoured cheque will be added to the debtors account and the same amount will be deducted from the bank or bills receivable account in the balance sheet.

**Sales Tax:** Sales tax is a tax collected by the sellers from their customers. Now sales tax is also known as VAT, i.e., Value Added Tax. The entries are:

When goods are sold on credit:

Debtors Account                          Dr  
    To Sales Account  
    To Sales Tax/VAT Account

When goods are sold in cash:

Cash Account                              Dr  
    To Sales Account  
    To Sales Tax/VAT Account

When Sales Tax/VAT is paid to the Government

Sales Tax/VAT Account                  Dr  
    To Bank Account

If sales tax/VAT is included within the selling price, for charging sales tax/VAT the entry will be:

Sales Account                              Dr  
    To Sales Tax/VAT Account

If any part of sales tax/VAT remains unpaid at the end of the year, then the said amount is to be shown as a liability within the balance sheet.

**Example:** The following are the balances attracted from the books of M/s Chabla Traders as on 31.3.2011. From these balances and information given, prepare trading and profit and loss account and balance sheet.

	Debit (₹)	Credit (₹)
Purchases	22500	—
Wages	5500	—
Sales	—	38250
Salaries	1500	—
Travelling expenses	600	—

Contd.

Discount allowed	700	–
Office expenses	600	–
Commission	500	–
Interest	–	3550
Trade expenses	650	–
Building	25000	–
Plant & machinery	22000	–
Debtors	5200	–
Creditors	–	9500
Carriage on purchases	700	–
Capital	–	35000
Cash in hand	900	–
Rent received	–	1850
Stock (opening)	6200	–
Insurance paid	400	–
Bill payable	–	5900
Bills receivable	4800	–
Discount received	–	3700
	97750	97750

The following adjustments are to be made:

1. Closing stock ₹ 6500.
2. Allow 5% interest on capital.
3. Outstanding salaries ₹ 500.
4. Office expenses outstanding ₹ 250.
5. Depreciate building by 5% machinery by 10.

**Solution:**

**Trading and Profit & Loss Account  
for the year ending 31<sup>st</sup> March 2011**

Particulars	Amount (₹)	Particulars	Amount (₹)
To Opening stock	6200	By Sales	38250
To Purchases	22500	By Closing stock	6500
To Wages	5500		
To Carriage on purchase	700		
To Gross Profit c/d	9850		
	44750		44750
To Salaries	1500	By Gross Profit b/d	9850
Add: Outstanding	500	By Interest	3550
To Travelling Expenses	600	By Rent Received	1850
To Discount Allowed	700	By Discount received	3700
To office expenses	600		
Add: Outstanding	250		
To Commission	500		
To Trade expenses	650		
To Insurance	400		
To Depreciation on building	1250		
Machinery	2200		
To Interest on capital	1750		
To Net Profit transferred to capital a/c	8050		
	18950		18950

**Balance Sheet**  
as on 31.3.2011

Liabilities	Amount (₹)	Assets	Amount (₹)
Bills Payable	5900	Cash in hand	900
Creditors	9500	Closing stock	6500
Outstanding salaries	500	Debtors	5200
Outstanding office expenses	250	Bill receivable	4800
Capital	35000	Plant & machinery	22000
Add: Net profit	8050	Less: Depreciation	2200
	43050	Building	25000
Add: Interest on capital	1750	Less: Depreciation	1250
	44800		23750
	60950		60950

**Example:** From the following balances taken from the books of M/s Ram & Sons and adjusted information, you are required to prepare profit and loss account for the year ending 31<sup>st</sup> December 2015 and prepare balance sheet as on 31.12.2015.

**Trial Balance**

	Debit (₹)	Credit (₹)
Stock on 1 Jan. 2015	50500	-
Purchases and Sales	100300	141200
Returns	2200	1800
Capital	-	40000
Drawings	5500	-
Land and Buildings	32000	-
Furniture	10,000	-
Debtors and Creditors	20,000	41000
Investment	15000	-
Cash in hand	2500	-
Interest	-	1000
Commission	-	3000
Postage & Stationery	6500	-
Direct expenses	5500	-
Fire insurance premium	2500	-
Salaries	10500	-
Bank overdraft	-	35000
	2,63,000	2,63,000

1. Closing stock on 31.12.2015 was valued at ₹ 62000.
2. Goods worth ₹ 500 are reported to have taken by the proprietor for his personal use in 2015.
3. ₹ 500 insurance premium paid is in respect of the quarter ended 31.3.2016.
4. Interest on investment ₹ 350 is yet to be received while ₹ 700 of the commission received is yet to be earned in 2016.
5. Salaries of ₹ 500 for Dec. 2015 and bank overdraft interest estimated at ₹ 2000 have to be paid.
6. Make provision for bad debts @ 5% on Sunday debtors.
7. Depreciation is to be provided on land and building @ 5% and on furniture @ 10% p.a.

**Solution:**

**Trading and Profit & Loss Account of M/s Ram & Sons  
for the year ended 31-12-2015**

		₹			₹
To Opening stock		50500	By Sales	141200	
To Purchases	100300		Less: Returns	2200	139000
Less: Returns	1800				
	<u>98500</u>		By Closing Stock		62000
Less: Goods for pass and use	500	98000			
To Direct expenses		5500			
To Gross Profit c/d		47000			
		<u>201000</u>			<u>201000</u>
To Salaries	10500		By Gross Profit b/d		47,000
Add: Outstanding	500	11000	By Commission	3000	
To Postage and stationery		6500	Less: Received in advance	700	2300
To Fire insurance premium	2500		By Interest	1000	
Less: Prepaid	500	2000	Add: Accrued	350	1350
To Interest outstanding (for bank overdraft)		2000			
To Provision for bad debts		1000			
To Depreciation on:					
Land & buildings	1600				
Furniture	1000	2600			
To Net Profit transferred to capital A/c		25550			
		<u>50650</u>			<u>50650</u>

**Balance sheet of M/s Ram & Sons  
as on 31-12-2015**

Liabilities		₹	Assets		₹
Creditors		41000	Cash in hand		2500
Outstanding salaries		500	Sunday debtors	20000	
Outstanding interest on overdraft		2000	Less: Provision for D/D	1000	19000
Bank overdraft		35000	Investments	15000	
Commission received in advance		700	Add: Accrued interest	350	15350
Capital	40,000		Stock		62000
Add: Net profit	25550		Insurance prepaid		500
	<u>65550</u>		Land & building	32000	
			Less: Depreciation	1600	30400
Less: Drawings (5500 + 500)	6000	59550	Furniture	10000	
			Less: Depreciation	1000	9000
		<u>138750</u>			<u>138750</u>

**Example:** On 31<sup>st</sup> December 2014, the following trial balance was extracted from the books of Mr A:

Debit Balance:	₹		₹
Debtors	25100	Bad Debts	550
Cash in hand	2000	Bills receivable	7400
Drawings	3500	Office expenses	1800
Carriage inward	3050	Advertising	2950
Carriage Outward	2250	Insurance	2100
Cash in bank	3750	<b>Credit Balances:</b>	
Sales returns	6810	Capital	39820
Salaries	10130	Sales	125485
Purchases	72560	Loan on Mortgage	11800
Rent and rates	2600	Purchases returns	1450
Stock on 1 Jan 1999	7625	Bills Payable	2700
Motor Vehicles	12500	Commission received	1450
Interest on loan	250	Bad debts reserve	690
Land and Building	14050	Discount	650
General Expenses	2870		
Bank Charges	200		

Prepare Trading and Profit and Loss Account for the year ended 31<sup>st</sup> December 2014:

- Salaries amounting to ₹ 650 and rates amounting to ₹ 250 are outstanding.
- Stock in hand on 31<sup>st</sup> December 2014 was valued at 5940.
- Interest on loan at 6% p.a. is unpaid for six months.
- Depreciate land and building at 5% and Motor vehicles at 10%.
- Make a provision for bad debts at 5% on debtors.
- Prepaid insurance ₹ 200.
- Manager's commission at 10% on net profit after charging such commission.
- Interest on drawings 5% p.a.

**Solution:**

**Trading and Profit and Loss Account  
for the year ended on 31<sup>st</sup> December 2014**

Particulars	Amount (₹)	Particulars	Amount (₹)
To Opening stock	7625	By Sales	125485
To Purchases	72560	Less: Returns	6810
Less: Purchases	1450	By Closing stock	5940
To Carriage inwards	3050		
To Gross profit c/d	42830		
	124615		124615
To Carriage outward	2250	By Gross Profit b/d	42830
To Salaries	10130	By Commission received	1450
Add: Outstanding	650	By Discount	650
	10780	By Interest on Drawings	175

*Contd*



To Office expenses		1800	
To Rent & Rates	2600		
Add: Outstanding	250	2850	
To General expenses		2870	
To Interest on loan (250+354)		604	
To Bad debts	550		
Add: New provision	1255		
	1805		
Less: Old provision	690	1115	
To Insurance	2100		
Less: Prepaid	200	1900	
To Advertising		2950	
To Bank charges		200	
To Depreciation			
On Land and Building	703		
On Motor Vehicles	1250	1953	
To Manager's Commission			
	$\left(\frac{10}{110} \times 15833\right)$	1439	
To Net profit transferred to capital A/c		14394	
		45105	45105

**Balance Sheet  
as on 31st December 2014**

Liabilities	Amount (₹)	Assets	Amount (₹)
Salaries outstanding	650	Land and Building	14050
Rates outstanding	250	Less: Depreciation	703
Loan on mortgage	11800	Motor Vehicles	12500
Interest on loan (6%)	354	Less: Depreciation	1250
Bills payable	2700	Prepaid insurance	200
Manager's commission	1439	Closing stock	5940
Capital	39820	Debtors	25100
Add: Net profit	14394	Less: Provision for	
	54214	Bad debts	1255
Less: Drawings	500	Bills receivable	7400
Less: Interest on drawing	175	Cash at bank	3750
	50539	Cash in hand	2000
	67732		67732

**Purchases of goods not recorded in books of accounts:** If goods have been received after purchasing but are not recorded in books, the adjustment entry will be:

Purchases A/c           Dr  
    To Creditor A/c

(Being omitted purchases recorded)

Therefore, the purchases in trading account and sundry creditors on the liability side of balance sheet will increase with the amount of purchases.

**Goods in Transit:** Sometimes, some goods were purchased but neither the delivery of goods has been effected nor the invoice for the same invoiced on the last date of accounting period. Such goods are known as 'Goods-in-transit'. The adjustment entry should be passed on the date when final accounts are prepared. The entry will be:

Goods in Transit A/c            Dr  
    To Sundry Creditors A/c

(Being goods purchased but in transit)

The effecting final accounts:

- (a) Goods in transit will be recorded on the asset side of balance sheet.
- (b) Same amount will also be added to sundry creditors on the liabilities side of the balance sheet.

**Goods sold on Approval Basis:** Sometimes, goods are sold to customers on the condition that they can return it if they do not like the goods. In such cases, goods so sold cannot be treated as sales because the customers can return these goods. they must be included in the stock at cost price. In such a case, these two entries will be passed:

(a) Sales A/c                      Dr (with sales value)  
    To Debtors A/c

(Being goods sent on approval basis)

(b) Closing Stock A/c    Dr (at cost price)  
    To Trading A/c

(Being cost of goods with customers included in closing stock)

The effect of these entries will be:

- 1. Sales on the credit side of the trading account will be reduced by the amount of stock lying with the customers at the sale price and on the assets side of the balance sheet, debtors will be reduced by the same amount.
- 2. Stock on approval at cost price will be added to the closing stock on the credit side of the trading account and will be shown on the asset side of the balance sheet.

**Trading A/c**

		By Sales Less: Sale on approval basis By Closing stock Add: Stock with customers
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**Balance Sheet**

<b>Liabilities</b>		<b>Assets</b>
		Debtors Less: Sale on approval basis Closing stock Add: Stock with customers

### Check Your Progress

Fill in the blanks:

1. In the \_\_\_\_\_, the cost of goods sold is shown on the left-hand side and the sales on the right-hand side.
2. All the \_\_\_\_\_ are charged to the trading account.
3. \_\_\_\_\_ are those expenses, which are incurred to run the business efficiently such as administration, selling, and distribution expenses.
4. \_\_\_\_\_ of the business can be judged from the total amount of assets available for the payment of liabilities.
5. If goods are withdrawn from the business for the personal use of the proprietor, then these are treated as \_\_\_\_\_.

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## 4.8 LET US SUM UP

- Final accounts comprise a trading and profit and loss account, and balance sheet. These are prepared at the end of the accounting year after the trial balance has been completed.
- The trading and profit and loss accounts provide a summary of the results of a business's trading activities during a given accounting year. They show the gross and net profit or loss for the year, and enable users to evaluate the performance of the enterprise.
- The balance sheet is a list of the assets and liabilities (and capital) of a business at the end of a given accounting year. It enables users to evaluate the financial position of the enterprise, including whether it is likely to be able to pay its debts. In the balance sheet assets are classified as either fixed or current, and liabilities as either current or long term. The balance sheet also contains several useful subtotals comprising net current assets, total assets less current liabilities, and net assets.
- The gross profit is the difference between the sales revenue and the cost of sales. The cost of sales is the amount of purchases as adjusted for the opening and closing stocks. The stock at the end of an accounting year has to be entered in the ledger by debiting a stock account and crediting the trading account. The trading and profit and loss accounts are then prepared by transferring the balances on the nominal accounts in the ledger to these accounts.
- The balance sheet is a list of the balances remaining in the ledger after the trading and profit and loss accounts have been prepared. It is extracted in essentially the same way as a trial balance, but presented using a more formal layout to show the two groups of both assets and liabilities, and pertinent subtotals.

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## 4.9 LESSON END ACTIVITY

Take an annual report of a company of your choice and study all the given accounting in it from a managerial perspective.

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## 4.10 KEYWORDS

**Balance Sheet:** A statement of the assets, liabilities, and capital of a business or other organization at a particular point in time, detailing the balance of income and expenditure over the preceding period.

**Manufacturing Account:** An account used to show what it costs to produce the finished goods made by a manufacturing business.

**Trading Account:** The first step of final account is trading account. Trading account is nominal account which is prepared at the end of accounting year. Trading account helps to find out gross profit or gross loss during the accounting period.

**Depreciation:** A reduction in the value of an asset over time, due in particular to wear and tear.

**Trial Balance:** A trial balance is a list of all the General ledger accounts (both revenue and capital) contained in the ledger of a business.

**Bad Debts:** A debt that is not collectible and therefore worthless to the creditor.

#### 4.11 QUESTIONS FOR DISCUSSION

1. What is Manufacturing Account? How is it prepared? Explain with suitable examples.
2. What do you understand by Final Accounts? How to prepare it?
3. What do you mean by Balance Sheet? Why is it prepared? Explain the difference between Trial Balance and Balance Sheet.
4. Explain the importance of adjustments in the final accounts. Explain any five with examples.
5. What is the difference between the Trading Account and Profit and Loss Account? What accounting information do we get from it?
6. What do you understand by Grouping and Marshalling of Balance Sheet? Explain the different forms of Marshalling.
7. Does the Balance Sheet represent a 'true and fair' financial position of the business? Explain.
8. How does profit and loss account differ from the trading account? Explain.
9. Prepare manufacturing account and trading account for the year ended in 31<sup>st</sup> March 2012 from the following particulars:

	₹		₹
Opening stock of raw material	15000	Power	700
Purchases of raw materials	55000	Closing stock of raw materials	5000
Opening stock of finished goods	5000	Closing stock of finished goods	10000
Purchase of finished goods	25000	Freight on raw materials	1500
Gas & water	800	Freight on finished goods	700
Factory rent	600	Sales of finished goods	125000
Returns in words (finished goods)	2200	Wages	3500
Returns outwards (finished goods)	1300	Closing stock of W-I-P	8000
Consumable stores	900	Opening stock of work in progress	7000
Return outwards (raw materials)	400		

(Ans: Cost of goods manufactured ₹ 71600, Gross profit ₹ 31800)

10. From the following balances of Mr X, prepare manufacturing, trading and profit and loss account for the year ended 31<sup>st</sup> March 2013 after taking into consideration the additional information.

	₹		₹
Purchase of raw materials	349800	Sales	560000
Discount (Dr)	2500	Opening Stock of raw materials	124400
Carriage inward	10200	Opening Stock of finished goods	63800
Advertisement	12500	Carriage outward	11400
Miscellaneous expenses	3800	Insurance (Fire)	2760
Interest paid	9792	Factory power	22900
Fuel and coal	11200	Salaries	9700
Rent, taxed and rates	12400	Electricity charges	3300
Printing and stationary	2000	Bad debts	7080
Factory wages	59700		
Commission paid	1000		

*Additional Information:*

- (a) Stock as on 31-3-2013: Raw Materials ₹ 46900, Finished Goods ₹ 152300.  
 (b) Expenses outstanding and payable are salaries ₹ 1100; rent ₹ 900; electricity ₹ 200; factory power ₹ 2100.  
 (c) Depreciate plant and machinery by ₹ 11690, furniture, and fixtures by ₹ 2860.  
 (Ans. Cost of goods manufactured ₹ 545090, GP. ₹ 103410, NP. ₹ 19518)

11. A provision for bad and doubtful debts, equals to 5% of debtors, is created every year-end by a business concern. From the particulars given, write up the Provision for Bad and Doubtful Debts Account for five consecutive years, accumulated bad debts are, for their necessary adjustment, transferred to the said provision account each year before the new provision is made for the next year.

Balances extracted from the trial balance:

Year	1 <sup>st</sup>	2 <sup>nd</sup>	3 <sup>rd</sup>	4 <sup>th</sup>	5 <sup>th</sup>
	₹	₹	₹	₹	₹
Sundry Debtors	45600	48500	56800	62000	58400
Bad debts written off	1800	2000	4000	2700	2800
Past bad debts recovered	-----	-----	-----	520	-----
Closing Adjustment:					
Bad debts written off	200	140	420	260	300

Balance of the provision for Bad and a Doubtful debt A/c at the beginning of the 1<sup>st</sup> year was ₹ 2500.

12. Prepare trading and profit & loss account from the following trial balance extracted from the books of Raphael on 31<sup>st</sup> December 2014.

	Dr (₹)	Cr (₹)
Purchases and Sales	7475	17650
Returns	200	125
Building	7500	–
Furniture and Fittings	640	–
Bank Overdraft	–	2850
Advertisement	450	–
Sundry Debtors and Creditors	3800	3500
Motor Vehicles	6000	–
Interest	118	–
Capital	–	12500
Stock on 01.01.2001	4460	–
Taxes & Insurance	1250	–
Commission	375	–
Bad debts	125	–
Cash	650	–
Provision for bad debts	–	200
General expenses	782	–
Audit fees	250	–
Wages	1200	–
Salaries	2300	–
	37200	37200

*Additional Information:*

- Stock in hand on 31<sup>st</sup> December 2014 was ₹ 4000.
- Depreciation on Building @ 5%, Furniture & Fittings @ 10% and Motor Vehicles @ 20%.
- Write off further ₹ 100 as bad debts and make provision further of 5% on sundry debtors.
- Salaries ₹ 300 and Taxes ₹ 120 are outstanding.
- One third of commission received in respect of work to be done in the next year.
- ₹ 85 is due for interest on bank overdraft.

(Ans. GP ₹ 8440; NP ₹ 1186; B/S ₹ 20666)

**Check Your Progress: Model Answer**

- Trading account
- Direct expenses
- Operating expenses
- Solvency
- Drawings

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## 4.12 SUGGESTED READINGS

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M. P. Pandikumar, *Accounting & Finance for Managers*, Excel Books, New Delhi.

R. L. Gupta and Radhaswamy, *Advanced Accountancy*.

V. K. Goyal, *Financial Accounting*, Excel Books, New Delhi.

Nitin Balwani, *Accounting & Finance for Managers*, Excel Books, New Delhi.

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## LESSON

# 5

## DEPRECIATION

### CONTENTS

- 5.0 Aims and Objectives
- 5.1 Introduction
- 5.2 Meaning of Depreciation
  - 5.2.1 Reasons for Depreciation
  - 5.2.2 Basic Features of Depreciation
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- 5.5 Accounting Standards 6 (Revised) - Depreciation Accounting
- 5.6 Let Us Sum Up
- 5.7 Lesson End Activity
- 5.8 Keywords
- 5.9 Questions for Discussion
- 5.10 Suggested Readings

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### 5.0 AIMS AND OBJECTIVES

After studying this lesson, you should be able to:

- Describe the meaning of depreciation
- State the methods of depreciation
- Compare straight line and written down value method

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### 5.1 INTRODUCTION

Depreciation accounting is mainly based on the concept of income. The concept of income is matching of revenues with expenses. The goods purchased are frequently



matched through immediate sale or within a year. The crux of the concept of income is that the expenses are to be matched against the revenues. The ultimate aim of matching is done in order to determine the volume of profit or loss of the transaction. If the assets are nothing but long-term assets procured by the enterprise, they should be matched against the revenues of them. The matching of expenditure of the assets incurred by the firm at the time of purchase against the revenues is the core task of the firm.

The benefits/revenues of the fixed assets are expected to accrue for many numbers of years but not within a year. The initial investment on the assets at the time of purchase should be matched against the revenue pattern of the same year after completion of the year in order to find out the profit perspectives of the long-term investment. To have an effective matching against the revenues on every year, the amount of purchase has to be stretched. The stretching of expenses into many years is known as depreciation.

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## 5.2 MEANING OF DEPRECIATION

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According to Dickens, Depreciation is the permanent and continuous diminution in the quality/quantity/value of the asset. In simple words, depreciation is the permanent decrease in the value of the fixed assets. It is a matching in between the fixed charge expense against the current year's revenue. The remaining/left which is the un-recovered portion should be carried forward to forthcoming years in order to match against the respective revenues. The ultimate purpose of the depreciation is to replace the fixed assets only at the moment of becoming useless through the current revenues.

Under the fixed assets the following items are not considered on which special considerations apply:

1. Forests, plantations and similar regenerative natural resources,
2. Wasting assets including mineral rights, expenditure on the exploration for and extraction of minerals, oil, natural gas and similar non-generative resources,
3. Expenditure on real estate development, and
4. Livestock.

### 5.2.1 Reasons for Depreciation

The main reasons of charging depreciation are as follows:

- **Wear and Tear of the Asset:** The long-term assets are becoming less efficient and poor quality in operations due to the continuous usage of the asset.
- **Exhaustion:** Nothing will be left due to the continuous extraction of resources. The resources in the oil wells, mine fields will be completely exhausted due to incessant extraction. This has to be replaced by a new method of exploration. Investment in new exploration methods requires depreciation as a charge against the revenues of the wells/fields.

*Example:* Oil & Natural Gas Corporation Ltd. (ONGC) indulges in the process of new oil exploration projects through research projects. The new projects should then be identified and invested by huge initial investment outlay through the current revenues out of the existing projects on account of replacement due to depletion of resources.

- **To Face Technological Obsolescence:** To replace the old machinery with new machinery, before the expiry of the economic life period of the asset in order to maintain the efficiency and economy of the asset. The typewriter was replaced by the electronic typewriter during the yester periods of office automation. To replace

the old typewriter which is neither efficient nor economical, it should be replaced by the new electronic typewriter through the depreciation charge on the old one.

- **Accident:** The value of the asset mainly depends upon the efficiency and economy; which gets affected due to accident.
- **Inadequacy:** The changes in scale of production or volume of activities may force production managers to discard a particular asset.
- **Time Element:** As time passes, some intangible assets like copyright, patents, lease, etc., lose their legal effectiveness. Hence, depreciation is chargeable to these assets in the form of amortisation.

### 5.2.2 Basic Features of Depreciation

The basic features of the depreciation can be summarised in the following manner:

- It is a charge against profit.
- It indicates diminution in service potential.
- It is based upon estimated loss and is not an actual loss.
- It is based on assumptions that include the effective life and residual value of the asset.
- It is a process of allocation and not a method of valuation.
- The cause of the depreciation is basically an internal cause, which includes wear and tear or depletion of the asset.
- It arises due to internal causes, but depreciation is charged in the profit and loss statement of the company as an expense.
- Depreciation of any asset is restricted only up to the useful life of the asset.
- It is charged on tangible fixed asset and is not charged on current asset.
- For charging depreciation on intangible asset, it is charged in the form of amortisation, wherein the total costs are charged to periodical revenues.

### 5.2.3 Objectives of Providing Depreciation

Depreciation is provided in assets to achieve the following main objects:

- **To know the exact amount of the cost of production:** Depreciation is an allocated cost of the fixed asset. It is to be calculated correctly and it is to be charged correctly against the revenues. It must be added in the cost of production.
- **Correct calculation of profits:** For determining the profits of the company, the cost against revenues should be charged correctly. Hence, the cost of depreciation should be treated correctly while calculating profits of the organisation.
- **Correct disclosure of fixed assets:** The disclosure of fixed assets is to be made in the balance sheet. Hence, the figures of fixed assets in the balance sheet cannot be ascertained properly if the correct amount of depreciation is not considered.
- **Making provisions for replacement of the assets:** Since the assets have a limited life, the stipulated lifespan of an asset comes to end. Hence, for making replacement of assets, appropriate provisions need to be made so that the new assets can be purchased after the useful life of the previous asset.
- **Maintenance of capital:** A significant amount of capital is invested in purchasing fixed assets. With regular use and passage of time, value of assets keeps on

reducing. Hence, depreciation on asset is treated as expired cost and it has to be matched with the asset.

- **Compliances:** Depreciation is also charged to meet compliance requirements under the Income tax Act, 1962.

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### 5.3 JOURNAL ENTRIES AND LEDGER ACCOUNTS

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There are two methods to record the depreciation on fixed assets in the books of the owner:

1. **When provision for depreciation account is maintained:** Under this method, the amount of depreciation each year is transferred to the provision for depreciation account and the assets are shown in the books at their original cost. And when an asset is sold on the expiry of its useful life, sales proceeds of the assets and the amount of provision for depreciation is transferred to the assets account. Profit or loss arises from the sale of the assets is carried to profit and loss account. Under this method, the following journal entries are passed in the books of owner:

- (a) *When depreciation is charged on Assets:*

Depreciation Account Dr.  
    To Provision for Depreciation Account

- (b) *When depreciation is transferred to P & L Account:*

P & L Account Dr.  
    To Depreciation Account

- (c) *When assets are sold on the expiry of useful life of the assets:*

Provision for Depreciation Account Dr.  
    To Assets Account

- (d) *If there is any profit on the sale of Assets:*

Assets account Dr.  
    To P & L Account

- (e) *If there is any loss on the sale of assets:*

P & L Account Dr.  
    To Assets Account

2. **When provision for depreciation account is not maintained:** In this case, the depreciation on the assets is not transferred to the provision for depreciation account, but that is transferred to assets account and the assets are shown at the written down value (cost of assets minus depreciation) in the balance sheet. Depreciation is treated as an expense and is transferred to the profit and loss account. Under this method, the following journal entries are passed in the books of the owner:

- (a) *When depreciation is charged on Assets:*

Depreciation Account Dr.  
    To Assets Account

- (b) *When depreciation is transferred to the P & L Account:*

P & L Account Dr.  
    To Depreciation Account

(c) *If the assets are sold at profit on the expiry of the useful life of Assets:*

Cash Account Dr.  
    To Assets Account  
    To P & L Account

(d) *In the case of loss the following entry is passed:*

Cash Account      Dr.  
P & L Account     Dr.  
    To Assets Account

## 5.4 METHODS OF CHARGING DEPRECIATION

There are various methods of depreciation:

1. Straight line method
2. Depletion or Output method
3. Machine hour rate method
4. Diminishing Balance or Written down method
5. Sum of digits method
6. Annuity method
7. Sinking fund method
8. Insurance policy method

In this lesson, we will discuss only about the straight line method and diminishing balance method in detail and rest will be described in short.

### 5.4.1 Straight Line Method

Under this method, depreciation is calculated as a fixed proportion on the original value of the asset. The depreciation is charged as fixed in volume on the original value of the asset at which it was purchased. The original value of the asset is nothing but the purchase value of the asset.

**Example:** Cost of Machine - ₹ 1,00,000

Estimated life of the machine - 5 years

Scrap value – Nil

**Solution:**

$$\text{Depreciation} = \frac{\text{Cost of the machine} - \text{Scrap value}}{\text{Economic Life period of the asset in years}}$$

$$\text{Depreciation} = \frac{1,00,000 - 0}{5} = 20,000$$

According to the concept of depreciation, the value of the asset is dispersed throughout the life of the period in order to match the respective earnings of the year after year. The purchase value of the asset is expenditure to be stretched to many numbers of years in order to equate with the revenues. To equate the revenues, the scrap value of the asset at the end of the life period is realized should be deducted and apportioned to the total number of the economic life period of the asset. The aim of deducting the scrap value of the asset is reducing the original value of the investment.

To understand the above calculation, the following table is most valuable:

Value of the asset (Begin) ₹ Col. 1	Depreciation ₹ Col. 2	Value of the asset End ₹ Col 3 = Col.1-Col. 2
1 <sup>st</sup> year – 1,00,000	20,000	80,000
2 <sup>nd</sup> year – 80,000	20,000	60,000
3 <sup>rd</sup> year – 60,000	20,000	40,000
4 <sup>th</sup> year – 40,000	20,000	20,000
5 <sup>th</sup> year – 20,000	20,000	“0”

From the above table, ₹ 20,000 is charged on every year to recover ₹ 1,00,000 during its life period i.e., 5 years.

**Example:** Original value of the investment - ₹ 1,00,000

Scrap value - ₹ 10,000

Life of the asset - 5 years

**Solution:**

$$\text{Depreciation} = \frac{1,00,000 - 10,000}{5 \text{ years}} = \frac{90,000}{5} = 18,000$$

To understand the methodology of straight line depreciation, the following table will illustrate the process.

Value of the asset (Begin) ₹	Depreciation ₹	Value of the asset (End) ₹
1 <sup>st</sup> year – 1,00,000	18,000	82,000
2 <sup>nd</sup> year – 82,000	18,000	64,000
3 <sup>rd</sup> year – 64,000	18,000	46,000
4 <sup>th</sup> year – 46,000	18,000	28,000
5 <sup>th</sup> year – 28,000	18,000	10,000 (Scrap value )

The scrap value of the asset is expected to realize only at the end of the life period of the asset i.e., 5 years.

**Example:** Mr. Shankar purchased a machine for ₹ 90,000 on 1<sup>st</sup> April 1999. Its probable working life was estimated at 5 years and its probable scrap value at the end of that time is ₹ 10,000. You are required to prepare the necessary account based on straight line method of depreciation for five years.

To prepare the various accounts of the enterprise connected to depreciation is as follows:

The depreciation charge process is carried out in three stages:

- **The asset to be initially purchased:** Purchase entry has to be carried out. How is the purchase made? While making the purchase there are two different accounts that are affected which are normally known as real accounts. At the moment of purchase on one side the asset is coming into the firm; on the other side the cash resources are depleted due to the payment of purchase bill of the asset.

		₹	₹
1 <sup>st</sup> April, 1999	Plant & Machinery A/c Dr	90,000	
	To Cash A/c		90,000
<b>Being Plant &amp; Machinery Purchased</b>			

- The next account involved in the process of accounting is depreciation account. Before transacting the depreciation entry in the books of accounts, we must find the amount of depreciation to be charged against every year's revenue.
- The amount of depreciation is to be calculated as follows:

$$\text{Depreciation} = \frac{\text{Original value of the asset} - \text{Scrap value}}{\text{Estimated life of the asset in years}}$$

$$= \frac{90,000 - 10,000}{5} = 16,000$$

- Depreciation is a fixed charge to be calculated on the value of the asset on every year and deducted from the original value. Depreciation is nothing but charge as expenditure against the revenues in accordance with the matching concept. Hence the depreciation non-recurring expenditure account and the plant & machinery account should be debited and credited respectively.
- For the accounting entry I year depreciation

		₹	₹
31 <sup>st</sup> March, 2000	Depreciation A/c Dr	16,000	
	To Plant Machinery A/c		16,000
<b>Being the first year depreciation is charged</b>			

- For the accounting entry II year depreciation

		₹	₹
31 <sup>st</sup> March, 2001	Depreciation A/c Dr	16,000	
	To Plant Machinery A/c		16,000
<b>Being the second year depreciation is charged</b>			

- For the accounting entry III year depreciation

		₹	₹
31 <sup>st</sup> March, 2002	Depreciation A/c Dr	16,000	
	To Plant Machinery A/c		16,000
<b>Being the third year depreciation is charged</b>			

- For the accounting entry IV year depreciation

		₹	₹
31 <sup>st</sup> March, 2003	Depreciation A/c Dr	16,000	
	To Plant Machinery A/c		16,000
<b>Being the fourth year depreciation is charged</b>			

- For the accounting entry V year depreciation

		₹	₹
31 <sup>st</sup> March, 2004	Depreciation A/c Dr	16,000	
	To Plant Machinery A/c		16,000
<b>Being the fifth year depreciation is charged</b>			

- The next account involved is the scrap value account which amounted ₹ 10,000.

While selling the residual portion of the asset, the firm is able to receive ₹ 10,000 as receipt as cash. The sale of residual part of the machinery leads to bring cash resources into the firm and in turn, the plant and machinery is going out of the firm.

- For the accounting entry of scrap value:

31 <sup>st</sup> March 2004	Cash A/c Dr	10000	
	To Plant Machinery A/c.		10000
<b>Being the residual part of the machinery is sold</b>			

- The next transaction is the final transaction pertaining to the posting of depreciation accounting balance under the P&L account.
- It is nothing but the transfer of Depreciation accounting balance into P&L account. At the end of every year, immediately after finalizing the accounting, balance of depreciation is regularly posted under the P&L account.
- The journal entry transfer is carried out as follows:
- For the I year depreciation transfer to P&L A/c

		₹	₹
31 <sup>st</sup> March, 2000	P&L A/c Dr	16,000	
	To Depreciation A/c		16,000
<b>Being the first year depreciation is transferred to P&amp;L A/c</b>			

- For the II year depreciation transfer to P&L A/c

		₹	₹
31 <sup>st</sup> March 2001	P&L A/c Dr	16,000	
	To Depreciation A/c		16,000
<b>Being the second year depreciation is transferred to P&amp;L A/c</b>			

- For the III year depreciation transfer to P&L A/c

		₹	₹
31 <sup>st</sup> March, 2002	P&L A/c Dr	16,000	
	To Depreciation A/c		16,000
<b>Being the third year depreciation is transferred to P&amp;L A/c</b>			

- For the IV year depreciation transfer to P&L A/c

		₹	₹
31 <sup>st</sup> March 2003	P&L A/c	Dr	16000
	To Depreciation A/c		16000
Being the fourth year depreciation is transferred to P&L A/c			

- For the V year depreciation transfer to P&L A/c

		₹	₹
31 <sup>st</sup> March 2004	P&L A/c	Dr	16000
	To Depreciation A/c		16000
Being the fifth year depreciation is transferred to P&L A/c			

**The preparation of Plant & Machinery account:** It is very easy to prepare the plant and machinery Ledger account.

#### Plant & Machinery A/c I Yr

Dr

Cr

Date	Particular	Amount ₹	Date	Particulars	Amount ₹
1 <sup>st</sup> April, 1999	To Cash A/c	90,000	31 <sup>st</sup> March, 2000	By Depreciation	16,000
				By Balance c/d (transferred to Second year Plant & Machinery A/c)	74,000
		90,000			90,000
	To Balance B/d	74,000			

#### Plant & Machinery A/c II Yr

Dr

Cr

Date	Particular	Amount ₹	Date	Particulars	Amount ₹
1 <sup>st</sup> April, 2000	To Balance B/d (transferred from I Yr Plant & Machinery)	74,000	31 <sup>st</sup> March, 2001	By Depreciation	16,000
				By Balance c/d (transferred to III Yr Plant & Machinery A/c)	58,000
		74,000			74,000
	To Balance B/d	58,000			

#### Plant & Machinery A/c III Yr

Dr

Cr

Date	Particular	Amount ₹	Date	Particulars	Amount ₹
1 <sup>st</sup> April, 2001	To Balance B/d (transferred from II Yr Plant & Machinery)	58,000	31 <sup>st</sup> March, 2002	By Depreciation	16,000
				By Balance c/d (transferred to IV Yr Plant & Machinery A/c)	42,000
		58,000			58,000
	To Balance B/d	42,000			



**Plant & Machinery A/c IV Yr**

Dr			Cr		
Date	Particular	Amount ₹	Date	Particulars	Amount ₹
1 <sup>st</sup> April, 2002	To Balance B/d (transferred from III Yr Plant & Machinery)	42.000	31 <sup>st</sup> Mar. 2003	By Depreciation	16.000
				By Balance c/d (transferred to V Yr Plant & Machinery A/c)	26.000
		42.000			42.000
	To Balance B/d	26.000			

**Plant & Machinery A/c V Yr**

Dr			Cr		
Date	Particular	Amount ₹	Date	Particulars	Amount ₹
1 <sup>st</sup> April, 2003	To Balance B/d (transferred from IV Yr Plant & Machinery)	26.000	31 <sup>st</sup> Mar. 2004	By Depreciation	16.000
				By Cash	10.000
		26.000			26.000

The next ledger account to be prepared is the Depreciation A/c.

**Depreciation A/c**

Date	Particulars	Amount ₹	Date	Particulars	Amount ₹
31 <sup>st</sup> Mar, 2000	To Plant & Machinery	16,000	31 <sup>st</sup> Mar, 2000	By P & L A/c	16,000
31 <sup>st</sup> Mar, 2001	To Plant & Machinery	16,000	31 <sup>st</sup> Mar, 2001	By P & L A/c	16,000
31 <sup>st</sup> Mar, 2002	To Plant & Machinery	16,000	31 <sup>st</sup> Mar, 2002	By P & L A/c	16,000
31 <sup>st</sup> Mar, 2003	To Plant & Machinery	16,000	31 <sup>st</sup> Mar, 2003	By P & L A/c	16,000
31 <sup>st</sup> Mar, 2004	To Plant & Machinery	16,000	31 <sup>st</sup> Mar, 2004	By P & L A/c	16,000

**Example:** M/s Muruganand & Co. is a trader bought furniture costing ₹ 2,20,000 for his new branch on 1<sup>st</sup> April, 2000. As the furniture bought was superior quality material. The auditors estimated its residual value at ₹ 20,000 after a working life of ten years. Further additions were made into the same category on 1<sup>st</sup> Oct., 2001 and 1<sup>st</sup> April, 2002 costing ₹ 16,800 and ₹ 19,000 (with a scrap value of ₹ 800 and ₹ 1000 respectively). The trader closed his accounts on 31<sup>st</sup> March every year and wanted to apply straight line method of depreciation. Show the furniture a/c for four years.

First step is to find out the depreciation of the furniture for various numbers of years i.e., 4 years. The depreciation is to be calculated on every year.

The most important point to be borne in our mind while calculating depreciation. the following points to be taken into consideration:

First, is there any % of depreciation charge given? If given, the depreciation has to be calculated on the volume of available balance at the end.

Secondly, if the % of depreciation charge is not given in our problem, how can the volume of depreciation be calculated?

The depreciation can be calculated as follows:

$$\text{Depreciation} = \frac{\text{Original value of the asset} - \text{Scrap value}}{\text{Life period of the asset}}$$

In this problem, due to absence of depreciation %, the above illustrated formula should have to be applied throughout the problem.

Date of Purchase Particulars	First Furniture 2000 ₹	Second furniture 2001 ₹	Third Furniture 2002 ₹	Total Depreciation cost ₹
Cost of the furniture R1	2,20,000	16,800	19,000	
Scrap value at the end (-) R2	20,000	800	1000	
Depreciable value of the furniture R3	2,00,000	16,000	18,000	
Life of the furniture R4	10 years	10 years	10 years	
Depreciation R5=R3/R4	20,000	1,600	1,800	
Depreciation for 2000-01	20,000	-----	-----	20,000
Depreciation for 2001-02	20,000	For 6 months 800	-----	20,800
Depreciation for 2002-03	20,000	1,600	1,800	23,400
Depreciation for 2003-04	20,000	1,600	1,800	23,400

Accounting entries are as follows:

Accounting entries for the accounting year 2000-2001

During the year 1<sup>st</sup> April 2,000 – 2,20,000 worth of furniture was bought

		₹	₹
1 <sup>st</sup> April, 2000	Furniture A/c Dr	2,20,000	
	To Bank A/c		2,20,000
<b>Being the furniture is purchased</b>			

Depreciation for the year 2000 for the first furniture:

		₹	₹
31 <sup>st</sup> Mar, 2001	Depreciation A/c Dr	20,000	
	To Furniture A/c		20,000
<b>Being depreciation charged</b>			

Accounting entries for the accounting year for 2001-02

Second new furniture bought during the month 1<sup>st</sup> Oct, 2001

		₹	₹
1 <sup>st</sup> April, 2001	Furniture A/c Dr	16,800	
	To Bank A/c		16,800
<b>Being new furniture procured</b>			

Depreciation for the first furniture:

		₹	₹
31 <sup>st</sup> Mar, 2002	Depreciation A/c Dr	20,000	
	To Furniture A/c		20,000
<b>Being the depreciation charged</b>			

Depreciation for the second furniture:

31 <sup>st</sup> Mar. 2002	Depreciation A/c	Dr	800	
	To Furniture A/c			800
<b>Being the depreciation charged for the second furniture for 6 months</b>				

Accounting entries for the accounting year for 2002-03:

Third new furniture bought during the month of 1<sup>st</sup> April, 2002.

1 <sup>st</sup> April. 2002	Furniture A/c	Dr	19,000	
	To Bank A/c			19,000
<b>Being the furniture purchased during the year</b>				

Depreciation charged for the first furniture:

31 <sup>st</sup> March. 2003	Depreciation A/c	Dr	20,000	
	To Furniture A/c			20,000
<b>Being the depreciation charged for the first furniture</b>				

Depreciation charged for the second furniture:

31 <sup>st</sup> March. 2003	Depreciation A/c	Dr	1,600	
	To Furniture A/c			1,600
<b>Being the depreciation charged for the second furniture</b>				

Depreciation for the third furniture:

31 <sup>st</sup> March. 2003	Depreciation A/c	Dr	1,800	
	To Furniture A/c			1,800
<b>Being the depreciation charged for the third furniture</b>				

Accounting entries for the fourth year 2003-04

Depreciation charged for the first furniture:

31 <sup>st</sup> March. 2004	Depreciation A/c	Dr	20,000	
	To Furniture A/c			20,000
<b>Being the depreciation charged for the first furniture</b>				

Depreciation charged for the second furniture

31 <sup>st</sup> March. 2004	Depreciation A/c	Dr	1,600	
	To Furniture A/c			1,600
<b>Being the depreciation charged for the second furniture</b>				

Depreciation for the third furniture:

31 <sup>st</sup> March. 2004	Depreciation A/c	Dr	1,800	
	To Furniture A/c			1,800
<b>Being the depreciation charged for the third furniture</b>				

In the next step, the furniture account to be prepared for every year is given.

**Furniture A/c (2000-01)**

Date	Particulars	Amount ₹	Date	Particulars	Amount ₹
1 <sup>st</sup> April, 2000	To Bank	2,20,000	31 <sup>st</sup> Mar. 2001	By Depreciation	20,000
				By Balance c/d	2,00,000
		2,20,000			2,20,000
31 <sup>st</sup> Mar, 2001	To Balance b/d	2,00,000			

**Furniture A/c (2001-02)**

Date	Particulars	Amount ₹	Date	Particulars	Amount ₹
1 <sup>st</sup> April, 2001	To Balance b/d	2,00,000	31 <sup>st</sup> Mar. 2002	By Depreciation	20,000
1 <sup>st</sup> Oct, 2001	To Bank	16,800		By Depreciation	800
				By Balance c/d	1,96,000
		2,16,800			2,16,800
31 <sup>st</sup> Mar. 2002	To Balance b/d	1,96,000			

**Furniture (2002-03)**

Date	Particulars	Amount ₹	Date	Particulars	Amount ₹
1 <sup>st</sup> April, 2002	To Balance b/d	1,96,000	31 <sup>st</sup> Mar, 2003	By Depreciation	20,000
1 <sup>st</sup> April, 2002	To Bank	19,000		By Depreciation	1,600
				By Depreciation	1,800
				By Balance c/d	1,91,600
		2,15,000			2,15,000
31 <sup>st</sup> Mar. 2003	To Balance b/d	1,91,600			

**Furniture (2003-04)**

Date	Particulars	Amount ₹	Date	Particulars	Amount ₹
1 <sup>st</sup> April, 2003	To Balance b/d	1,91,600	31 <sup>st</sup> Mar. 2004	By Depreciation	20,000
				By Depreciation	1,600
				By Depreciation	1,800
				By Balance c/d	1,68,200
		1,91,600			1,91,600
31 <sup>st</sup> Mar. 2004	To Balance b/d	1,68,200			

### 5.4.2 Written Down Value Method

This method also has the same methodology in charging depreciation on the fixed assets like fixed percentage. Though it bears similar approach in charging depreciation, it is different in application from the straight line method. Under this method, the depreciation is charged on the value of the asset available at the beginning of the year.

The following formula highlights the application of this method in charging depreciation:

$$= 1 - (S/C)^{1/n}$$

The meaning of the above illustrated formulae is discussed through the explanation of two different components.

The first one is  $(S/C)^{1/n}$  the ratio of the scrap value of the asset on the original value is appropriately apportioned throughout the life period. It is nothing but the percentage of scrap value widened across the life period of the asset. Once the scrap value percentage is known, the next important step is to determine the depreciable value of the asset. The depreciable value of the asset can be derived by deducting the percentage from 1.

**Example:** Life of the asset (n) = 3 years

Expected scrap value at the end of 3 years = ₹ 12,800

Original Investment = ₹ 2,00,000

Find out the percentage of depreciation to be charged.

**Solution:**

Under this method, to charge depreciation as well as to find out the value of the asset as on a particular date, the depreciation percentage must be given. In this problem, depreciation % is not given, in order to determine the above illustrated formulae should be applied:

$$\begin{aligned} &= 1 - (S/C)^{1/n} \\ &= 1 - (\text{₹ } 12,800/\text{₹ } 2,00,000)^{1/3} \\ &= 1 - 4/10 = 6/10 = 60\% \end{aligned}$$

The following workings will obviously facilitate the understanding of the charge of depreciation:

The value of the Asset at the beginning of 1<sup>st</sup> Year = ₹ 2,00,000

(-) Depreciation 60% on ₹ 2,00,000 (Original value) = ₹ 1,20,000

Value of the asset at the beginning of 2<sup>nd</sup> Year = ₹ 80,000

(-) Depreciation 60% on ₹ 1,20,000. (Book Value) = ₹ 48,000

Value of the asset at the beginning of 3<sup>rd</sup> Year = ₹ 32,000

(-) Depreciation 60% on ₹ 32,000 (Book Value) = ₹ 19,200

Value of the asset at the end of the year = ₹ 12,800

**Example:** Calculate the depreciation using straight line method and WDV method of depreciation from the information given below:

Cost of equipment = ₹ 8,000

Estimated useful life = 4 years

Scrap value at the end of useful life = ₹ 500

Depreciation rate for reducing balance method = 50%

**Solution:**

(i) Computation of Depreciation under SLM:

Dep. = ₹ 8000 - ₹ 500/4 years

= ₹ 1875

(ii) Rate of depreciation for reducing balance method is 50%.

$$\text{Dep.} = \text{Net Book Value} \times 50\%$$

The following table shows a comparison between the two methods of depreciation:

	Straight-line ₹	Reducing Balance ₹
Cost	8,000	8,000
Depreciation - year 1	1,875	4,000
Net book value	6,125	4,000
Depreciation - year 2	1,875	2,000
Net book value	4,250	2,000
Depreciation - year 3	1,875	1,000
Net book value	2,375	1,000
Depreciation - year 4	1,875	500
Net book value (disposal value)	500	500

**Example:** On 1<sup>st</sup> April, 2000, a firm purchases machinery worth ₹ 3, 00,000. On 1<sup>st</sup> October, 2002 it buys additional machinery worth ₹ 60,000 and spends ₹ 6,000 on its erection. The accounts are closed normally on 31 March. Assuming the annual depreciation to be 10%, show the machinery account for 3 years under the written down value method.

**Solution:**

Accounting Journal entries for the year 2000-01:

During the year 1<sup>st</sup> April 2,000 - ₹ 3,00,000 worth of machinery was bought:

		₹	₹
1 <sup>st</sup> April. 2000	Machinery A/c Dr	3,00,000	
	To Bank A/c		3,00,000
<b>Being the machinery is purchased</b>			

Depreciation for the year 2000 for the first machinery:

		₹	₹
31 <sup>st</sup> Mar. 2001	Depreciation A/c Dr	30,000	
	To Machinery A/c		30,000
<b>Being depreciation charged</b>			

Accounting Journal entries for the year 2001-02:

Depreciation for the year 2001 for the first machinery:

		₹	₹
31 <sup>st</sup> Mar. 2001	Depreciation A/c Dr	27,000	
	To Machinery A/c		27,000
<b>Being depreciation charged</b>			

Accounting Journal entries for the year 2002-03:

During the year 2002 new machinery worth of ₹ 60,000 was purchased. Before determining the volume of depreciation, the amount of original value of the machinery should be found out.

Original value of the asset = The purchase price of the asset + Erection charges incurred

$$= ₹ 60,000 + ₹ 6,000 = ₹ 66,000$$

		₹	₹
1 <sup>st</sup> April, 2002	Machinery A/c Dr	66,000	
	To Bank A/c		66,000
<b>Being the machinery is purchased</b>			

Depreciation for the year 2002 for the first machinery:

		₹	₹
31 <sup>st</sup> March, 2003	Depreciation A/c Dr	24,300	
	To Machinery A/c		24,300
<b>Being depreciation charged</b>			

Depreciation for the year 2002 for the second machinery:

		₹	₹
31 <sup>st</sup> Mar, 2003	Depreciation A/c Dr	3,300	
	To Machinery A/c		3,300
<b>Being depreciation charged</b>			

After passing the journal entries, the next step is to prepare ledger account of machinery.

**Machinery A/c (2000-01)**

Dr			Cr		
Date	Particulars	Amount ₹	Date	Particulars	Amount ₹
1 <sup>st</sup> April, 2000	To Bank	3,00,000	31 <sup>st</sup> Mar, 2001	By Depreciation	30,000
				By Balance c/d	2,70,000
		3,00,000			3,00,000
31 <sup>st</sup> March, 2001	To Balance b/d Transfer to Machinery A/c (2001-02)	2,70,000			

**Machinery A/c (2001-02)**

Dr			Cr		
Date	Particulars	Amount ₹	Date	Particulars	Amount ₹
1 <sup>st</sup> April, 2000	To Balance b/d	2,70,000	31 <sup>st</sup> Mar. 2001	By Depreciation	27,000
				By Balance c/d	2,43,000
		2,70,000			2,70,000
31 <sup>st</sup> Mar. 2001	To Balance b/d Transfer to Machinery A/c (2002-03)	2,43,000			

**Machinery A/c (2002-03)**

Dr			Cr		
Date	Particulars	Amount ₹	Date	Particulars	Amount ₹
1 <sup>st</sup> April, 2000	To Balance b/d	2,43,000	31 <sup>st</sup> Mar. 2001	By Depreciation First machinery	24,300
1 <sup>st</sup> Oct, 2002	To Bank	66,000		By Depreciation Second machinery	3,300
				By Balance c/d	2,81,400
		3,09,000			3,09,000
31 <sup>st</sup> Mar, 2003	To Balance b/d	2,81,400			

**5.4.3 Sinking Fund Method**

The sinking fund is a method wherein a fund is created to meet a specific purpose such as:

- To replace a wasting asset
- To renew a lease
- To replace an asset

When a sinking fund is created, the objective is to provide for replacement of the asset. Hence, the amount kept separate to cover the cost of the wasting asset is termed as a depreciation amount.

**5.4.4 Annuity Method**

The Annuity method considers that besides losing the cost of the asset, the company also loses interest on the amount that is invested in buying that particular asset. Hence, while accounting, the interest factor lost is also taken into consideration.

**5.4.5 Insurance Policy Method of Depreciation**

The insurance policy is purchased, against which the premium is paid. At the end of the insurance period, a prescribed amount is received which can be used for replacement of the asset.



#### 5.4.6 Sum of Years' Digit Method

The sum of the years' digit method is an accelerated form of calculating depreciation. This kind of method takes into consideration expected life and adds together the digit for each year. For example, if the useful life of an asset is 5 years, then the sum of the years shall be calculated as:

$1 + 2 + 3 + 4 + 5 = 15$  and depreciation shall be calculated for the five years in the following manner:

- 5/15 for year 1
- 4/15 for year 2
- 3/15 for year 3
- 2/15 for year 4
- 1/15 for year 5

#### 5.4.7 Depletion or Output Method

Depletion is periodic charge in expense relating to use of natural resources. It is primarily used in situations where the company uses the asset for such applications as oil reserves, gravel pits, coal deposits, etc.

#### 5.4.8 Machine Hour Rate Method

Under this method, the working hours of a machine during its entire life are estimated and thereafter the cost of the machine is divided by the estimated hours. Hence, depreciation on the basis of machine hours is derived.

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### 5.5 ACCOUNTING STANDARDS 6 (REVISED) - DEPRECIATION ACCOUNTING

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Depreciation in the books of accounts is charged as per Accounting Standard-6, details of which are already mentioned above. Some of the other relevant consideration as per Accounting Standard-6 is as follows:

***Treatment in case there is change in the useful life of an asset:*** If there is a change in useful life of an asset, the outstanding depreciable amount on the date of the change in the estimated useful life shall be allocated over the remaining useful life of the asset.

If there are any changes in the historical cost of an asset due to exchange fluctuations or price adjustments, depreciation on the revised unamortised depreciable amount should be provided prospectively for the rest of the life of the asset.

If the assets are revalued, the provision for depreciation should be made on the revalued amount for the remaining useful life of the asset.

In the financial statement, the following matters are to be disclosed:

- The historical cost or any cost substituting it
- The total depreciation for the period
- The related accumulated depreciation
- The method of charging depreciation

### Check Your Progress

Fill in the blanks:

1. \_\_\_\_\_ can be created for replacement of fixed assets.
2. Amount of depreciation if charged on the basis of \_\_\_\_\_ remains constant for every year.
3. The original value of the asset is the \_\_\_\_\_ of the asset.
4. Reserve is created to strengthen the \_\_\_\_\_ of the business.
5. The profits can be distributed without providing for depreciation with the prior permission of the \_\_\_\_\_.

## 5.6 LET US SUM UP

- Depreciation is the decrease in the value of assets at the given date due to wear and tear, obsolescence, efflux of time, accident and exhaustion.
- Cost of assets, residual value of assets, and useful life of assets are the important factors of depreciation.
- There are several methods for providing depreciation on fixed assets. The method of the depreciation is selected on the basis of various factors as – types of assets, nature of business and circumstances prevailing in the business etc.
- Under straight line method, depreciation is calculated as a fixed proportion on the original value of the asset.
- Under written down value method, the depreciation is charged on the value of the asset available at the beginning of the year.

## 5.7 LESSON END ACTIVITY

Mr. Ramesh purchased a second hand machine for ₹ 24,000 on 1<sup>st</sup> April, 2006. He spend ₹ 10,000 on its overhaul and installation. Depreciation is written off 10% p.a. on the original cost. On 30<sup>th</sup> June, 2008 machine was found to be unsuitable and sold for ₹ 19,000. Prepare the machine account from 2006 to 2008 assuming that accounts are closed on 31<sup>st</sup> December, every year.

## 5.8 KEYWORDS

**Book Value of the Asset:** The value of the asset after deducting the depreciation from the value of the asset at the beginning.

**Depreciation:** Continuous reduction/decrease/diminution in the value of the asset.

**Depreciation Accounting:** Recording the entries of depreciation through journal, ledger accounts of Depreciation, Fixed Asset and Profit & Loss account.

**Original Value of the Asset:** The value of the asset at the time of purchase or acquisition.

**Scrap Value of the Asset:** It is the value at the end of the life period of the asset; when the asset cannot be put for further usage.

## 5.9 QUESTIONS FOR DISCUSSION

1. Rakesh purchased a Machine for ₹ 12,000. The expected life of machine is 4 years. If its scrap realizes ₹ 1,200, calculate the amount of depreciation to be

charged from profit and loss a/c for 4 years. Prepare machine account of all the 4 years under straight line method of charging depreciation.

2. On 1<sup>st</sup> October 2002 M/s Goyal Traders, installed one machine in their shop at a total cost of ₹ 1,50,000. On 1<sup>st</sup> April, 2004 another machine of the cost of ₹ 50,000 was installed.
3. Depreciation is charged at 10% p.a. on the reduced balances every year. Accounts are closed on every 31<sup>st</sup> March. Prepare Machine Account for first three years.
4. On 1.2003 M/s K.K. traders of Rajasthan purchased plants amounted to ₹ 2,00,000 and decided to write off depreciation @ 25% on written down value method. Show the plants a/c for first three years.
5. Thaper Oil and Fats Limited purchased furniture for the office amounting to ₹ 12,500. The company wanted to charge depreciation @ 10% p.a.

Prepare Furniture a/c for three years when:

- (a) Depreciation is charged on original cost method and
  - (b) When it is charged on reducing balance method.
6. Elucidate the process of depreciation accounting.
  7. Explain the key methods of charging depreciation.
  8. State the difference between the straight line method and written down value method with suitable examples.
  9. What are the key reasons for charging depreciation?
  10. Construct the key depreciation entries for charging and recording depreciation.
  11. Golden Transport Company, New Delhi purchased 3 Trucks at ₹ 4,00,000 each on 1<sup>st</sup> Jan 2003 from the dealer. The company decided to charge 20% depreciation on the basis of original cost of trucks. Prepare Trucks A/c for 3 years and find out its w.d.v. at the end of 3<sup>rd</sup> year.

#### **Check Your Progress: Model Answer**

1. Depreciation funds
2. Straight line method
3. Purchase value
4. Financial position
5. Central Government

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### **5.10 SUGGESTED READINGS**

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M. P. Pandikumar, *Accounting & Finance for Managers*, Excel Books. New Delhi.

R. L. Gupta and Radhaswamy, *Advanced Accountancy*.

V. K. Goyal, *Financial Accounting*, Excel Books, New Delhi.

Nitin Balwani, *Accounting & Finance for Managers*, Excel Books. New Delhi.

## **UNIT III**



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## LESSON

# 6

## AN INTRODUCTION TO DEPARTMENTAL ACCOUNTS

### CONTENTS

- 6.0 Aims and Objectives
- 6.1 Introduction
- 6.2 Advantages of Departmental Accounts
- 6.3 Methods of Departmental Accounting
- 6.4 Different Types of Departments
- 6.5 Allocation of Common Expenditure to Different Departments
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- 6.7 How to Deal with Unrealized Profit (Stock Reserve)?
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- 6.9 Departmental Trading and Profit and Loss Account
- 6.10 Let Us Sum Up
- 6.11 Lesson End Activity
- 6.12 Keywords
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### 6.0 AIMS AND OBJECTIVES

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After studying this lesson, you should be able to:

- Describe the **advantages** of **Departmental Accounts**
- Discuss how to **allocate common expenditure** to different departments
- Define inter-departmental transfer and how to deal with it in accounts
- Explain how to calculate and deal with **unrealized profit on unsold inter-departmental stock** in hand

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### 6.1 INTRODUCTION

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Generally, any business entity is divided into number of departments, either based on their functionalities like Human Resource Department, Research and Development Departments etc.. or based on cost and profit sections, like, Accounts Department (cost centre), Sales Department (Profit centre), or on any predetermined criterion for forming the departments. The Company management is interested to know which department is generating how much and whether the departments are running efficiently. Departmental Accounts are drawn to find out efficiency and profitability of each department individually. This would enable the management to compare the

departmental efficiency at individual level, since these accounts can be used to control the costs and wastage management in the departments.

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## 6.2 ADVANTAGES OF DEPARTMENTAL ACCOUNTS

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- Departmental accounts help the management to ascertain departmental performance, which would help them understand the operating and working efficiency of each department individually.
- Departmental accounts provide a basis for inter-departmental comparison. This will also help the managers to focus on highly efficient departments to boost the revenue. The management will be able to control wastage and losses in lesser efficient departments so as to boost their operating efficiency.
- Departmental accounts also provide tool for assessing the growth potential of the department which if boosted, would result in overall addition to revenue generation and leads to improved overall cost control.
- Departmental accounts can be a basis to prove that the capital investment (in terms of working capital like inventory etc., or fixed capital like machinery etc.) in the department would be appropriate and would add to overall profitability of the company.
- Departmental accounts are a way to understand whether a department is exercising sufficient cost control and also whether the department is individually profitable or not. This is Management Information System (MIS) tool which helps improve cost control and arrive at better profitability.

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## 6.3 METHODS OF DEPARTMENTAL ACCOUNTING

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There are two methods of departmental accounting, which are discussed below:

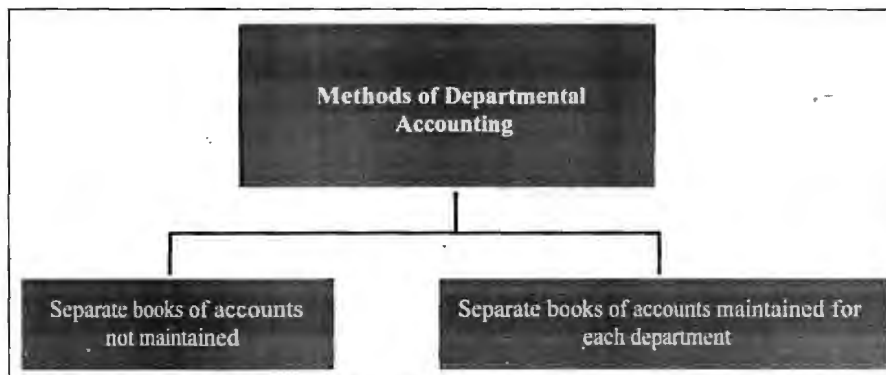


Figure 6.1: Departmental Accounting Methods

- **When separate books of accounts not maintained and all accounts maintained for all department:** This method is also known as columnar basis where all accounts for all departments are maintained in tabular format. In this case, there is single set of books, in which every subsidiary book like purchase book, sales book etc., are prepared in columnar format, where each column represents each department.

This method of departmental accounting enables to arrive at accurate profit or loss for each department individually.

- **When separate books of accounts are maintained for each department:** Under this method, books of accounts are maintained separately for each department. Here, every accounting record including stock accounts, purchase book, sales

book etc., is maintained separately for all the departments. However, under this method, appropriate basis for allocation of common expenditure has to be established. This is because, profit and loss for each department needs to be calculated first and then transferred to General P and L account.

## 6.4 DIFFERENT TYPES OF DEPARTMENTS

The various types of departments are discussed below:

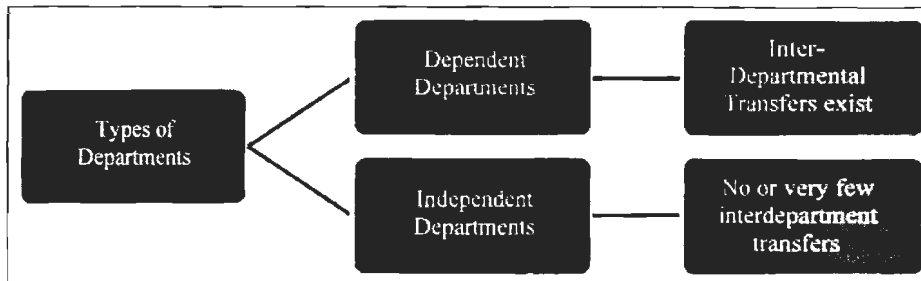


Figure 6.2: Types of Departments

- **Independent Departments:** Independent departments have very few exchange or transfer or any kind of inter-departmental transactions. Due to negligible number of inter-departmental transactions, this set up is known as Independent Departments.
- **Dependent Departments:** This is totally opposite of Independent Departments' setup. Here, the departments have frequent transfers, especially of goods inside the organisation. In such cases, output of one department is used captively in another department (as input). The transferring departments usually have a profit margin for goods transferred to another department. This requires the elimination of profit margin from the inventory to arrive at rightful profit and income figure.

## 6.5 ALLOCATION OF COMMON EXPENDITURE TO DIFFERENT DEPARTMENTS

There are three types of expenses with respect to departmental accounts, which are:

1. **Direct Expenses:** These expenses are directly incurred by the department and can be directly assigned to the particular department. These expenses are easily identifiable and pertain to a specific department. For example, purchases of material or goods.
2. **Common Expenditure:** This expenditure is incurred by the company as a whole, and benefit flowing from such expenditure is derived by all the departments. In such cases, these common expenditures are apportioned and charged to department, based on appropriate allocation basis.

For example, rent paid by the company is ₹ 10000 and there are 4 departments who occupy the company space. In such scenario, rent can be apportioned on the basis of floor area, which is 300 sq. feet for Department 1, 300 sq. feet for department 2, 200 sq. feet for department 3 and 200 sq. feet for department 4. Here rent of ₹ 10000 would be apportioned and charged to departments as below:

Department 1 – ₹ 3000

Department 2 – ₹ 3000

Department 3 – ₹ 2000

Department 4 – ₹ 2000



Following table will guide with respect to appropriate basis for allocation of common expenditure, where the allocation basis is not mentioned.

**Table 6.1: Basis for Allocation of Common Expenditure**

Common expenditure	Basis of allocation
Rent, rates and taxes	- Floor area occupied by the department or, - Time period
Repairs and Maintenance	- Floor area occupied by the department or, - Time period
Building Insurance	- Floor area occupied by the department or, - Time period
Lighting and Heating expenses (For e.g., electricity expenses)	- Energy consumed by each department (in terms of meter readings etc.) or, - Floor space occupied by each department
Selling and distribution expenditure (For e.g., selling commission)	Net Sales revenue of each department (excluding inter departmental sales)
Carriage inward	Net Purchases by each department (excluding inter departmental transfers)
Any other purchase related expenditure (For e.g., Discount received, Freight etc.)	Net Purchases by each department (excluding inter departmental transfers)
Wages	Time basis
Salaries	Time basis
Depreciation	- Asset value or, - Usage time
Insurance	- Asset value or - Stock value or, - Usage time or, - Actual insurance premium
Repairs and maintenance (fixed assets)	- Asset value or, - Usage time
Administrative expenditure (For e.g., manager's salary)	- Time basis or, - Equal apportionment
Employee Welfare expenses (For e.g., canteen expenditure etc.)	Number of employees in each department
Workmen's Expenditure (For e.g., Provident Fund etc.)	- Wages pertaining to the departments or, - Number of employees in each department
Factory Manager's salary	Time basis (time devoted by the manager towards each department)

3. **General Expenditure:** Common expenditure like interest on loan or income tax etc., cannot be apportioned and allocated to departments. These expenditures are general expenditure. General expenditure need not be segregated and charged to departments. These expenses are to be taken to General Profit and Loss Account.

General income like interest on investment etc., also cannot be credited to departmental Profit and Loss account. This income is also to be taken to general profit and loss account.

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## 6.6 INTER-DEPARTMENTAL TRANSFERS

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Many a times the goods are transferred from one department to other departments. In such cases, the goods so transferred should be credited to the department who is supplying them and debited to the department who is receiving it.

There are more than one ways to deal with transfer the goods from one department to another department, which is enumerated below.

1. **Cost basis:** If the inter-departmental transfers are at cost (implying that no profit margin is included in the inventory), then there would be no need to off load the unrealized profit from the stock so transferred.
2. **Market price basis:** In such cases, the goods are transferred at the market price irrespective of the cost of goods. This would give rise to two scenarios as below.
  - (a) *Where cost is more than market price:* If the cost of the goods so transferred exceeds the market price (i.e., transfer price), then there is no profit margin included. Hence, there is no need to eliminate the unrealized profit in such case.
  - (b) *Where cost is less than market price:* In such cases, it is required to eliminate the unrealized profit in inventory and Profit and Loss account.
3. **Cost plus agreed mark up:** This pricing is similar to where the goods are sold to external customers. Generally, the transferring department would have pre-determined profit mark up on the cost of goods. This would obviously warrant the offloading the unrealized profit from inventory.

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## 6.7 HOW TO DEAL WITH UNREALIZED PROFIT (STOCK RESERVE)?

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When the goods are transferred at a price which includes pre-determined mark up or profit margin, then it is mandatory to offload the unrealized profit from the inventory so as to arrive at accurate profit.

### *Stock Reserve*

Stock reserve refers to unrealized profit which needs to be eliminated from the ending inventory at the end of the accounting period. Such stock reserve would be calculated using the following formula.

$$\text{Transfer price of unsold inventory} \times \frac{\text{Profit included in transfer price}}{\text{Transfer price}}$$

### *Accounting Treatment of Stock Reserve*

- The entry for creation of stock reserve would be passed at the end of accounting year as below.

General Profit and Loss Account                      Dr.  
     To Stock Reserve Account

(Being provision entry passed for unrealized profit on unsold inventory)

- In the beginning of the immediately next year, the above entry for stock reserve creation would be reversed.

Stock Reserve Account                                      Dr.

    To General Profit and Loss Account

(Being the stock reserve provision reversed)

- In case, the beginning inventory is also inclusive of unrealized profit (stock reserve), then one single entry can also be passed for both beginning inventory and ending inventory (for elimination of stock reserve). This entry will include creation of stock reserve for ending unsold inventory and reversal of stock reserve for beginning inventory.

### Balance Sheet Disclosure

Unsold inventory at the end of the accounting year has to be stated at the cost and hence the stock reserve is reduced from the ending inventory. This treatment is applicable where the transfer price includes the mark up or profit margin. The stock reserve would be disclosed as following in the balance sheet.

Liabilities		Assets
<b>Current Assets:</b>		
Ending Inventory	XXX	
Less: Stock reserve	XXX	
		XXX

**Example:** M/s Prabhas had two departments – Department D and Department S. Prepare consolidated Trading Account and Departmental Trading Account for the year ended 31<sup>st</sup> December 2017.

Particulars	Department D (₹)	Department S (₹)
Opening stock	20,000	12,000
Purchases	92,000	68,000
Sales	1,40,000	1,12,000
Wages	12,000	8,000
Carriage	2,000	2,000
Closing Stock:		
Goods purchased	4,500	6,000
Closing stock:		
Finished goods	24,000	14,000
Goods transferred:		
Purchased goods – by S to D	10,000	–
Goods transferred:		
Purchased goods – By D to S	–	8,000
Goods transferred – Finished Goods – by D to S	35,000	–
Goods transferred – Finished Goods – by S to D	–	40,000
Finished goods returned – by D to S	10,000	–
Finished goods returned – by S to D	–	7,000

Purchased goods are transferred at their departmental purchase cost, whereas finished goods are transferred at departmental market price. You are further informed that 20% of the closing finished inventory for department D and Department S represent finished goods received from other department.

**Solution:**

**Departmental Trading Account  
for the year ended 31<sup>st</sup> December 2017**

Particulars	Dept. D	Dept. S	Particulars	Dept. D	Dept. S
To Stock	20,000	12,000	By Sales	1,40,000	1,12,000
To Purchases	92,000	68,000	By Purchased goods transferred	8,000	10,000
To Wages	12,000	8,000	By Finished goods transferred	35,000	40,000
To Carriage	2,000	2,000	By Finished goods returned	10,000	7,000
To Purchased goods transferred	10,000	8,000	By Closing stock:		
To Finished goods transferred	40,000	35,000	Purchased goods	4,500	6,000
To Finished goods returned	7,000	10,000	Finished goods	24,000	14,000
To Gross Profit	38,500	46,000			
	<b>2,21,500</b>	<b>1,89,000</b>		<b>2,21,500</b>	<b>1,89,000</b>

**Consolidated Trading Account  
for the year ending on 31<sup>st</sup> December 2017**

Particulars	(₹)	Particulars	(₹)
To Opening Stock	32,000	By Sales	2,52,000
To Purchases	1,60,000	By Closing Stock:	
To Wages	20,000	Purchased Goods	10,500
To Carriage	4,000	Finished Goods	38,000
To Stock Reserve (refer note)	2,196		
To Gross profit	82,304		
	<b>3,00,500</b>		<b>3,00,500</b>

Calculation of Stock reserve:

Particulars	Dept. D	Dept. S
Goods Sold	1,40,000	1,12,000
Add: Goods transferred	35,000	40,000
Less: Goods returned	(7,000)	(10,000)
<b>Goods sold plus transferred</b>	<b>1,68,000</b>	<b>1,42,000</b>
<b>Gross profit Rate</b>		
Closing stock (out of goods transferred)	4,800	2,800
20% of the closing stock of finished stock		
Rate of Gross Profit	$\frac{38,500}{1,68,000} \times 100$ = 22.916%	$\frac{46,000}{1,42,000} \times 100$ = 32.934%
<b>Stock Reserve:</b>		
Dept D (transferred from S)	= 4,800 × 32.934% = 1,555	
Dept. S (transferred from D)	= 2,800 × 22.916% = 641	
Total Stock Reserve	= 1,555 + 641 = 2,196	

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## 6.8 MEMORANDUM STOCK AND MEMORANDUM MARK UP METHOD

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This method is particularly useful when the transfer or department has to transfers to more than one department. This method requires the company to maintain two types of accounts namely, Memorandum Stock Account and Memorandum Mark Up Account.

### *Memorandum Stock Account*

When goods are transferred to another department, those goods are debited to Memorandum Stock Account at cost plus mark up. This transfer price is equal to general selling price.

Sales revenue is credited to memorandum Stock Account. However, when it is necessary to bring the selling price down, at such time reduction in mark-up is effected in this account as well.

### *Memorandum Mark Up Account*

This account is specially devised to record the loading and unloading of the profit or "mark-up" on the goods transferred to or from other departments.

When goods are transferred to another department or received from another department, amount of "mark-up" would be charged to or credited to Memorandum Mark Up Account.

When mark-up is required to be reduced (when selling price is required to be reduced), reduction in mark-up is to be recorded in Memorandum Mark Up Account as well.

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## 6.9 DEPARTMENTAL TRADING AND PROFIT AND LOSS ACCOUNT

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Departmental Trading Account and Profit and Loss Account can be prepared in two ways, depending upon how the set of books are maintained for departments.

1. ***When all accounts for every department are maintained in a single set of books of accounts:*** In such case, columnar 'Trading and Profit and Loss Account' is prepared. Every department is assigned a column in the 'Trading and Profit and Loss Account'.

Here, direct expenditure can be recorded in the column of specific department. Common expenditure will be apportioned and charged to departments on appropriate and rational basis of allocation. General expenditure will be directly taken to General Profit and Loss Account.

2. ***When separate set of books is maintained for each department:*** This method is beneficial when there are negligible inter departmental transfers. In this case, every department maintains its own Trading and Profit and Loss Account.

Direct recognizable expenditure is directly debited to the Trading and Profit and Loss Account by the department. Common expenditure is allocated on the rational basis, when the management is interested to understand accurate departmental performance in addition to overall gross profit.

**Example:** Prepare the following for the year ending on 31<sup>st</sup> March 2016.

- Departmental Trading and General Profit and Loss Account
- Balance sheet as on date

**Financial data:**

Item	(₹)
Land and Building	12,500
Furniture	2,500
Debtors	20,000
Drawings	28,000
Cash at Bank	1,00,000
Capital	30,000
Creditors	10,000
Opening stock:	
Department P	3,000
Department Q	4,000
Purchases:	
Department P	1,00,000
Department Q	1,50,000
General Expenses	1,40,000
Sales:	
Department P	2,00,000
Department Q	3,20,000

**Additional Information:**

- Closing stock of Department P = ₹ 13,000 (includes goods from Department Q at ₹ 4,000 at cost to Department P)
- Closing stock of Department Q = ₹ 26,000 (includes goods from Department P at ₹ 9,000 at cost to Department P)
- Sales of Department P include goods transferred to Department Q of value of ₹ 20,000, which is equal to market price
- Sales of Department Q include goods transferred to Department P of value of ₹ 30,000, which is equal to market price.
- Opening stock of Department P and Q includes goods valuing at ₹ 1,000 and ₹ 1,500, from Department Q and P respectively. These goods are at cost to transferring department.
- Depreciation rate for
  - ❖ Land and Building – 5%
  - ❖ Furniture – 10%

**Solution:**

**Departmental Trading Account  
for the year ended 31<sup>st</sup> March 2016**

Particulars	Dept. P	Dept. Q	Total	Particulars	Dept. P	Dept. Q	Total
To Opening stock	3,000	4,000	7,000	By Sales	1,80,000	2,90,000	4,70,000
To Purchases	70,000	1,30,000	2,00,000	By Goods transferred	20,000	30,000	50,000
To Goods transferred	30,000	20,000	50,000	By Closing Stock	13,000	26,000	39,000
To Gross Profit	1,10,000	1,92,000	3,02,000				
	<b>2,13,000</b>	<b>3,46,000</b>	<b>5,59,000</b>		<b>2,13,000</b>	<b>3,46,000</b>	<b>5,59,000</b>

**General Profit and Loss Account  
for the year ended 31<sup>st</sup> March 2016**

Particulars	(₹)	Particulars	Total
To General expenses	1,40,000	By Gross profit	
To Depreciation		Dept. P	1,10,000
Land and Building	625	Dept. Q	1,92,000
Furniture	250		<b>3,02,000</b>
To Provision for unrealized profit			
Dept. P	2,400		
Dept. Q	4,950		
To Net Profit	1,53,775		
	<b>3,02,000</b>		<b>3,02,000</b>

**Working Note:**

Calculation of unrealized profit

$$\text{Dept. P} = \text{Rate of gross profit} = \frac{1,10,000}{2,00,000} \times 100 = 55\%$$

$$\text{Dept. Q} = \text{Rate of gross profit} = \frac{1,92,000}{3,20,000} \times 100 = 60\%$$

Hence, provision for unrealized profit for

$$\text{Department P} = 60\% \times ₹ 4,000 = ₹ 2,400$$

$$\text{Department Q} = 55\% \times ₹ 9,000 = ₹ 4,950$$

Since the goods are transferred at cost to transfer or department, it is not required to adjust any unrealized profit (stock reserve) in opening stock.

**Balance sheet  
as at 31<sup>st</sup> March 2016**

Liabilities	(₹)	Assets	(₹)
Capital	30,000	Fixed Assets	
Add: Profit	1,53,775	Land and Building	12,500
	1,83,775	Less: Depreciation	625
Less: Drawings	28,000		<b>11,875</b>
	<b>1,55,775</b>		

Contd. .

Sundry Creditors		10,000	Furniture	2,500	
			Less: Depreciation	250	2,250
			Stock		
			Dept. P	13,000	
			Dept. Q	26,000	
				39,000	
			Less: Stock Reserve	7,350	31,650
			Sundry Debtors		20,000
			Cash at Bank		1,00,000
		<b>1,65,775</b>			<b>1,65,775</b>

**Check Your Progress**

Fill in the blanks:

1. Departmental accounts provide a basis for \_\_\_\_\_ comparison.
2. \_\_\_\_\_ departments have very few exchange or transfer or any kind of inter departmental transactions.
3. \_\_\_\_\_ expenditure is incurred by the company as a whole and benefit flowing from such expenditure is derived by all the departments.
4. \_\_\_\_\_ refers to unrealized profit which needs to be eliminated from the ending inventory at the end of the accounting period.
5. Memorandum Stock Account and Memorandum Mark-up Account is maintained when the goods are transferred at \_\_\_\_\_.

## 6.10 LET US SUM UP

- Departmental accounts enable the management to understand whether the departments are operating efficiently.
- Departmental accounting is a tool to control cost and wastage at department level, which will help boost the overall profitability of the organisation.
- There are two methods to maintain the Departmental Accounts:
  - ❖ When separate set of books are maintained for each department (independent departments)
  - ❖ When all accounts for every departments is maintained in single set of books, in columnar format (dependent departments)
- Direct expenditure which can be recognised for a particular department is directly debited to the particular department.
- Common expenditure like rent, electricity etc., have to be apportioned and allocated on a rational and appropriate basis to all the departments.
- General expenditure (mainly financial expenditure like interest on loan etc.) cannot be apportioned since it is impractical and illogical. Hence, these expenses are directly taken to General P and L Account.



- Goods are transferred from one department to another department at one of the three ways as below:
  - ❖ At cost
  - ❖ At market price (includes unrealized profit in unsold inventory)
  - ❖ At cost plus agreed mark-up (includes unrealized profit in unsold inventory)
- Stock reserve needs to be offloaded from the unsold inventory (beginning as well as ending) to arrive at accurate profit figure.
- Memorandum Stock Account and Memorandum Mark-up Account is maintained when the goods are transferred at cost plus mark up and transfers are to more than one departments.

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## 6.11 LESSON END ACTIVITY

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Department A transferred 4,000 units of material X at ₹ 10 per unit to Department B. The actual cost of materials of Department A is ₹ 8 per unit. Find out the Stock Reserve on 1,000 units of material X which could not be consumed by Department B during the year.

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## 6.12 KEYWORDS

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**Departmental Accounting System:** Departmental accounting system refers to Accounting Information System where all financial information is maintained like revenue, expenses, losses and gains for the departments are recorded.

**Inter-departmental Transfers:** Inter-departmental transfer refers to goods transferred from one department to another within the same entity.

**Dependent Department:** The departments which have inter-departmental transfers are known as dependent department.

**Independent Departments:** These departments have negligible or very few inter-departmental transfers within the entity.

**Stock Reserve:** Stock reserve refers to unrealized profit in opening and closing stock where the inter-departmental transfers are at market price or at cost plus mark up.

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## 6.13 QUESTIONS FOR DISCUSSION

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1. Explain the situations when the stock reserve needs to be eliminated from opening and closing stock.
2. What are Memorandum Stock and Memorandum Mark Up Account?
3. When all accounts for every department is maintained in separate books, which method of departmental accounting is used and why?
4. Prepare Departmental Profit and Loss Account for Glam and Company the year ending 31<sup>st</sup> December 2016.

Particulars	Dept. A	Dept. B	Dept. C
Opening stock	2,000	1,500	3,000
Purchases	11,000	3,000	15,000
Closing stock	3,000	2,500	4,000
Sales	18,000	9,000	27,000
Staff salaries	2,800	5,000	6,000

Following general expenditure are also incurred by the Glam and Company:

Particulars	(₹)	Allocation Basis
Rent	3,500	Floor space occupied
Repairs	4,800	Sales
Air Conditioning	2,000	Floor space occupied
General Expenses	1,200	—

*Floor Space Occupied*

Dept.	Ratio
A	1/5
B	1/2
C	3/10

5. Prepare Departmental Trading for the year ending 31<sup>st</sup> December 2015.

**Trial Balance**

Particulars	(₹)
<b>Purchases (at cost of ₹ 1,00,000)</b>	
Dept. X	1,000 units
Dept. Y	2,000 units
Dept. Z	2,400 units
<b>Opening Stock</b>	
Dept. X	120 units
Dept. Y	80 units
Dept. Z	152 units
<b>Sales</b>	
Dept. X	1,020 units @ ₹ 20 each
Dept. Y	1,920 units @ ₹ 22.50 each
Dept. Z	2,496 units @ ₹ 25 each

Gross Profit rate is same in all departments. Prepare Departmental Trading Account.

**Check Your Progress: Model Answer**

1. Inter-departmental
2. Independent
3. Common
4. Stock reserve
5. Cost plus mark up

**6.14 SUGGESTED READINGS**

- M. P. Pandikumar, *Accounting & Finance for Managers*, Excel Books, New Delhi.  
 R. L. Gupta and Radhaswamy, *Advanced Accountancy*.  
 V. K. Goyal, *Financial Accounting*, Excel Books, New Delhi.  
 Nitin Balwani, *Accounting & Finance for Managers*, Excel Books, New Delhi.

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# LESSON

# 7

## BRANCH ACCOUNTS

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### CONTENTS

- 7.0 Aims and Objectives
- 7.1 Introduction
- 7.2 Types of Branches
- 7.3 Preparation of Books of Accounts
- 7.4 Debtor System
- 7.5 Stock and Debtors System
- 7.6 Final Accounts System
- 7.7 Wholesale Branch System
- 7.8 Let Us Sum Up
- 7.9 Lesson End Activity
- 7.10 Keywords
- 7.11 Questions for Discussion
- 7.12 Suggested Readings

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### 7.0 AIMS AND OBJECTIVES

After studying this lesson, you should be able to:

- Describe the importance of branch accounts
- Know the types of branches
- Prepare the books of accounts

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### 7.1 INTRODUCTION

A branch means any subordinate subdivision of a business. As per the sec. 29 of Companies Act, 1956, a branch is any establishment carrying on either the same or substantially the same activity as that carried on by the head office of the company. For example, Bata has its branches all over the country. Each branch is treated as a separate profit centre and hence the profit or loss of each branch is computed separately. The head office of the firm has to keep strict control over various activities of each branch and ensure its smooth functioning.

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### 7.2 TYPES OF BRANCHES

The branches can be divided into the following categories:

- Dependent Branches
- Independent Branches
- Foreign Branches

1. **Dependent Branches:** Dependent branches are those branches which do not keep the full system of accounting. The following are the key features of dependent branch accounting:
  - (a) The dependent branches are not allowed to make any purchases and they sell goods received from the head office.
  - (b) Goods are supplied by the head office to such branches either at cost price or at invoice price.
    - (i) All the major expenses are paid by the head office.
    - (ii) Normally the goods are sold for both the cash and credit.
2. **Independent Branches:** Independent branches are those branches which keep the full system of accounting. They are allowed to purchase goods from the open market and also supply to the head office, if necessary. They can pay their expenses from the cash realised and can have the bank account on their own name.
3. **Foreign Branches:** When a branch is located out of the home country, it is called foreign branch. Foreign branches keep their accounts in the foreign currency. In this lesson, we will discuss about the accounting treatment of dependent branches.

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### 7.3 PREPARATION OF BOOKS OF ACCOUNTS

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As we discussed earlier dependent branches do not keep a **complete** set of books. The head office is responsible to keep the books of accounts for dependent branches. The following are the key methods which are adopted by head office to keep the branch accounts:

1. **Debtors System:** This system of accounting is used for those branches which are small in size. Under this system, the head office simply opens a Branch Account for each branch in which it records all transactions relating to the branch.
2. **Stock and Debtor System:** Under this system, the head office does not open any Branch Account. Under this system, the following ledger accounts are opened:
  - (a) Branch Stock Account
  - (b) Branch Debtors Account
  - (c) Branch Expenses Account
  - (d) Branch Adjustment Account
  - (e) Branch Profit and Loss Account

#### *Purpose of Preparing Branch Accounts*

- (a) To find out the profit or loss of each branch.
  - (b) To know the financial position of each branch.
  - (c) To make estimation of cash and stock for each branch.
  - (d) To know the performance of each branch.
  - (e) To make business expansion strategies.
  - (f) To fulfill the statutory requirements.
3. **Final Accounts System:** Under this system, the head office prepares 'Trading and Profit and Loss Account' in order to find out profit or loss of each branch and a Branch Account to find out the amount due to, or due from, that branch. In this case, the Branch Account simply acts as a personal account.

4. **Whole Sale Branch System:** Manufacturers may sell goods to the consumers either through the wholesalers and approved stock brokers or through their branches. In order to know whether self-retailing through branch is more profitable than wholesaling, it is necessary to make distinction between profit due to wholesale and profit due to retail business of the branch. Wholesale price is always less than retail price.

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## 7.4 DEBTOR SYSTEM

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As stated earlier under this system, the head office simply opens a branch account which records all the transactions relating to a particular branch. Branches are also not required to ascertain profit or loss as no information relating to the cost of sales is given to them. Under debtor system, the goods may be invoiced to branch at cost or invoice price.

### *In Case of Goods are Sent at Cost Price*

In case of goods are sent at cost the following journal entries are passed in the books of head office:

(a) ***When Goods are sent to Branch***

Branch A/c	Dr.
To Goods Sent to Branch A/c	
(Goods sent to branch)	

(b) ***Cash sent to Branch***

Branch A/c	Dr.
To Cash A/c	
(Cash sent to branch)	

(c) ***When goods are returned to head office by branch***

Goods Sent to Branch A/c	Dr.
To Branch A/c	
(Goods returned by branch)	

(d) ***When amount received from branch***

Cash/bank A/c	Dr.
To Branch A/c	
(Cash received from branch)	

(e) ***For closing goods sent to branch A/c***

Goods sent to branch A/c	Dr.
To Purchases A/c	
(Balance stock transferred to purchase/trading A/c)	

(f) ***For transferring profit/loss to Profit and loss A/c***

(i) ***In case of profit***

Branch A/c	Dr.
To Profit and Loss A/c	
(Balance stock transferred to purchase/trading A/c)	

(ii) *In case of loss*

Profit and Loss A/c                      Dr.  
     To Branch A/c

(Balance stock transferred to purchase/trading A/c)

**Pro Forma of Branch A/c**

Particular	Amount (₹)	Particular	Amount (₹)
To Opening balance		By Opening balance	
Stock		O.S. expenses	
Debtors		Creditors	
Petty Cash		By Bank A/c	
Furniture		Cash sales	
Prepaid expenses		Collections from debtors	
To Goods sent to branch A/c		By Goods sent to branch A/c	
To Bank A/c (for expenses)		(for goods returned by branch)	
To Closing balance		By Closing balances	
O.S. expenses		Stock	
Creditors		Debtors	
To Profit transferred to profit and loss A/c		Petty cash	
		Furniture (less depreciation)	
		Prepaid expenses	
		By Loss transferred to profit and loss A/c	

**Example:** The GM Ltd. Delhi has a sales branch in Karnal. From the following figures, prepare Karnal Branch Account and also ascertain the profit or loss of the branch.

	₹
Goods sent to branch	50,000
Cash sent to branch for expense	3,500
Cash received from the branch	52,000
Stock at branch on 31 <sup>st</sup> December	5,500
Petty cash in hand at branch	500

**Solution:****In the books of Head Office****Karnal Branch Account**

Particulars	₹	Particulars	₹
To Goods Sent to Branch A/c	50,000	By Cash	52,000
To Bank A/c	3,500	By Stock at Branch A/c	5,500
To Profit transferred to P & L A/c	4,500	By Cash at Branch A/c	500
	58,000		58,000

***In Case of Goods are Sent at Invoice Price***

When goods are sent at invoice price (which is higher than the cost price) it is necessary to make adjustment for the amount of difference between the cost price and invoice price.

*What is loading?*

Loading is the difference between the invoice price and cost price.

The following additional journal entries are passed in the books of head office:

**(a) For adjustment of loading in opening stock**

Adjustment for Goods Sent to Branches A/c                      Dr.

Or

Stock Reserve A/c

To Branch Account

(Adjustment for difference between invoice & cost price)

**(b) For adjustment of loading in closing stock**

Branch A/c    Dr.

To Adjustment for Stock with Branch A/c

Or

To Stock Reserve A/c

(Adjustment for difference in value (Invoice & cost price))

**Example:** ABC & Co. of Delhi has a branch at Mumbai. Goods are sent by the head office at invoice price which is at a profit of 20% on invoice price. All expenses of the branch are paid by the head office. From the following particulars, prepare branch account in the head office books when, goods are shown at an invoice price.

Opening balances:	(₹)
Stock at invoice price	11,000
Debtors	1,700
Petty cash	100
Goods sent to branch at invoice price	20,000
Expenses made by head office:	
Rent	600
Wages	200
Salary, etc.	900
Remittances made to head office:	
Cash sales	2,650
Cash collected from debtors	21,000
Goods returned by branch at invoice price	400
Balances at the end:	
Stock at invoice price	13,000
Debtors at the end	2,000
Petty cash	25





3. *Sales of goods by branch*

(a) *For cash sale*

Cash A/c Dr.  
    To Branch Stock A/c  
(Cash sales at branch)

(b) *For credit sale*

Branch Debtors A/c Dr.  
    To Branch Stock A/c  
(Cash sales at branch)

4. *Cash receipts from branch debtors*

Cash A/c Dr.  
    To Branch debtors A/c  
(Cash received form branch debtors)

5. *For sales return*

Branch stock A/c Dr.  
    To Branch debtors A/c  
(Cash received form branch debtors)

6. *For discount allowed, bad debts, etc.*

Branch Expenses A/c Dr.  
    To Branch Debtors A/c  
(Expenses on branch debtors)

7. *For payment of branch expenses*

Branch Expenses A/c Dr.  
    To Cash A/c  
(Branch expenses paid by head office)

8. *If there is shortage/loss of stock, then*

Branch Adjustment A/c (with amount of loading) Dr.  
Branch profit and loss A/c (with cost of storage) Dr.  
    To Branch Stock A/c  
(Loss in Stock at branch)

9. *For surplus of stock at branch*

Branch stock A/c Dr.  
    To Branch adjustment A/c (with amount of loading)  
    To Branch profit and loss A/c (with cost of storage)  
(Surplus in stock at branch)



Discount allowed to customers	200
Goods returned by customers	100
Goods spoiled	50
Opening stock (at invoice price)	3,000
Opening debtors	2,000

**Solution:****In the books of the head office****Branch Stock Account**

Particulars	₹	Particulars	₹
To Balance b/d	3,000	By Cash (sales)	17,400
To Supplies from Head office (125% of 15,200)	19,000	By Branch Debtors A/c (Credit sales)	5,600
To Branch Debtors (Returns by debtors)	100	By Branch Adjustment A/c (Spoilage of goods)	50
To Net profit transferred to General Profit & Loss A/c	950		
	23,050		23,050

**Branch Expenses Account**

Particulars	₹	Particulars	₹
To Cash: Rent & Rates	900	By Branch Adjustment A/c (Transfer)	1,960
Wages	760		
Sundry expenses	100		
To Branch debtors A/c: Discount allowed	200		
	1,960		1,960

**Branch Debtors Account**

Particulars	₹	Particulars	₹
To Balance b/d	2,000	By Cash	5,000
To Branch Stock A/c (credit sales)	5,600	By Discount (Branch expenses) A/c	200
		By Branch stock A/c (Returns)	100
		By Balance c/d	2,300
	7,600		7,600

**Branch Adjustment Account**

Particulars	₹	Particulars	₹
To Branch stock A/c (spoilage of goods)	50	By Good supplied to branch A/c	3,800
To Branch expenses A/c	1,960	By Stock reserve A/c	600
To Net profit transferred to general Profit & Loss A/c	2,390		
	4,400		4,400

**Goods Supplied to Branch Account**

Particulars	₹	Particulars	₹
To Branch Adjustment A/c	3,800	By Branch stock A/c	19,000
To Purchases A/c	15,200		
	19,000		19,000

### Stock Reserve Account

Particulars	₹	Particulars	₹
To Branch adjustment a/c	600	By Balance b/d	600

### Jaipur Branch Account

Particulars	₹	Particulars	₹
To Opening stock	3,000	By Cash (cash sales)	17,400
To Opening debtors	2,000	By Received from branch debtors	5,000
To Goods sent to branch	19,000	By Closing debtors a/c <sup>(3)</sup>	2,300
To Cash: Rent & Rates	900	By Adjustment for opening stock	600
Wages	760	By Adjustment for goods sent	3,800
Sundry expenses	100		
To Net profit transferred to general Profit & Loss a/c <sup>(1)</sup>	3,340		
	29,100		29,100

#### Working Notes:

1. According to branch stock and debtors system, total net profit transferred to General profit & Loss A/c is ₹3,340 i.e., ₹950 from Branch stock A/c and ₹2,390 from Branch adjustment A/c.
2. Profit is separated by using 25% on cost or 20% on sale basis i.e., 1/5 of selling price.
3. For closing debtors balance, see Branch Debtors A/c.

## 7.6 FINAL ACCOUNTS SYSTEM

The profit or loss of a dependent branch can also be worked out by preparing a Memorandum Branch Trading and Profit & Loss Account. This account is prepared on the basis of cost of goods sent to the branch (not the invoice price). Apart from the Branch Trading and Profit & Loss Account, the head office also maintains the Branch Account. But, under this system, the Branch Account is in the nature of a personal account which shows only the mutual transactions between the head office and the branch, the balance of Branch Account, therefore, represents the net assets of the branch.

**Example:** A-one Ltd., Bhopal has a branch at Madras to which the goods are sent at cost plus 25%. The Madras branch keeps its own Sales Ledger and remits all cash received to the head office every day. All expenses are paid by the head office. The transactions for Madras Branch during the year ending December 31, 2008 were as follows:

	₹		₹
Stock (1-1-2008)	11,000	Return inwards	500
Debtors (1-1-2008)	100	Cheques sent to branch:	
Petty cash	100	Rent	600
Cash sale	2,650	Wages	200
Credit sales	23,950	Salary and other expenses	900
Goods sent to branch	20,000	Stock (31-12-2008)	13,000
Collection on ledger account	21,000	Debtors (31-12-2008)	2,000
Goods returned to H. O.	300	Petty cash (31-12-2008)	
Bad debts	300	(including misc. income ₹ 25 not remitted)	125
Allowance to customers	250		

Prepare the Memorandum Branch Trading and Profit and Loss A/c and Madras branch A/c for the year ending Dec 31, 2008.

**Solution:**

**Memorandum Branch Trading and Profit and Loss A/c  
for the year ending 31-12-2008**

Dr.	₹	Cr.	₹
<b>Particulars</b>		<b>Particulars</b>	
To O. S. (₹ 11,000 – ₹ 2,200)	8,800	By Sales	
To Goods sent to branch (20,000 – 4,000)	16,000	Cash	2,650
To Wages	200	Credit	23,950
To Gross profit c/d	11,740		26,600
		Less: Returns	500
		By Goods sent to HO (₹ 300 – ₹ 60)	240
		By Closing stock (₹ 13,000 – ₹ 2,600)	10,400
	<b>36,740</b>		<b>36,740</b>
To Bad debts	300	By Gross profit b/d	11,740
To Allowance	250	By Misc. income	25
To Rent	600		
To Salaries and other expenses	900		
To Profit transferred to general profit and loss A/c	9,715		
	<b>11,765</b>		<b>11,765</b>

**Madras Branch A/c**

Dr.	₹	Cr.	₹
<b>Particulars</b>		<b>Particulars</b>	
To Balance b/d		By Bank A/c	
Stock	8,800	Cash received from debtors	21,000
Debtors	100	Cash sales	2,650
Petty cash	100	By Goods sent to branch (returns to HO)	240
To Goods sent to branch A/c	16,000	By Balance c/d	
To Bank A/c		Stock	10,400
Rent	600	Debtors	2,000
Wages	200	Petty cash	125
Salaries and other exp.	900		
To Profit as per Branch Trading and Profit and Loss A/c	9,715		
	<b>36,415</b>		<b>36,415</b>

## 7.7 WHOLESALE BRANCH SYSTEM

Sometimes the manufacturing organisations (head office) sell their products through wholesalers as well as through own branches. In case the head office decides two prices. (i) Wholesale price; and (ii) Retail price. Goods are supplied to the wholesalers and branches at wholesale price, that is, cost plus profit. The branches are supposed to sell these goods at retail price which is greater than the wholesale price. It means the branches earn more profit than the head office. But the total profit (Retail price-cost)

cannot be considered as branch profit. The real profit of the branch shall be the difference between the wholesale price and retail price.

The wholesale price means cost plus profit. Therefore in the books of head office Branch Stock Account shall be maintained at wholesale price. At the end of the accounting period, the problem arises only when the goods received from head office remains unsold at branch, because it includes a part of profit which has been charged by the head office. To calculate the proportion of profit, the value of unsold goods shall be reduced from wholesale price to cost price.

At the end of accounting year, the following entry shall be made:

Profit & Loss A/c (H.O.)                      Dr.  
    To Stock Reserve A/c

(Reserve created for the difference in the wholesale price and cost price of Branch closing stock)

**Example:** M/s Gaba and co. of Delhi submits the following particulars regarding the branch transactions of its Mumbai branch for the year ended March 31, 2006:

	H.O (₹)	Branch (₹)
Stock on 1-4-2005	72,000	28,800
Goods purchased during the year	4,18,000	—
Indirect expenses	21,800	3,900
Goods sent to branch at invoice price	1,29,600	—
Sales	3,78,000	1,45,800
Goods received by branch	—	1,29,600
Goods sold to regional stockists	79,200	—

Generally goods are invoiced to branch and regional stockists at 20% below the list price. The list price is calculated at 80% above the cost. Goods are sold to the customers at the list price by the HO and the branch both.

You are required to prepare the Trading and Profit and Loss A/c of the head office and the branch for the year ended on March 31, 2006.

**Solution:**

**In the books of Head Office  
Trading and Profit and Loss A/c  
for the year ended on March 31, 2006**

Dr.	₹	Cr.	₹
Particulars		Particulars	
To O.S.	72,000	By Sales	3,78,000
To Purchases	4,18,000	By Goods sent to the branch	1,29,600
To GP c/d	2,31,800	By Regional stockists	79,200
		By Closing stock	1,35,000
	<b>7,21,800</b>		<b>7,21,800</b>
To Indirect exp.	21,800	By Gross profit b/d	2,31,800
To Stock reserves (41760 + 44/144)	12,760	By Stock reserve (OS) (28800 + 44/144)	8,800
To Net Profit	2,06,040		
	<b>2,40,600</b>		<b>2,40,600</b>

**Branch Trading and Profit and Loss A/c  
for the year ended on March 31, 2006**

Dr.			Cr.
Particulars	₹	Particulars	₹
To OS	28,800	By Sales	1,45,800
To Goods from head office	1,29,600	By Closing stock	41,760
To GP c/d	29,160		
	<b>1,87,560</b>		<b>1,87,560</b>
To Indirect exp.	3,900	By GP b/d	29,160
To General profit and loss a/c	25,260		
	<b>29,160</b>		<b>29,160</b>

**Working notes:**

1. **Calculation of list price and invoice price**

Let cost price is = ₹ 100

List price = ₹ 100 + 80% of ₹ 100 = ₹ 180

Thus invoice price = ₹ 180 – 20% of ₹ 180 = ₹ 144

2. **Calculation of closing stock at the branch**

	₹
OS at the branch	28,800
Goods sent by the HO	1,29,600
	<b>1,58,400</b>
Less: Cost of goods sold to customers (1,45,800 × 144/180)	1,16,640
Closing stock at the branch	41,760

3. **Calculation of closing stock at HO**

	₹
Opening Stock	72,000
Add: Goods purchased	4,18,000
	<b>4,90,000</b>
Less: Cost of goods sold	
Sold to customers (3,78,000 × 100/180) = 2,10,000	
Goods sent to branch (1,29,600 × 100/144) = 90,000	
Goods sent to stockists (79,200 × 100/144) = 55,000	3,55,000
Closing stock at the HO	<b>1,35,000</b>

**Check Your Progress**

Fill in the blanks:

- As per the \_\_\_\_\_ of Companies Act, 1956, a branch is any establishment carrying on either the same or substantially the same activity as that carried on by the head office of the company.
- Each branch is treated as a separate \_\_\_\_\_ and hence the profit or loss of each branch is computed separately.

Contd...

3. \_\_\_\_\_ branches are those branches which are not keeping the full system of accounting.
4. \_\_\_\_\_ branches are those branches which are keeping the full system of accounting.
5. Foreign branches keep their accounts in the \_\_\_\_\_.
6. The Branch Account is in the nature of a \_\_\_\_\_ account which shows only the mutual transactions between the head office and the branch.
7. Goods are supplied to the whole-seller and branches at wholesale price, that is, \_\_\_\_\_.

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## 7.8 LET US SUM UP

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- The extent of business expansion is responsible for opening of the new branches.
- The branches are of three types: Dependent Branches, Independent Branches and Foreign Branches.
- Dependent branches are such which are not free, either to buy or sell without the head office directives.
- Independent branches are such which are free to buy and sell the goods, i.e., Branches which buy goods according to its requirements and sell goods for cash as well as on credit.
- In case of dependent branches, complete set of books is not required because dependent branches are required to remit cash daily to the head office or deposit it in a bank account as per instructions of the head office.
- Stock at branch and cash at branch are to be shown in the balance sheet of the head office as an asset and the goods sent to branch is shown in the trading account.
- Complete set of accounts connected with the branch are kept in the head office whereas office branch maintains the cash records only which is sent to the head office by the branch.
- When goods are sent by the head office to branch/es at an invoice price which is more than the cost price. then the object of the head office is to exercise, (1) more control on stock by preparing branch stock register, and (2) to keep the amount of profit as secret.
- When goods are sent by head office to branch at an invoice price, then stock and debtor system can be used to ascertain profit or loss of the branch.

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## 7.9 LESSON END ACTIVITY

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X Ltd. operates a retail branch at Mumbai. All purchases are made by the head office in Calcutta, goods being charged out to the Branch at selling price which is cost plus 25%. All the expenses of branch are paid through head office cheques. Cash collected from customers and the ready money sales are daily banked to the credit of the head office. From the following particulars of the branch write up, the necessary accounts



arrives at the branch profit or loss, in the head office books, by using stock and debtors system.

Particulars	₹	Particulars	₹
Debtors at start	15,000	Invoiced Inventory at beginning	30,000
Debtors at end	19,000	Invoiced Inventory at end	28,000
Ready money sales during the year	1,30,000	Salaries	12,000
Cash Received on Ledger Account	1,20,000	Rent etc	10,000
Return to H.O. at Invoiced Amount	5,000	Bad debts	4,000
Normal Leakage and Spoilage	4,000	Discount and Allowances	6,000

## 7.10 KEYWORDS

**Dependent Branches:** Dependent branches are such which are not free either to buy or sell without the head office directives.

**Debtors System:** This system of accounting is used for those branches which are small in size. Under this system, the head office simply opens a Branch Account for each branch in which it records all transactions relating to the branch.

**Independent Branches:** Independent branches are such which are free to buy and sell the goods, i.e., branches which buy goods according to its requirements and sell goods for cash as well as on credit.

**Loading:** Loading is the difference between the invoice price and cost price.

**Stock and Debtor System:** Under this system, the head office does not open any Branch Account.

## 7.11 QUESTIONS FOR DISCUSSION

1. How many types of branches are there? What entries are made in the books of company to incorporate branch's trial balance?
2. Explain the causes of difference in the balances shown by the H.O. and the Branch.
3. How are normal and abnormal losses are treated in the branch account?
4. What are the different systems of accounting of dependent branches?
5. How to compute the profit of dependent branches?
6. Illustrate the branch stock account with a suitable example.
7. Delhi Traders, Delhi opened a branch at Baroda on 1<sup>st</sup> January 2006. The following information is available in respect of the branch for the year 2006.

	₹
Goods sent to the branch	70,000
Cash sales at the branch	40,000
Credit sales at the branch	60,000
Salaries of the branch paid by the Head Office	25,000
Office Expenses of the branch paid by the Head Office	10,000
Cash remittances to branch towards petty cash	6,000
Petty cash at branch on 31.12.2006	500
Debtors at branch as on 31.12.2006	5,000
Stock at branch on 31.12.2006	27,000

Prepare Branch Account to show the profit/loss from the branch for the year 2006.

8. A Head Office at Mumbai has branch at Chennai in charge of a manager. The ratio of gross profit on turnover at the branch was 25% constant throughout the year. The Branch manager is entitled to a commission of 10% of the profit earned by the branch calculated before charging his commission, but subject to a deduction from such commission a sum equal to 50% of any ascertained deficiency of Branch Stock. All goods were supplied to the branch by the Head Office.

From the following figures extracted from the branch books, calculate the commission due to the manager for the year ended 31<sup>st</sup> December, 2006.

Particulars	₹	Particulars	₹
Stock as on 1.1.06 at Cost	31,210	Establishment Expenses	22,550
Goods received from Head Office at Cost	1,08,700	Drawings by Manager against Commission	1,000
Sales	1,46,400	Stock on 31.12.06 at Selling Price	39,880

9. From the following details prepare Branch Account in the books of Head Office:

	₹
Goods sent to branch at cost	40,000
Goods returned by branch at cost	2,000
Branch credit sales	51,000
Cash sales at branch	3,500
Cash remitted to head office by branch	40,000
Expenses paid by head office	10,000
Discount allowed to customers by branch	1,800
Closing Stock with Branch at Cost	14,000
Branch Debtors (Closing balance)	7,700

10. Kapur Brothers has a branch at Lucknow, Goods are invoiced to his branch at 20% profit on invoice price. From the following details, prepare 'Branch Account' in the books of Head Office showing branch profit:

	₹
Credit sales	1,12,000
Goods supplied to branch at invoice price	3,80,000
Cash sales	2,48,000
Cash received from debtors	1,00,000
Wages (Paid by head office)	15,200
Rent (Paid by head office)	18,000
Discount allowed to customers	4,000
Sundry expenses (Paid by head office)	1,000
Goods returned by customers	2,000
Depreciation on furniture	1,000
Goods spoiled	1,000

**Check Your Progress: Model Answer**

1. Sec 29
2. Profit centre
3. Dependent
4. Independent
5. Foreign currency
6. Personal
7. Cost plus profit

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**7.12 SUGGESTED READINGS**

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M. P. Pandikumar, *Accounting & Finance for Managers*, Excel Books, New Delhi.

R. L. Gupta and Radhaswamy, *Advanced Accountancy*.

V. K. Goyal, *Financial Accounting*, Excel Books, New Delhi.

Nitin Balwani, *Accounting & Finance for Managers*, Excel Books, New Delhi.

## **UNIT IV**



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# LESSON

# 8

## ROYALTY

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### 8.0 AIMS AND OBJECTIVES

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After studying this lesson, you should be able to:

- Define royalty
- Calculate the minimum rent under royalty
- Compute short workings

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### 8.1 INTRODUCTION

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Royalty is an amount payable for utilizing the benefit of certain rights vested with some other person. For example, a landlord possesses right over the mine in his land. the author of book possesses right over his book. When the rights are leased the owner receives a consideration for the same which is called royalty. Royalty is a periodical

sum based on the output payable by the lessee to the lessor for having utilized the rights of the lessor. The person who makes the payment to the owner of asset is known as lessee and the owner of the asset is known as lessor. Royalty is a business expense and closed and transferred to profit and loss account.

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## 8.2 MEANING OF ROYALTY

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According to William Pickles, "*Royalty is the remuneration payable to a person in respect of the use of an asset, whether hired or purchased from such person, calculated by reference to and varying with quantities produced or sold as a result of such asset.*"

The term royalty is concerned with the assets of tangible or intangible in nature. The assets like land, building, mines, copyright, patent, trademark etc., are attracted with royalty. Royalty is a periodical payment to be paid by the user of the assets of the above nature. It is a sum payable for enjoying the benefits of certain rights vested with the other person. The person who makes payment and uses the assets is known as 'Lessee'. And the person who surrenders the right and receives the royalty is known as 'Lessor'.

The 'Lessor' is the owner of assets. Author of a book, holder of patent, land lord of mine etc., are the examples of Lessor. The lessee acquires the right to use the lessor's property. For it, the lessee pays a certain amount to the lessor, which is termed as royalty. Publisher, patent user, trade mark user, licencee etc., are the examples of lessee.

Royalty payable is ordinary business expenditure for the lessee and royalty receivable is an income for the lessor. It can be paid either on the basis of unit sold or on the basis of output. If it is paid on the basis of the unit sold, it is transferred to profit and loss account. Royalties paid on the basis, if output is transferred to the production account. If nothing is specified, royalties paid is transferred to profit and loss account.

A royalty is generally paid to the owner of the right under the following cases:

1. When the government or local authority allows some person to collect forest products like honey, herbs, clay etc., from the forest, the government or local authority is the owner or lessor and the person who collects is the lessee.
2. When the owner of mines like coal, copper, stone allows other party to extract materials from land.
3. When the right of owner like copyright, patent right, trade mark, exclusive right of design are licenses to some other party.

### 8.2.1 Nature of Royalty Account

Royalty Account is nominal in the nature. So it is debited in the books of party paying it and credited in the books of the party receiving it. As it is a nominal account, the amount is transferred either to P & L Account or Production Account, depending upon its treatment as direct or indirect expenses as the case may be.

### 8.2.2 Royalty Agreement

A royalty agreement will normally contain clauses dealing with the following:

- (a) Minimum rent – guaranteed amount which the landlord, inventor or author is to receive whatever the output maybe.
- (b) Royalty per unit per output
- (c) Right to recoup short-workings
- (d) Right to subject part or whole of tenancy agreement

## 8.3 ROYALTIES IN ACCOUNTING

The owner of a long term asset such as for example a patent or copyright can issue a licence to another party allowing them to use the asset in return for payments referred to as royalties. The owner of the asset who issues the licence and receives the royalty is known as the licensor. The person who makes use of the asset and pays the royalty is known as the licensee.

Royalties can take many different forms and the calculations can be complex however, fundamentally they depend on the amount to which the asset is used by the licensee. For example, a publisher might pay a royalty to an author for each copy of their book sold, or a manufacturer might pay a royalty to an inventor based on the revenue earned from the sale of their product.

### 8.3.1 Royalty Payment Accounting

#### *Example – Licensee*

The developer (licensor) of a video game grants a licence to a publisher (licensee) in return for royalty payments. The publisher agrees to produce market and distribute the game to end users.

The royalty payments to the developer are to be made in two stages:

1. An advance royalty payment of ₹ 5,000 when the agreement is signed.
2. A regular payment of ₹ 8.00 for each game sold.

#### *Advance on Royalties*

The advance royalty payment of ₹ 5,000 is paid on the signing of the royalty agreement and is classified as a prepayment in the accounting records of the publisher (licensee).

The following bookkeeping journal is used to record the royalty advance.

#### Advance on Royalties

Account	Debit (₹)	Credit (₹)
Advance on Royalties	5000	
Cash		5000
<b>Total</b>	<b>5000</b>	<b>5000</b>

The developer in effect receives upfront payment of future royalties.

Since the developer earns ₹ 8.00 for each game sold, the ₹ 5,000 represents a prepayment of ₹ 625 ( $₹ 5,000/8$ ) sales. From the publisher's point of view, this is a prepayment and is included as a balance sheet current asset until the royalty is earned by the developer when the game is sold.

#### *Regular Royalty Payments*

Suppose at the end of the first accounting period 500 video games have been sold. The royalty due to the developer is ₹ 4,000 ( $500 \times 8.00$ ), and the publisher posts the following journal entry to record the payment.

#### Regular Royalty Payments

Account	Debit (₹)	Credit (₹)
Royalty expense	4000	
Advance on royalties		4000
<b>Total</b>	<b>4000</b>	<b>4000</b>



The developer has now earned royalties of ₹ 4,000 and the publisher transfers this from the prepayment account (advance on royalties) to the royalty expense account. The balance on the advance on royalties account is now ₹ 1,000.

During period 2 a further 600 games are sold and the royalty due to the developer (licensor) is ₹ 4,800 (600 × 8.00). The publisher (licensee) now posts the following bookkeeping entry.

#### Regular Royalty Payments

Account	Debit (₹)	Credit (₹)
Royalty expense	4800	
Advance on royalties		1000
Royalties payable		3800
<b>Total</b>	<b>4800</b>	<b>4800</b>

The royalty expense for the period is ₹ 4,800, since the balance on the advance payments account is ₹ 1,000, the developer is owed a further ₹ 3,800. If the amount is paid after the period end (which it is in this example), it is shown as a balance sheet current liability account under the heading royalties payable. The balance on the advance payments account is now zero.

#### Stepped Royalty Payments

Stepped royalties are simply a method of calculating the royalty due. A stepped royalty arrangement changes the royalty rate at different levels of sales.

In the above example, the royalty due was ₹ 8.00 for each video game sold. Under a stepped royalty arrangement the rate might have been ₹ 8.00 for the first 1,000 games sold and ₹ 9.00 thereafter. In this case, the royalty due would have been calculated as follows.

##### Period 1:

$$\text{Sales} = ₹ 500$$

$$\text{Royalty} = ₹ 500 \times ₹ 8.00 = ₹ 4,000$$

##### Period 2:

$$\text{Sales} = ₹ 600$$

$$\text{Royalty} = ₹ 500 \times ₹ 8.00 + ₹ 100 \times ₹ 9.00 = ₹ 4,900$$

The total sales are 1,100, during period 2 the sales reach the 1,000 step and the royalty rate is increased to ₹ 9.00 per sale for the final 100 units sold during the accounting period.

### 8.3.2 Royalty Income Accounting

#### Example – Licensor

The licensor receives royalty income from the licensee. In the above example, the developer was the licensor and received a royalty at the agreed rate from the publisher (the licensee).

Using the same information from the example above, the developer would make the following bookkeeping entries to record the transactions.

#### Advance on Royalty Income

The developer receives the royalty advance of ₹ 5,000 from the publisher.

### Unearned Royalty

Account	Debit (₹)	Credit (₹)
Cash	5000	
Unearned Royalties		5000
<b>Total</b>	5000	5000

Since the royalty has not yet been earned, the advance is recorded in a balance sheet (unearned royalties) account representing a current liability to the publisher until the game has been sold in sufficient quantities to earn the royalty.

#### **Regular Royalty Income**

In period 1, 500 copies of the game are sold and the developer earns 4,000 in royalties and makes the following posting.

#### Regular Royalty Income

Account	Debit (₹)	Credit (₹)
Unearned royalties	1000	
Royalties receivable	3800	
Royalty revenue		4800
<b>Total</b>	4800	4800

The royalty revenue for the period is ₹ 4,800, since the balance on the unearned royalty account is ₹ 1,000, the developer is owed a further ₹ 3,800. If the amount is paid after the period end (which it is in this example), it is shown as a balance sheet current asset account under the heading royalties receivable. The balance on the unearned royalty account is now zero.

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## 8.4 MINIMUM RENT

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Minimum rent is the minimum amount guaranteed to the lessor by the lessee at the initial stages of agreement when the production is nil or very low. Generally every royalty agreement contains the MR clause. Minimum rent becomes payable only when the royalty is less than the MR. A contract is entered into between the landlord and the lessee for payment of royalty, usually calculated upon the quantity of production or sale at a certain stipulated rate. This means that if there is little or no production or sale, the landlord would receive little or no royalty at all, thus undermining the monetary interest of the landlord. For some reasons or other, the lessee may not take that much enthusiasm in the execution of the work to which royalty relates. To avoid such a situation, the landlord and the lessee agree upon a minimum periodical amount that the landlord will receive from the lessee, even if the actual royalty as calculated on the basis of actual production or sale is less than such minimum amount. This assured and mutually agreed periodical minimum amount is known as "Minimum Rent".

For example, suppose royalty per ton of production is ₹ 100 and the minimum (annual) rent is ₹ 5,00,000. Now, if the actual production is 3,000 tons, then actual royalty would become ₹ 3,00,000. In this case, the minimum rent of ₹ 5,00,000 will have to be paid by the lessee. On the other hand, if the actual production is 6,000 tons, then the actual royalty would become ₹ 6,00,000. In this case, ₹ 6,00,000 will have to be paid by the lessee.

Thus, as there is a stipulation for minimum rent, then either the minimum rent or the actual royalty whichever is more, shall have to be paid by the lessee. The minimum rent is also called dead rent, certain rent, fixed rent, etc.

## 8.5 SHORT WORKINGS/REDEEMABLE DEAD RENT

Short workings are the amount by which the minimum rent exceeds the actual royalty. In other words, it refers to the amount by which the actual royalty falls short of the minimum rent. In the above example, the short workings is ₹ 2,00,000 (₹ 5,00,000 – ₹ 3,00,000). Where there is short working in any period the lessee is liable to pay the minimum rent and, in effect, short workings become the part of the minimum rent not represented by the use of rights. The question of short workings will arise only when there is a stipulation for minimum rent in the agreement. The following figure will help to understand the above matters:

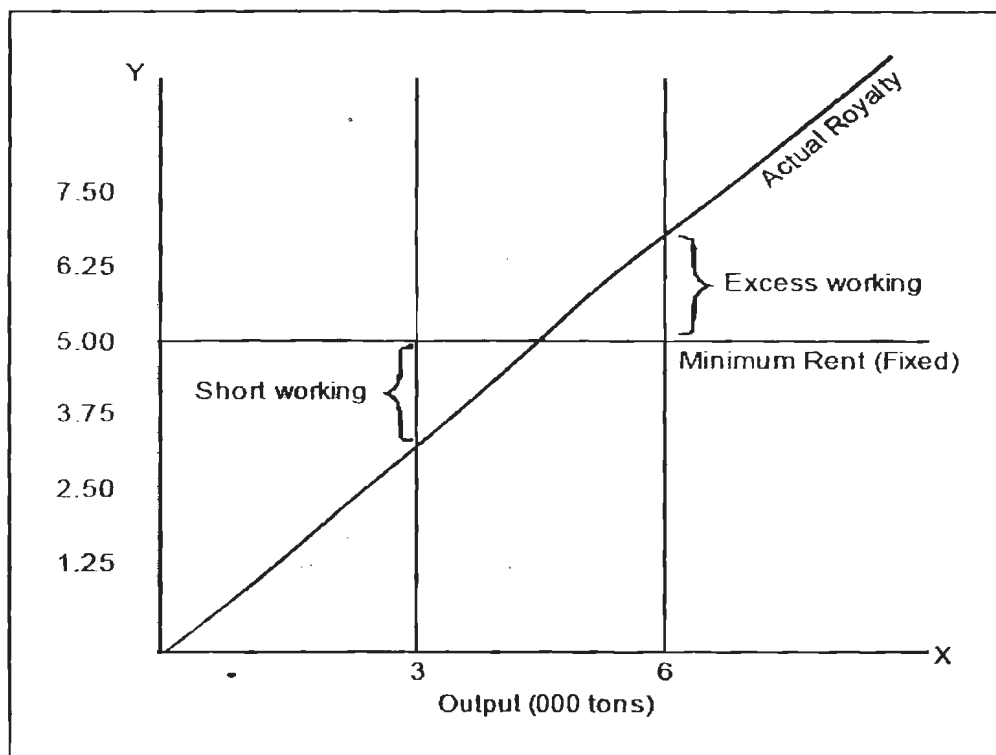


Figure 8.1: Short Workings and Minimum Rent

**Excess working/surplus:** It refers to the amount by which the actual royalty exceeds the minimum rent. In the above example, the excess workings is ₹ 1,00,000 (₹ 6,00,000 – ₹ 5,00,000) if the production is 6,000 tons.

**Ground rent/Surface rent:** It refers to the fixed yearly or half-yearly rent payable by the lessee to the landlord in addition to the minimum rent.

## 8.6 RECOUPMENT OF SHORT WORKINGS

Generally the royalty agreement contains a provision for carrying forward the short workings with a view to adjust it in the future. In the subsequent years, such short working is adjusted against the surplus royalty. This process of adjustment is called recoupment of short workings. The right of recoupment of short workings enables the lessee to recover the excess payment, made in the earlier years (when actual royalty was less than the minimum rent) in subsequent years. A time is usually set upon the number of years for which such short workings can be recouped. This time limit for recoupment of short workings may be fixed or fluctuated. If the short workings (partly or wholly) cannot be recouped within the specified time, they lapse and are charged to Profit and Loss Account in the year when that specified time limit for recoupment ends.

Therefore, short workings are the losses of the lessee, not in the year of their occurrence, but in the year they lapse.

- **Fixed right:** When the lessee can recoup short workings within a certain period from date of the lease, it is termed as fixed right. For example, short workings can be recouped within four years from the date of lease. The short workings of subsequent years cannot be recouped.
- **Fluctuating right:** When the lessee can recoup short workings of any year during the next following year(s), as per agreement, it is termed as fluctuating right. For example, short workings can be recouped in the next two years subsequent to the year of short workings.

Any short working which cannot be recouped within the specified period becomes irrecoverable and it should be charged to Profit and Loss Account in the year in which it becomes so. However, the recoupable short workings should be carried forward and they are shown in the Balance Sheet as a current asset.

### 8.6.1 Provision against Short Workings

Recoupable short workings are shown in the Balance Sheet as a current asset though it is not certain that in future they can be recouped. For different reasons (such as fall in demand, increase in completion, etc.) it may not be possible to recoup the short workings in future though the legal right to recoup exists. Therefore, as a prudent policy, a provision for recoupable short workings should be made by debiting Profit and Loss Account in the year in which short workings arise. In this case, in the Balance Sheet, provision is to be shown on the liability side and short workings on the assets side. The irrecoverable short workings are adjusted against such provision instead of charging it to the Profit and Loss Account of the year in which it becomes irrecoverable. After short workings are recouped, the excess provision is credited to Profit and Loss Account as a prior period adjustment.

The above methods of accounting for short workings are adopted, when the amount of short workings is huge and chances of recovery uncertain.

#### *Purpose of Fixing Minimum Rent*

The following are the main purposes of fixing a minimum rent:

1. The landlord receives periodically at least a minimum rational amount.
2. The lessee is indirectly inspired for the sake of his own interest to reach a minimum level of performance.
3. In the absence of minimum rent, the lessee may acquire rights from different landlords to avoid competition and purposely may under-utilise such rights.

### 8.6.2 Causes of Arising Minimum Rent and Short

The following are the key reasons of arising minimum rent and short workings:

#### *From Lessee's Point of View*

When the amount of actual royalty as calculated on the actual production of sale at the agreed rate is less than the amount of minimum rent then minimum rent comes into picture. As stated earlier the shortfall of actual royalty as compared with the minimum rent is called short workings. Thus actual royalty is less than minimum rent,

$$\text{Minimum rent} - \text{Actual royalty} = \text{Short workings}$$

$$\text{or, Minimum rent} = \text{Actual royalty} + \text{Short workings}$$

### ***From Landlord's Point of View***

Minimum rent = Actual royalty receivable + Short workings suffered by the lessee.

In fact, landlord is to receive the higher of the minimum rent and the actual royalty. Therefore, when the actual royalties fall short of minimum rent, he gets the minimum rent. In this case, expression 'Royalty Suspense' is more appropriate than 'Short workings Allowable'.

Therefore, the equation will be:

$$\text{Minimum rent} = \text{Royalty receivable} + \text{Royalty suspense}$$

It is called "Royalty Suspense" because, usually the extra payment (i.e., over the actual royalty) that the landlord receives, can be recovered by the lessee from the excess working (when the royalty is more than minimum rent). The matter of recovery hangs uncertainly over future, and that is why it is called "Royalty Suspense".

### ***Strike and Lockout, etc.***

In the event of a strike or lockout, the minimum rent can be reduced proportionately only when there is an agreement to that effect between the parties. Otherwise as per Section 56 of the Contract Act, the strikes and lockout will not be an excuse for reduction in the minimum rent.

In the examination when it is given that there was strike or lockout for some period, the minimum rent cannot be reduced proportionately without giving a proper note. In this connection, it should be noted that there may be an agreement between the parties to reduce short workings instead of minimum rent in the event of any strike or lockout.

### ***Income Tax***

As per the provision of the Income Tax Act 1961, it is the duty of the payer of royalty to deduct tax at the prescribed rate, and to deposit the tax so deducted to the credit of the Central Government within a specified time. The payment may be made at any office of the RBI or SBI or its subsidiaries conducting Government business. This tax deducted at source in no way affects the amount of charge for royalty. The landlord will get the amount of royalty after adjustment of tax. Income Tax is also deductible on any amount paid as minimum rent.

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## **8.7 ACCOUNTING TREATMENT OF ROYALTY**

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There are two alternative situations that are provided for royalty accounting:

1. When the contract does not provide for the requirement of minimum rent.
2. When the contract provides for the requirement of a minimum rent.

### **8.7.1 When Minimum Rent is not Required**

Where the contract does not provide for a minimum rent requirement, the lessee pays to the landlord the actual amount of royalties. Following are the accounting entries made:

#### ***In the Books of the Lessee***

(a) ***When production is made:***

*Debit:* Royalties payable account

*Credit:* Landlords account

(With the actual payable value of units produced)

(b) *When payment is made:*

*Debit:* Landlords account

*Credit:* Bank account

***In the Books of the Landlord***

(a) *When production is made:*

*Debit:* Lessee's account

*Credit:* Royalties receivable account

(With actual payable value of units produced).

(b) *When payment is received:*

*Debit:* Bank account

*Credit:* Lessee's account

(With actual money received).

**Example:** On 1<sup>st</sup> January 2002, Jenga Ltd. took the lease of a coal field at a royalty of ₹100 per ton of coal raised. The royalties were payable annually. During the first three years, the quantity of coal raised was 2,000, 4,000 and 4,500 tons respectively.

***Required:***

Show the accounts to record royalty in the books of Jenga Ltd. for the first three years.

***Solution:***

The calculations are tabulated as follows:

Year	Output	Royalties (₹)
I	2,000	2,00,000
II	4,000	4,00,000
III	4,500	4,50,000

Ledger in the books of the leasee

**Jenga Ltd.**  
**Royalties Payable Account**

Dr.			Cr.		
2002	Landlord	2,00,000	2002	Manufacturing a/c	2,00,000
2003	Landlord	4,00,000	2003	Manufacturing a/c	2,00,000
2004	Landlord	4,50,000	2004	Manufacturing a/c	2,00,000

Dr.			Cr.		
2002	Bank	2,00,000	2002	Royalties Payable	2,00,000
2003	Bank	4,00,000	2003	Royalties Payable	2,00,000
2004	Bank	4,50,000	2004	Royalties Payable	2,00,000

### 8.7.2 When Minimum Rent is Required

The contract may provide that a minimum rent be paid annually, except in the years when actual royalties exceed the minimum rent. Under such circumstances, the accounting treatment of royalty will be as follows:

#### *Accounts in the Books of the Lessee*

In the year in which actual royalties are less than the minimum rent.

1. Debit: Royalties payable account  
Credit: Landlords account
2. Debit: Short working account  
Credit: Landlord's account  
(With short working amount i.e., the excess of minimum rent over actual royalties)
3. Debit: Landlord's account  
Credit: Bank account  
(With amount paid)

In the year when actual royalties exceed the minimum rent.

1. Debit: Royalties payable account  
Credit: Landlord's account  
(With the actual royalties)
2. Debit: Landlord's account  
Credit: Bank account  
(With amount paid)

#### **Check Your Progress**

Fill in the blanks:

1. The \_\_\_\_\_ is the owner of assets.
2. Short working is the amount by which the \_\_\_\_\_ exceeds the actual royalty.
3. \_\_\_\_\_ refers to the amount by which the actual royalty exceeds the minimum rent.
4. This process of adjustment is called \_\_\_\_\_ of short workings.
5. Recoupable short workings are shown in the Balance Sheet as a \_\_\_\_\_.
6. The shortfall of actual royalty as compared with the minimum rent is called \_\_\_\_\_.

### 8.8 LET US SUM UP

- Royalties are usage-based payments made by one party (lessor) to another (lessee) for ongoing use of an asset, sometimes an intellectual property (IP) right.
- Royalties are typically a percentage of gross or net sales derived from use of an asset or a fixed price per unit sold of an item but there are also other modes and metrics of compensation.

- A royalty interest is the right to collect a stream of future royalty payments, often used in the oil industry and music industry to describe a percentage ownership of future production or revenues from given leasehold, which may be divested from the original owner of the asset.
- Recoupment refers to the right of the lessee to recover the short workings of the earlier years. Recoupment is possible only if the agreement provides for it. The recoupment may be permitted within a particular time or there may not be any limitation of time.

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## 8.9 LESSON END ACTIVITY

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List the key royalty rates in India.

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## 8.10 KEYWORDS

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**Royalty:** Royalty is the sum payable for utilizing the right vested with some other person.

**Minimum Rent:** Minimum rent is the minimum amount guaranteed to the lessor by the lessee at the initial stages of agreement when the production is nil or very low.

**Short workings:** Minimum Rent – Actual Royalty

**Recoupment:** Recoupment refers to the right of the lessee to recover the SW of the earlier years.

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## 8.11 QUESTIONS FOR DISCUSSION

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1. Define royalty.
2. What are the key provisions regarding the minimum rent under royalty accounting?
3. Write a note on short workings.
4. What is Royalty Agreement?
5. What is fixed right and fluctuating right?
6. Highlight the main purpose of fixing a minimum rent.
7. Discuss the key reasons of arising minimum rent and short workings.
8. Describe the two alternative situations that are provided for royalty accounting.

### Check Your Progress: Model Answer

1. Lessor
2. Minimum rent
3. Excess working
4. Recoupment
5. Current asset
6. Short workings



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## 8.12 SUGGESTED READINGS

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M. P. Pandikumar, *Accounting & Finance for Managers*, Excel Books, New Delhi.

R. L. Gupta and Radhaswamy, *Advanced Accountancy*.

V. K. Goyal, *Financial Accounting*, Excel Books, New Delhi.

Nitin Balwani, *Accounting & Finance for Managers*, Excel Books, New Delhi.

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## LESSON

# 9

## INSOLVENCY ACCOUNTS

### CONTENTS

- 9.0 Aims and Objectives
- 9.1 Introduction
- 9.2 Insolvency of Individuals and Partnership Firms
  - 9.2.1 Individuals and Partnerships
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  - 9.3.3 Preferential Creditors
- 9.4 Deficiency Account (Bankruptcy of Company)
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- 9.6 Let Us Sum Up
- 9.7 Lesson End Activity
- 9.8 Keywords
- 9.9 Questions for Discussion
- 9.10 Suggested Readings

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### 9.0 AIMS AND OBJECTIVES

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After studying this lesson, you should be able to:

- Understand the concept of Insolvency of Individuals and Partnership firms
- Explain Statement of Affairs and Deficiency Account (Bankruptcy of Company)
- Discuss some of the problems in Insolvency Accounts

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### 9.1 INTRODUCTION

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A person is commonly said to be insolvent if he is unable to meet his liabilities as and when claimed. That is, when a person becomes heavily indebted due to various circumstances and it becomes impossible for him to pay his debts fully. In law, the term “insolvent” is restricted to a person whose liabilities exceed his assets and against whom the court makes an order of adjudication.

Thus insolvent is a person who is not in a position to pay his liabilities in full and has been declared as an insolvent by an Insolvency court. Insolvency means the procedure by which the State takes in possession of the property of the Debtor for realization and equitable distribution among the creditors of the insolvent.

The proceedings in such cases are called Insolvency Proceedings. The terms 'Insolvency' and 'Bankruptcy' are more or less synonymous. The word 'Insolvency' is used in India and 'Bankruptcy' in England.

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## 9.2 INSOLVENCY OF INDIVIDUALS AND PARTNERSHIP FIRMS

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An insolvent is a person unable to pay or settle his just debts. When a person or a partnership firm or Hindu undivided family is not able to meet its liabilities and is in financial difficulties, the Court intervenes, at the instance of the creditors or the debtor himself, and brings about a settlement whereby the debtor surrenders his entire property and obtains freedom from having to pay his debts. A joint stock company may also be insolvent but the necessary action in this respect is taken under the Companies Act—the company has to be wound up and its assets realized and distributed in accordance with that Act.

Insolvency and bankruptcy mean the same thing. The latter term is used in the United Kingdom, the former in India. It is "a proceeding by which, when a debtor cannot pay his debts or discharge his liabilities or the persons to whom he owes money or has incurred liabilities cannot obtain satisfaction of their claims, the State, in certain circumstances, takes possession of his property through an officer appointed for the purpose, and such property is realized and distributed in appropriate proportions among the persons to whom the debtor owes money or has incurred pecuniary liabilities." The officer is called Official Receiver and is appointed by the Court.

When a petition is presented, the Court decides whether the person should be adjudicated as insolvent or not. If the debtor is declared insolvent, he has to surrender all his property to the Official Receiver and prepare statements showing his financial position.

Later, when the property has been distributed among creditors, the debtor petitions the Court for discharge. In certain circumstances, the Court may refuse to grant discharge. On obtaining the discharge (which may be conditional), the debtor becomes a free man again. He has no obligation to pay the previous unsatisfied claims against him. In the Presidency Towns of Mumbai, Kolkata and Chennai, the Presidency Towns Insolvency Act 1909 applies. In the rest of India, the Provincial Insolvency Act of 1920 applies. The two Acts are similar except some minor differences.

### 9.2.1 Individuals and Partnerships

There is one chief difference between insolvency of individuals and partnership firms. In case of individuals, no distinction is made between private assets and business assets and similarly for liabilities. Suppose A runs a business; he owes ₹ 3,50,000 to business creditors and has assets in his business amounting to ₹ 2,60,000; he also owes privately ₹ 40,000 and owns household assets totaling ₹ 45,000. For purposes of insolvency, his total liabilities will be ₹ 3,90,000, i.e., ₹ 3,50,000 + ₹ 40,000 and his total assets will be ₹ 3,05,000, i.e., ₹ 2,60,000 + ₹ 45,000; ₹ 3,05,000 will be distributed proportionately among the creditors without distinction between business and private creditors.

In case of partnership, a distinction between firm's liabilities and assets and private liabilities and assets of partners is made. Private assets must first be utilized for paying private liabilities. If there is a surplus, it is utilized to pay firm's liabilities.

Firm's assets must first be utilized to pay firm's liabilities and, if there is a surplus, a partner can utilize his share of the surplus to pay his private liabilities. It should be noted that a minor partner is not liable to contribute to the assets of the firm out of his

private estate. In his case, therefore, the firm's creditors will not be able to look to his private estate for satisfaction of their claims. In other words, the private estate and private liabilities of a minor partner will be kept totally separate from those of the firm.

In case of a non-trading individual, the Doctrine of Reputed Ownership does not apply. The doctrine means that goods which are in the possession, order or disposition of the insolvent in his trade or business, by the consent and permission of the true owner, under such circumstances that he is reputed to be the owner of such goods, are divisible among creditors.

### **Interest**

No creditor is entitled to interest after the date of the bankruptcy or insolvency but if all claims can be fully met, interest at 6% p.a. up to the date of payment will be allowed.

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## **9.3 STATEMENT OF AFFAIRS**

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When a person or a firm is adjudicated as insolvent, he or the firm has to prepare a statement showing the financial position. The true financial position can be shown by preparing a sort of balance sheet. The only point to remember is that the "balance sheet" must show the assets at realizable value and not at book value. The purpose is to show how much money will be available for distribution among creditors and, therefore, for this purpose assets should be put down at the figure they are expected to fetch. All liabilities should be recorded. This can be done by setting down assets at their realizable value and the amount payable to creditors.

Statement of affairs is a statement of capital, liabilities and assets. Statement of affairs is prepared under the single entry system in order to find out the amount of opening or closing capital of the business. For the purpose of determining the amount of opening capital, the statement of affairs is prepared on the opening date. The statement of affairs is prepared on the closing date for the purpose of determining the amount of closing capital. It is also known as the balance sheet of single entry system.

Statement of affairs is prepared like the balance sheet. All the liabilities are shown on left-hand side and all the assets are shown on right-hand side. The difference between the total assets and total liabilities is considered as the amount of capital.

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

Correct final accounts of a business can be prepared in the records those are maintained under the double entry system. However, where the record is incomplete, and it is not all possible to complete it by double entry, in such cases the final accounts can be only approximately prepared by means of a statement of affairs. In appearance the statement of affairs is similar to a balance sheet. For this purpose, two comparative statements of affairs are prepared – one at the commencement of the year and other at the end of the year. The excess of the assets over the liabilities as shown by the statement will represent the capital of the firm. If capital at the end shows an increase as compared to the amount of capital at the start the difference will represent profit, and if the capital at the end is less than the capital at the beginning the difference will be loss. In this calculation, however, two more factors should be taken into account.

1. Where fresh capital has been introduced into the business during the account period, the closing capital may be taken to have been increased to that extent. To arrive at the true profit or loss, therefore, the amount of fresh capital introduced is deducted from the closing assets as determined under such circumstances.

2. Where drawings have been made by the proprietor during the accounting period, such drawings reduce the amount of capital at the close. In order to calculate net profit, it is necessary therefore that amount withdrawal should be added to the capital at the close, before deducting from it the capital at the beginning.

Formula for determining the net profit is put as follows:

$$\text{(Capital at the End + Drawings – Additional Capital Introduced) – Capital in the beginning}$$

### 9.3.1 How to Prepare Statement of Affairs?

At the time of liquidation of company, a very important statement is made for showing estimated realizable value and liabilities expected to rank. That statement is called statement of affairs. To prepare statement of affairs is also important because by making statement of affairs we can know what amount of surplus or deficiency in balance. Company Act, 1956 has given its format. Different items are estimated as per different lists. Now, we are preparing and explaining statement of affairs according to the list of assets and liabilities. You should remember all items of statement of affairs' thoroughly. Difference between the estimated value of assets and liabilities will be estimated value of surplus or deficiency.

#### *List A: Assets not Specifically Pledged*

First of all, we make the list of assets which are not on pledge. You should not take any loan by giving these assets as security. We write these assets' estimated realizable value instead of book value because creditors are interested to know what amount they will receive after selling of these assets in market. Value of call in area will be assets under list A. In these assets, we can include:

- (i) Balance at bank
- (ii) Cash in hand
- (iii) Marketable Securities
- (iv) Bills Receivable
- (v) Trade Debtors
- (vi) Loan and Advance
- (vii) Unpaid calls
- (viii) Stock in trade
- (ix) Freehold property
- (x) Leasehold property
- (xi) Plant and property
- (xii) Furniture Fittings, Utensils etc.
- (xiii) Investment other than marketable securities
- (xiv) Livestock
- (xv) Other property

#### *List B: Assets Specifically Pledged*

In list B, we include estimated realizable value of all the assets specially mortgaged, pledged, or otherwise given as security. We also classify these pledged assets into under possession of company and not under the possession of company. We will

calculate surplus or deficiency after deducting these assets' estimated realizable value from amount of secured loan and then adjusted it in estimated realizable value of assets which are not pledged.

Assets Specifically Pledged	(A) Estimated Realizable Value	(B) Secured Creditors	(C) (If Secured Creditors are more than Estimated Realizable Value)	(D) (If Secured Creditors are less than Estimated Realizable Value)
	xxxxxx	xxxxxx	(B) - (A)	(A) - (B)

**List C: Preferential Creditors**

Now, we deduct preference creditors of list C from the total of List A and List B amount.

**List D: Debenture holders Secured by a floating charges**

The balance after deducting list C preference creditors is used for deducting the amount of debentures secured by a floating charges and its payable interest.

**List E: Unsecured Creditors**

The balance of assets after deducting list D debenture holders amount is used for deducting the amount of unsecured creditors.

**List F: Preference Shares**

In this list, we include all the payable amount of preference shares which is deducted from realizable asset's balance after deducting list E's liability.

**List G: Equity Shares**

In this list, we include all the payable amount of equity shareholders which is deducted from realizable asset's balance after deducting List F's liability. For calculating equity shares exact value, we deduct irrecoverable unpaid calls.

**List H: Surplus or Deficiency**

Balance will be surplus or deficiency which will be included in list H.

Suppose, the following particulars are given in respect of the position of Shri Reckless:

	₹
Freehold Property (expected to realise ₹ 25,000)	36,000
Plant and Machinery (expected to realise ₹ 10,000)	45,000
Stock in Trade (market value ₹ 56,000)	65,000
Book Debts—Good	10,000
Doubtful (expected to realise 60%)	20,000
Bad	6,000
Sundry Creditors for goods supplied	1,10,000
Loan Creditor (having a mortgage on buildings)	20,000
Bank Overdraft (having a lien on stock)	70,000
Bills of Exchange in hand, all good	8,000

Bills of Exchange discounted (of which ₹ 2,000 are expected to be dishonoured)	5,000
Shares in A Ltd. (market value, ₹ 3,500)	2,000
Cash in hand	100
5 months' wages due to clerk	750
Taxes due to Government and Municipal Corporation	150
Capital introduced originally	10,000

The position may be presented as under:

**Balance Sheet of Shri Reckless  
as on....**

Liabilities	Amount	Assets	Book value	Realisable value
	₹		₹	₹
Sundry Creditors	1,10,000	Freehold Property	36,000	25,000
Add: Bills Discounted	<u>2,000</u>	Plant and Machinery	45,000	10,000
	1,12,000	Stock-in-trade	65,000	56,000
Loan Creditors (having a mortgage on freehold property)	20,000	Sundry Debtors:		
Bank Overdraft (having a lien on stock)	70,000	Good	10,000	10,000
Wages due to clerk	750	Doubtful	20,000	12,000
Taxes due to Government and Municipal Corporation	150	Bad	6,000	—
		Shares in A Ltd.	2,000	3,500
		Bills Receivable	8,000	8,000
		Cash in hand	100	100
		Deficiency (balancing figure)		78,300
	<u>2,02,900</u>		<u>1,92,100</u>	<u>2,02,900</u>

Proprietor's Capital has not been included in the "Balance Sheet" because the purpose is to show how much will be the deficiency as far as creditors are concerned.

### 9.3.2 Form

The Insolvency Acts are not satisfied by the statement prepared above. The statement has to be presented in a statutory form. The form requires the liabilities and assets to be grouped and shown in a certain way. It will be seen from the above illustration that there are certain creditors who have no security. Others have sufficient security to cover their claims in full and some have some security but not sufficient to cover their claims fully. The following have no security.

	₹
Sundry Creditors	1,10,000
Creditors for dishonored bills of exchange previously discounted	2,000
Clerk for wages	750
Government and Municipal Corporation	<u>150</u>
<b>Total</b>	<b><u>1,12,900</u></b>

The loan creditor claims ₹ 20,000 but he has as security the freehold property, which is expected to realize ₹ 25,000. He, therefore, is fully secured. Further, he will have to give up the surplus of ₹ 5,000 to the Official Receiver for distribution among other

creditors. The Bank claims ₹ 70,000 but has as security stock-in-trade which is expected to realize ₹ 56,000 only. The Bank will sell the stock and adjust ₹ 56,000 against the overdraft and claim another ₹ 14,000 from the Official Receiver. The Bank is partly secured.

Thus, from the point of view of security, the creditors are:

- Unsecured
- Fully secured
- Partly secured

### 9.3.3 Preferential Creditors

Out of the unsecured creditors, some have to be paid, under the law, before others. Such creditors are known as preferential. By law, the following are the Preferential Creditors:

- (a) All debts due to Government or local authority.
- (b) The salary of any clerk in respect of services rendered to the insolvent during four months before the date of the presentation of the petition, not exceeding ₹ 300 for each such clerk. (In case of the Provincial Insolvency Act, the maximum amount per clerk is ₹ 20).
- (c) The wages of any servant or labourer in respect of services rendered to the insolvent during four months before the date of the presentation for the petition not exceeding ₹ 100 for each, such labourer or servant (₹ 20 in case of Provincial Insolvency Act).
- (d) Rent due to the landlord not exceeding one month's rent. (Rent is not preferential under the Provincial Insolvency Act.)

In the example given above, the clerk has to get ₹ 750. His claim will be preferential to the extent of ₹ 300; the remaining ₹ 450 being treated as unsecured. Taxes due to Government will be preferential. Therefore, in the above illustration, preferential creditors are ₹ 450, i.e., ₹ 300 + ₹ 150. The remainders are unsecured creditors which will now amount to ₹ 1, 12,450. The above-mentioned debts are payable in full but if the assets of the debtor are not sufficient to pay all these debts, they will rank equally. These debts must be paid at once except to the extent the Official Receiver retains money for purposes of expenses and administration.

Thus, the creditors come to be split under four categories—unsecured, fully secured, partly secured and preferential. The debtor has to prepare separate lists for each of these categories e.g., containing the names of unsecured creditors is marked "List A"; that containing particulars of fully secured creditors is marked "List B"; that containing the names of partly secured creditors is marked "List C" and that giving names of preferential creditors is marked "List D". On the assets side, property is listed in "List E" book debts in "List F" and bills of exchange in hand in "List G". The deficiency account is labeled as "List H".

While preparing the statement of affairs, the following points have to be noted:

- (a) The assets which have been mortgaged or charged in favour of fully or partly secured creditors must not be included on the assets side. If any surplus is left after paying fully secured creditors, it should be shown on the assets side unless the surplus is to be utilized for paying partly secured creditors. No amount will be entered in the outer column against fully secured creditors; but the amount along with the estimated value of security should be shown in the inner column. Against partly secured creditors, the amount remaining unpaid after utilization of security is to be shown in the outer column.



- (b) Preferential creditors are shown on the liabilities side without the amount being shown in the outer column: the amount of preferential creditors is deducted from the assets side. (This is because these creditors are payable in full.)
- (c) On the extreme left hand side, a column, "gross liabilities", is to be provided. This does not enter into calculations but shows all liabilities including contingent liabilities at full figures. The outer column on the liability side is labeled "Expected to Rank."
- (d) On the assets side, two columns are provided, one to show book value and the other to show "Expected to produce".

Statement of Affairs of Shri Reckless  
as on...

Gross Liabilities	Liabilities	Expected to Rank	Property and Assets	Book value	Expected to Produce
₹	₹	₹		₹	₹
**1,15,450	Unsecured Creditors as per List A	1,12,450	Property as per List E:		
20,000	Fully Secured Creditors as per List B		Cash in hand	100	100
	Estimated Value of security		Shares in A Ltd.	2,000	3,500
	Surplus carried to contra (or other side)		Plant and Machinery	45,000	10,000
70,000	Partly Secured Creditors as per List C		Book Debts as per List F:		
	Estimated value of security	14,000	Good	10,000	10,000
			Doubtful	20,000	12,000
			Bad	6,000	-
450	Creditors for taxes and wages as per List D, deducted as per contra		Bills of Exchange as per List G:	8,000	8,000
			Surplus as per contra	-	5,000
				91,100	48,600
			Preferential creditors for taxes and wages as per List D, deducted (per contra)		450
			Deficiency as explained in List H		48,150
2,05,900		1,26,450			78,300
					1,26,450

\*\* The gross liability for unsecured creditors is ₹ 1,15,450 because to ₹ 1,12,450, ₹ 3000 in respect of liability for discounted bills should be added i.e. for purpose of gross liability the full ₹ 5000 for bills discounted should be included.

The statement of affairs is only a special sort of balance sheet.

**Some points to be remembered:**

Besides, the ordinary creditors for goods, unsecured creditors will include bills payable, bills discounted likely to be dishonoured, liability likely to arise in respect of any other contingent liability and the private liabilities of the debtor (if the debtor is an individual). All these amounts should be added and written as one figure in the Statement of Affairs.

Creditors often have first or second charge over some of the assets. Those who have first charge will have priority for recovering their claim out of the sale proceeds of the asset under charge. If any surplus is left, then only creditors having second charge will be able to get something.

Suppose the position is as follows:

- A having first charge on buildings ₹ 25,000
- B having second charge on buildings ₹ 30,000

If the building is estimated to realize only ₹ 20,000, A will be partly secured, since the amount is insufficient to meet his claim fully; B will be unsecured, since no surplus is left after paying A. If the amount expected to be realized by sale of buildings is ₹ 45,000, A will be fully secured and B will be partly secured because, against his claim of ₹ 30,000, the surplus left after paying A will be ₹ 20,000, i.e., 45,000–25,000. If the building realizes ₹ 60,000, both A and B will be fully secured (although B in fact will be paid after A) and there will be a surplus of ₹ 5,000 to be utilized for payment of unsecured and preferential creditors.

**Example:** Mr. P of Mumbai, finding himself unable to meet his creditors, has to prepare a Statement of Affairs for which the following particulars are available:

Leasehold Property ₹ 1,00,000 estimated to realise ₹ 90,000.

Plant and Machinery ₹ 40,000 estimated to realise ₹ 30,000.

Stock in Trade ₹ 20,000 estimated to realise ₹ 14,000:

Book Debts. Goods ₹ 60,000; Doubtful ₹ 5,000 estimated to realize 50%; Bad, ₹ 14,000.

Bills in hand ₹ 3,750.

Life Policy for ₹ 25,000 whose surrender value is ₹ 5,000 held by the insurance company against a loan of ₹ 2,000.

Household Furniture ₹ 3,600; Household Debts ₹ 2,900.

Bills Discounted ₹ 6,000; ₹ 2,000 likely to be dishonoured.

Loan on mortgage of Leasehold ₹ 50,000; Cash in hand ₹ 100.

Bank Overdraft secured by personal guarantee of P's brother and second mortgage on Leasehold ₹ 50,000.

Unsecured Creditors ₹ 1,50,000. Loan from N ₹ 2,500 secured by a second charge on life policy. Ground Rent on Leasehold for three months accrued ₹ 250.

He could not pay his office clerks' (two in number) salaries for six months, ₹ 1,500 and also rates and taxes amounting to ₹ 1,500.

Prepare the Statement of Affairs.

**Solution:**

**Notes:** The unsecured creditors are as follows:

	₹
Household debts	2,900
Bills discounted likely to be dishonoured	2,000
Unsecured creditors	1,50,000
2 month's rent (one month's rent is preferential)	167
Clerks' salary (in excess of ₹ 300 per clerk)	900
	1,55,967

The fully secured creditors are as follows:

	Amount ₹	Security ₹
Insurance Co.	2,000	5,000
N	2,500	—
Loan on mortgage of leasehold	50,000	90,000

The Bank will be partly secured because after meeting the first charge on leasehold, ₹ 40,000 will be left and that will be insufficient to meet the bank overdraft fully. The personal guarantee of P's Statement of Affairs.

The preferential creditors are as follows:

	₹
One month's rent	83
Salaries of two clerks	600
Taxes due	1,500
	2,183

## 9.4 DEFICIENCY ACCOUNT (BANKRUPTCY OF COMPANY)

When any company becomes bankrupt, at that time, deficiency account is prepared. This account shows the reasons of company's deficiency. Company's deficiency may be happened due to high level of losses, decrease the value of assets or any other reason. This account is not made on double entry system. But this account is the statement of simple calculations. First of all, we make the list of items which either contribute the deficiency or increase the deficiency. After this, we deduct the items which either reduce the deficiency or contribute the surplus.

Following is its proforma:

Particular	Amount (₹)
<b>{A} Items contributing to deficiency or reducing surplus</b>	
1. Excess of capital and liabilities over assets as shown by balance sheet	XXXXX
2. Net dividend and bonus declared during the period from end of financial year to the date of statement of affair.	XXXXX
3. Net Trading losses	XXXXX
4. Losses other than trading losses written off or for which provision has been made in the books during the same period.	XXXXX
5. Estimated losses now written off or for which provision has been made for purpose of preparing the statement	XXXXX
6. Other items contributing to deficiency or reducing surplus	XXXXX
<b>{B} Less Item reducing deficiency or contributing surplus</b>	XXXXX
1. Excess of assets over capital and liabilities	XXXXX
2. Net trading profit	XXXXX
3. Profit and income other than trading profit during the same period	XXXXX
4. Other Item reducing deficiency or contributing surplus	XXXXX
<b>Deficiency or Surplus as per statement of Affairs</b>	XXXXX

## 9.5 PROBLEMS ON INSOLVENCY ACCOUNTS

Some of the problems in Insolvency accounts are given below.

### *Accounting Problems on the Calculation of Different Forms of Creditors*

**Example:** Mr. X of Calcutta, finding himself unable to meet his creditors, has to prepare a Statement of Affairs for which the following particulars are available:

Leasehold Property ₹ 1,00,000, estimated to realise ₹ 90,000; Plant and Machinery ₹ 40,000, estimated to realise ₹ 30,000; Stock-in-trade ₹ 20,000, estimated to realise ₹ 14,000; Book Debts; Good ₹ 60,000, Doubtful ₹ 5,000, estimated to realise 50%; Bad Debts ₹ 14,000.

Bills in hand ₹ 3,750.

Life Policy for ₹ 25,000 whose surrender value is ₹ 5,000 held by insurance company against a Loan of ₹ 2,000.

Household furniture ₹ 3,600; Household Debt ₹ 2,900; Bills Discounted ₹ 6,000; ₹ 2,000 likely to be dishonoured. Loan on Mortgage of Leasehold ₹ 50,000.

Cash in hand ₹ 100.

Bank Overdraft secured by personal guarantee of X's brother and second mortgage on Leasehold, ₹ 50,000.

Unsecured Creditors ₹ 1,50,000; Loan from N. ₹ 2,500 secured by a second charge on life policy. Ground Rent on leasehold for three months accrued ₹ 250.

He could not pay his office clerk's (two in number) salaries for six months, ₹ 1,500, and also rates and taxes amounting to ₹ 1,500.

Prepare a Statement of Affairs.

### **Solution:**

Before preparing the Statement of Affairs of Mr. X., we are to calculate the different forms of creditors:

#### (a) Calculation of Total Unsecured Creditors

	₹
(i) Unsecured Creditors	1,50,000
(ii) Bills Discounted (likely to be dishonoured)	2,000
(iii) Household Debts	2,900
(iv) Salary of office clerks @ ₹ 300 × 3	900
(v) Outstanding rent (two months' rent is preferential i.e., $250 \times 2/3$ )	167
	<b>1,55,967</b>

#### (b) Calculation of Fully Secured Creditors

	₹
(i) Loan on mortgage on leasehold	50,000
(ii) Insurance Co. (as the surrender value is ₹ 5,000 both Mr. N and Insurance Co. can be fully covered having a surplus of ₹ 500)	2,000
(iii) Mr. N	2,500
	<b>54,500</b>

(c) After meeting the first charge on leasehold, only ₹ 40,000 is left which is not possible to meet the Bank Overdraft fully. As such, Bank will be partly secured. Personal guarantee of X's brother cannot be considered at all.

(d) Calculation of Preferential Creditors

	₹
(i) Outstanding Rent (₹ 250 × 1/30)	83
(ii) Clerk's Salaries	600
(iii) Outstanding taxes	1,500
	2,183

### Preparation of Statement of Affairs and a Deficiency Account

**Example:** From the following Trial Balance of Mr. X who commenced business on January 1, 1990, you are asked to prepare a Statement of affairs and a Deficiency Account:

	₹		₹
Cash	2,300	Creditors (Unsecured)	1,80,000
Stock-in-trade	6,660	Secured Creditors	25,000
Debtors (All good)	1,30,000	Preferential claims for rent, rates and taxes	1,900
Furniture	2,820	Capital	13,500
Investment in Shares	5,000	Profit (1988,1989)	55,540
Value of securities held by creditors	35,000		
Loss (1990)	25,000		
Drawings (up to Dec. 1990)	69,160		
	2,75,940		2,75,940

**Solution:**

#### Statement of Affairs of Mr. X as at 31<sup>st</sup> December 1990

Gross Liabilities	Liabilities	Expected to Rank	Property and Assets	Book Value	Expected to Produce
₹	₹	₹	₹	₹	₹
1,80,000	Unsecured Creditors as per List 'A'	1,80,000	Property as per List 'E'		
			Cash	2,300	2,300
			Stock-in-trade	6,660	6,660
2,500	Fully Secured Creditors as per List 'B'		Furniture	2,820	2,820
	Creditors	2,500	Investments	5,000	5,000
	Estimated		Debtors as per List 'F'	1,30,000	1,30,000
	Value of security	3,500	Bills of Exchange as per List 'G'	-	-
	Surplus as per Contra	1,000	Surplus as per contra	-	1,000
	Partly Secured Creditors as per List 'C'		Preferential Creditors deducted as per contra List 'D'		1,56,780
1,900	Preferential creditors as per List 'D'	1,900			1,900
	Deducted as per contra	1,900	Deficiency as per list 'H'		1,54,880
		Nil			25,120
		1,80,000			1,80,000

## Deficiency Account

	₹		₹
Excess of assets over liabilities as on 1 <sup>st</sup> Jan. 1988	13,500	Loss	25,000
Profits	55,540	Drawings	69,160
Deficiency –as per Statement of Affairs	25,120		
	94,160		94,160

*Missing Information:*

Sometimes the full information relating to the Deficiency Account is not available. In that case, students are advised to prepare a trial balance on the basis of book value figures and not on the basis of estimated realisable value and calculate the difference between the totals of the two sides which, in other words, should be considered as the value of missing information.

*Preparation of Statement of Affairs and Deficiency Account*

**Example:** From the following information prepare a Statement of Affairs and Deficiency Account of Mr. Ashis Sadhukhan who was declared insolvent under the Provincial Towns Insolvency Act:

His capital was ₹ 7,000 and his drawings were ₹ 7,000.

His assets consisted of:

- (i) Book Debts ₹ 10,000 of which ₹ 8,000 was considered good and the balance estimated to produce ₹ 1,000.
- (ii) Stock (book value ₹ 15,000) estimated to produce ₹ 9,000.
- (iii) Machinery (book value ₹ 16,000, cost Price ₹ 18,000) estimated to produce ₹ 11,000.
- (iv) Freehold house (private property) valued at ₹ 12,000 the debt of which was lodged with the bank as security for an overdraft on business account ₹ 8,000.
- (v) His life policy (surrender value ₹ 6,000) was given as a part security for a private loan of ₹ 10,000. His unsecured creditors amounted to ₹ 40,300 and he owed ₹ 500 to his clerk as salary for two months just preceding the date of his insolvency.

*Solution:*

From the above problem, it becomes necessary to prepare a trial balance in order to calculate the missing information relating to profit and losses of the business i.e., for preparing Deficiency Account. It should be remembered that at the time of preparing trial balance, private assets (i.e., Freehold House, Life Policy etc.) and private liabilities (i.e., loan) are not to be considered at all.

Moreover, book values of assets are to be taken into consideration and not the cost price.

	₹		₹
Drawings	7,000	Capital	7,000
Book Debt	10,000	Overdraft	8,000
Stock	15,000	Unsecured Creditors	40,300
Machinery	16,000	Outstanding Salary	500
Accumulated Losses (Bal. fig. or missing information)	7,800		
	55,800		55,800

Statement of Affairs of Mr. X Ashis Sadhukhan  
as at.....

Gross Liabilities	Liabilities	Expected to Rank	Property and Assets	Book value	Expected to Produce
₹		₹		₹	₹
40,600	Unsecured Creditors as per List 'A'		Property as per List 'E'		
		40,600	Stock	15,000	9,000
54,500	Fully Secured Creditors as per List 'B'		Machinery	16,000	11,000
	Overdraft	8,000	Debtors as per List 'F'		
	Estimated value of securities	12,000	Good	8,000	8,000
	Surplus		Doubtful	2,000	1,000
	—per Contra	4,000	Bad	—	—
10,000	Partly Secured Creditors as per List 'C'		Bills of Exchange as per List 'G'		
	Private loan	10,000			29,000
	Estimated value of security	6,000	Add: Surplus as per contra		4,000
					33,000
200	Preferential Creditors as per List 'D'		Preferential creditors as per List 'D'		
	Salary	200	—per Contra		200
	Less: Per contra	200			32,800
			Deficiency as per List 'H' (bal. fig.)		11,800
		44,600			44,600

Deficiency Account

	₹		₹
Surplus Excess of assets over Liabilities	7,000	Drawings	7,000
Private assets introduced		Accumulated losses (from T.B.)	7,800
Further life Policy: 6,000		Loss on realisation:	
Freehold Property 12,000	18,000	Stock (15,000 – 9,000) 6,000	
Deficiency A/c		Machinery (16,000 – 11,000) 5,000	
—as per Statement of Affairs	11,800	Debtors (2,000 – 1,000) 1,000	12,000
		Losses for fresh loan	10,000
	36,800		36,800

**Notes:** It has been pointed out above that while preparing Trial balance private assets and private liabilities are not to be considered at all. But the same are to be taken into consideration while ascertaining insolvency losses. Private assets either increase capital of the proprietor or increase assets in the Statement of Affairs. In the present case, however, as private assets have been given as security, as such, liabilities have been reduced and that is why the same is not shown as an asset.

Accounting Problem on Partnership

**Example:** On 31<sup>st</sup> August 1998, an order of adjudication as insolvent was made against X and Y who carry on partnership business.

The balances in the firm's book as on that date included the following:

	₹
(i) Trade Creditors	1,29,000
(ii) Preferential Creditors	11,700
(iii) Bank Overdraft [holding security of the firm's assurance policy for ₹ 30,000 on the life of Y (surrender value ₹ 10,000) and assurance policy for ₹ 1,00,000 on the life of X (own policy surrender value ₹ 48,000)]	1,27,000

(iv) Plant and Machinery (estimated to produce 70,000)	1,43,000	
(v) Fixtures and Fittings (estimated to produce ₹ 27,500)	45,000	
(vi) Stock-in-trade (estimated to produce ₹ 54,000)	75,000	
(vii) Investments (estimated to produce ₹ 2,500)	10,000	
(viii) Policy on life of Y (as above) estimated to produce ₹ 10,000	10,000	
(ix) Debtors:		
Good	43,000	
Doubtful (estimated to produce ₹ 3,000)	6,000	
Bad Debts	10,000	
(x) Cash in hand	500	
(xi) Capital:		
X	1,40,000	
Y	<u>1,00,000</u>	2,40,000

During the 13<sup>th</sup> months to 31<sup>st</sup> August 1998 X drew ₹ 40,000 and Y ₹ 30,000. Private assets of X and Y amounted to ₹ 4,000 and ₹ 3,000, respectively. Book Values of these assets were ₹ 7,000 and ₹ 5,000, respectively. Y had private liabilities of ₹ 12,000.

You are required to prepare:

1. Individual partner's Statement of Affairs and Deficiency Accounts.
2. The firm's Statement of Affairs and the Deficiency Account.

**Solution:**

Gross Liabilities	Liabilities		Expected to Rank	Property and Assets	Book value	Expected to Produce
₹		₹	₹		₹	₹
48,000	Partly secured creditors: Firm's B.O. <i>Less:</i> Estimated value of security	48,000 <u>48,000</u>	—	Capital less Drawings Other Assets	1,00,000 7,000	— 4,000
	Surplus as per Surplus A/c (transfer to the firm's Statement of Affairs)		4,000			
			4,000		1,07,000	4,000

- Notes:** 1. X's Statement of Affairs has not been prepared in proper form.  
2. Firm's capital is treated as private investments, i.e., assets.

**Surplus Account**

Excess of private assets over private liabilities	₹ 1,55,000*	Loss on realisation of assets: Investments (1,40,000 – 40,000) Other Assets (7,000 – 4,000) Firm's Liability Suspense— —as per Statement of Affairs	₹ 1,00,000 3,000 48,000 4,000
	<u>1,55,000</u>		<u>1,55,000</u>

\*The surplus or excess of private assets over private liabilities has been calculated as under:

	₹	₹
Investments (in the firm) (1,40,000 – 40,000)	1,00,000	—



Other assets (Book Value)	7,000	—
Surrender Value of Life Policy	48,000	—
Private Capital I (bal. fig.)	—	1,55,000
	<u>1,55,000</u>	<u>1,55,000</u>

**Y's Statement of Affairs  
as at 31<sup>st</sup> August 1998**

Gross Liabilities	Liabilities	Expected to Rank	Property and Assets	Book Value	Expected to Produce
₹		₹		₹	₹
12,000	Private Liabilities	12,000	Capital Less		
			Drawings	70,000	—
			Other Assets	5,000	3,000
			Deficiency as per		
			Deficiency A/c	—	9,000
		<u>12,000</u>		<u>75,000</u>	<u>12,000</u>

**Deficiency Account**

	₹		₹
Excess of private assets over private liabilities	63,000	Loss on realisation of assets:	
		Investments	70,000
Deficiency (as per Statement of Affairs)	9,000	Other Assets	2,000
	<u>72,000</u>		<u>72,000</u>

**Firm's Statement of Affairs  
as at 31<sup>st</sup> August 1998**

Gross Liabilities	Liabilities	Expected to Rank	Property and Assets	Book Value	Expected to Produce
(₹)	(₹)	(₹)	(₹)	(₹)	(₹)
1,29,000	Unsecured creditors as per list 'A'	1,29,000	Property as per list 'E'		
—	Fully secured creditors as per list 'B'		Cash in hand	500	500
	Partly secured creditors as per 'C'		Investments	10,000	2,500
			Stock-in-Trade	75,000	54,000
			Fixture and Fittings	45,000	27,500
			Plant and Machinery	1,43,200	70,000
1,27,000	Bank Overdraft	1,27,000	Surplus from X's private estate	—	4,000
	Less: Paid by X	48,000			
		79,000	Debtors as per list 'F'		
	Less: Estimated value of security	10,000	Good	43,000	43,000
			Doubtful	6,000	3,000
			Bad Debts	10,000	—
11,700	Preferential Creditors as per list 'D'	11,700	Bills of exchange as per list 'G'		2,04,500
	Less: Per contra	11,700	Preferential Creditors as per list 'D' deducted		
			—per Contra		11,700
			Deficiency as per list 'H'		1,92,800
					5,200
		<u>1,98,000</u>			<u>1,98,000</u>

Before preparing the Deficiency Account, we are to prepare the following Trial Balance in order to find out the profit or loss of the firm:

**Trial Balance of the Firm**

	₹		₹
Plant and machinery	1,43,000	Trade Creditors	1,29,000
Fixtures and Fitting	45,000	Preferential Creditors	11,700
Stock-in-trade	75,000	Bank	1,27,000
Investments	10,000	Capital:	
Y's Life Policy	10,000	X	1,40,000
Debtors:		Y	1,00,000
Good	43,000		
Doubtful	6,000		
Bad Debts	10,000		
Cash-in-hand	500		
Drawings:			
X	40,000		
Y	30,000		
Accumulated Losses (bal. fig.)	95,200		
	<b>5,07,700</b>		<b>5,07,700</b>

**Deficiency Account**

	₹		₹	₹
Excess of assets over liabilities	2,40,000	Drawings		
Surplus from X's estate	4,000	X	40,000	
X's life policy used for		Y	30,000	70,000
Bank Overdraft	48,000	Loss of Realisation of assets:		
Deficiency as per Statement of Affairs	5,200	Investments	7,500	
		Stock-in-Trade	21,000	
		Fixture & Fittings	17,500	
		Plant	73,000	
		Debtors	13,000	1,32,000
		Accumulated Losses (as per T.B.)		95,200
	<b>2,97,200</b>			<b>2,97,200</b>

**Preparation of Statement of Affairs and Deficiency Account**

**Example:** The assets of Mr. Z on 30<sup>th</sup> June 1990, as shown by his books of accounts, were ₹ 1,68,000 and his liabilities ₹ 1,32,000. He filed an Insolvency petition in the court and estimated his deficiency to be ₹ 90,000.

After making the above estimate he found that the following items were not passed through his books of account:

- (a) Interest at 6% p.a. on his capital from 1<sup>st</sup> January 1990.
- (b) A contingent liability of ₹ 7,500 for bills discounted by him for ₹ 15,000.
- (c) Amount due as wages — ₹ 900; as salaries — ₹ 2,100; as Rent — ₹ 900; as Rates & Taxes — ₹ 600.

Prepare Mr. Z's Statement of Affairs and his Deficiency Account.

**Solution:**

**Statement of Affairs of Mr. Z**  
as at 30<sup>th</sup> June 1990

Gross Liabilities	Liabilities	Expected to Rank	Property and Assets	Book Value	Expected to Produce
₹		₹		₹	₹
*1,47,900	Unsecured creditors as per list 'A'	1,40,400	Property as per list 'E'		
	Fully secured creditors as per list 'B'		Sundry Assets	1,68,000	42,000†
	Partly secured creditors as per list 'C'		Book debts as per list 'F'	—	—
	3,600 Preferential creditors as per list 'D'		Bills Receivable as per list 'G'	—	42,000
	Deducted as per contra	3,600	Less: Preferential creditors as per contra		3,600
		3,600	Deficiency as per list 'H'		38,400
		1,40,400			1,02,000
					1,40,400

**Workings**

**Unsecured Creditors**

† Estimated Realisable Value:

	Gross	Expected to Rank		₹
	₹	₹		₹
Liabilities	1,32,000	1,32,000	Liabilities	1,32,000
Liab. on Bills Discounted	15,000	7,500	Less: Estimated Deficiency	90,000
Outstanding Rent	900	900		
	1,47,900	1,40,400		42,000

Note: Outstanding rent has been included in unsecured creditors by the application of Provincial Insolvency Act.

**Deficiency Account**

	₹		₹
Excess of assets over liabilities (1,68,000 – 1,32,000)	36,000	Loss on realisation of assets (1,68,000 – 42,000)	1,26,000
Deficiency as per Statement of Affairs	1,02,000	Loss on Bills discounted	7,500
		Loss on account of unrecorded Liabilities:	
		Wages	900
		Salaries	2,100
		Rent	900
		Rates & Taxes	600
	1,38,000		4,500
			1,38,000

**Preparation of Statement of Affairs and Deficiency Account of an Individual who is declared as Insolvent**

**Example:** From the following information prepare a Statement of Affairs and a Deficiency Account of Mr. X who is declared insolvent on 31<sup>st</sup> December 1999. Total credit is ₹ 62,000 including preferential creditors ₹ 1,000. Secured creditors holding a first charge on Building ₹ 15,000 and another secured creditor holding a second charge on Building ₹ 14,000. Building (Book value ₹ 32,000); estimated to realise ₹ 25,000; Debtors ₹ 18,000 (Bad Debt estimated ₹ 2,000). Machinery estimated to realise (60% of book value) ₹ 12,000. Stock (Book Value ₹ 6,000) estimated to realise ₹ 4,000. Bank Balance ₹ 1,000.

He commenced his business on 1.1.1995 with an initial Capital of ₹ 20,000. His drawings were ₹ 200 more than those of the previous year. His drawings were ₹ 1,800 in the year 1999.

The profit of business in first four years was ₹ 4,200. But in the last year business incurred a loss of ₹ 5,200. He paid ₹ 4,000 to his creditor friend on 8.12.1999 by fraudulent preference. He gifted ₹ 1,000 to his daughter on the occasion of her marriage on 9.12.1999. A discounted bill of ₹ 1,200 was dishonoured on 31.12.1999.

**Solution:**

**Statement of Affairs of Mr. X  
as at 31<sup>st</sup> December 1999**

Gross Liabilities	Liabilities		Expected to Rank	Property and Assets	Book Value	Expected to Produce
₹			₹		₹	₹
37,200	Unsecured creditors as per list 'A'		37,200	Property as per list 'E'		
15,000	Fully secured creditors as per list 'B'	15,000		Cash at Bank	1,000	1,000
	Less: Estimated value of security	25,000		Stock	6,000	4,000
	Surplus to creditors having second charges	10,000		Machinery	20,000	12,000
14,000	Partly secured creditors as per list 'C'	14,000		Debtors as per list 'F'		
	Less: Estimated value of security	1,000	4,000	Good	16,000	16,000
1,000	Preferential creditors as per list 'D'			Bad Debts	2,000	—
	Less: as per Contra	1,000		Bills of exchange as per list 'G'		
				Less: Preferential Creditors as per list 'D'		33,000
				-per Contra		1,000
				Deficiency as per list 'H'		32,000
						9,200
			41,200			41,200

**Deficiency Account**

	₹			₹
Excess of assets over liabilities on 1.1.1999	20.000	Loss		5.200
Net Profit (from 1.1.95 to 31.12.99)	4.200	Bad Debts		2.000
Deficiency as per Statement of Affairs	9.200	Expenses other than usual business expenses since 1.1.1999		
		Drawings	7,000	
		Gift to daughter	1,000	8,000
		Loss on realisation of assets:		
		Building		7.000
		Machinery		8.000
		Stock		2.000
		Loss on account of bills discounted		1.200
	33.400			33.400

Amount of Drawings to be calculated as under:

1999 ₹ 1,800; 1998 ₹ 1,600; 1997 ₹ 1,400; 1996 ₹ 1,200; 1995 ₹ 1,000.

**Notes:**

1. Gift made to daughter amounting to ₹ 1,000 is treated as Drawings.
2. ₹ 4,000 paid to creditor friend by fraudulent preference is absolutely void and, as such, the same has been added back to creditors as also increased by debtors for the like amount.

**Preparation of Statement of Affairs and Deficiency Account of an Individual Who is declared as Insolvent**

**Example:** Mr. Bad is insolvent. He supplies to you the following information as on March 31,1990:

Creditors for goods	52,500
Salary due to clerk	700
Taxes due to Government	2,100
Bank loan secured by lien on stock of the book value of ₹ 35,000	17,500
Cash in hand	100
Furniture (expected to realise ₹ 3,500)	7,000
Stock (expected to realise 60%)	52,500
Book debts (goods)	7,000
Book debts (doubtful, expected to realise 4%)	17,500
Bills Receivable (₹ 5,250 bad)	8,750
Bills discounted (₹ 3,500 bad)	10,500
Loan from Mrs. Bad	17,500

Mr. Bad commenced business six years ago with a capital of ₹ 43,750. He drew ₹ 8,750 each year for private purposes, but did not maintain proper books of accounts. Mrs. Bad gave up her jewellery valued at ₹ 7,000 to the receiver.

Prepare the Statement of Affairs and Deficiency Account of Mr. Bad.

**Solution:**

**Statement of Affairs of Mr. X Bad  
as at 31<sup>st</sup> March, 1990**

Gross Liabilities	Liabilities	Expected to Rank	Property and Assets	Book Value	Expected to Produce
₹			₹	₹	₹
80,500	Unsecured creditors as per list 'A'	73,500	Property as per list 'E'		
17,500	Fully secured creditors as per list 'B'		Cash in hand	100	100
	Estimated value of security (60% of 35,000)	21,000	Stock (52,500 – 35,000)	17,500	10,500
	Surplus carriers to contra	3,500	Furniture	7,000	3,500
	Partly secured creditors as per 'C'		Jewellery from wife	–	7,000
Nil	Preferential creditors as per list 'D'		Books debts as per list 'F'		
2,800	Salary & taxes Deducted as per Contra	2,800	Good	7,000	7,000
		2,800	Doubtful	17,500	7,000
			Bills receivable as per list 'G'	8,750	3,500
			Surplus from contra		3,500
			Less: Preferential Creditors as per contra		42,100
			Deficiency as per list 'H'		2,800
		73,500			39,300
					34,200
					73,500

**Deficiency Account**

Excess of assets over liabilities as on 1 <sup>st</sup> April 1984	₹ 43,750	Bad Debts as per List 'F'	₹ 10,500
Net Profit arising from carrying on business from 1 <sup>st</sup> April 1984 to the date of adjudication after meeting usual trade expense <sup>2</sup>	11,300	Expenses incurred since 1 <sup>st</sup> April 1984 other than usual business expenses viz., Household Expenses (8,750 × 6)	52,500
Income or profit from other sources since 1 <sup>st</sup> April 1984 (Jewellery from wife)	7,000	Other Losses :	
Deficiency as per Statement of Affairs	34,200	Loss on realisation of–	
		Furniture	3,500
		Stock (40% of 52,500)	21,000
		Bills Receivable	5,250
		Loss on Bills Discounted	3,500
	96,250		96,250

**Workings:**

1. Calculation of Unsecured Creditors

	Gross	Expected to Rank
	₹	₹
Trade Creditors	52,500	52,500
Liabilities for Bills discounted	10,500	3,500
Loan from Mrs. Bad	17,500	17,500
	<u>80,500</u>	<u>73,500</u>

2. The following Trial Balance is to be prepared for the purpose:

**Trial Balance**

	₹		₹
Cash	100	Creditors	52,500
Furniture	7,000	Outstanding Salary	700
Stock	52,500	Outstanding Taxes	2,100
Debtors (7,000 + 17,500)	24,500	Bank Loan	17,500
Bills Receivable	8,750	Loan from Mrs. Bad	17,500
Drawings (8,750 × 6)	52,500	Capital	43,750
		Accumulated Profit ( <i>bal. fig.</i> )	11,300
	1,45,350		1,45,350

3. It has been assumed that Mrs. Bad had given loan from her 'Stridhan' and, as such, the same has been included in unsecured creditors.

**Preparation of a Deficiency Account and Statement of Affairs**

**Example:** On 31<sup>st</sup> December 1994 Sarbasanta files his petition in bankruptcy on which date the receiving order was made. You are instructed by the official receiver in bankruptcy to assist the debtor in the preparation of a Deficiency Account and Statement of Affairs.

Your investigations disclosed the following:

<b>Assets</b>	<b>Book value</b>	<b>Estimated to Produce</b>
	₹	₹
Freehold Property subject to a first mortgage thereon having been given to fully secured creditors and a second charge to partly secured creditors	1,20,000	1,00,000
Stock-in-trade	57,000	39,000
Furniture	7,000	3,000
Book Debts:		
Good	61,000	61,000
Doubtful	27,000	20,000
Bad	17,000	—
Bills Receivable	3,000	—
Cash in hand	1,000	1,000

**Liabilities**

His liabilities amount to ₹ 3,50,000 of which ₹ 74,000 was fully secured, ₹ 38,000 partly secured; Liabilities for rent, wages etc. were ₹ 4,500 claimed to be preferential. There was also a contingent liability of bills under discount of ₹ 27,400 of which ₹ 2,000 was expected to rank.

He has household furniture of the estimated value of ₹ 2,500, and life policies of the surrender value of ₹ 6,000. The two latter items were not in his books of accounts.

Out of liabilities for rent etc. ₹ 2,000 was admitted as preferential.

On 1.1.1992 his capital was ₹ 1,30,000.

During the three intervening years, trading results, interest on capital and drawings were:

	Trading Results	Drawings	Interest on Capitals
	₹	₹	₹
To 31.12.1992	4,000 (Profit)	8,000	6,000
To 31.12.1993	75,000 (Loss)	10,000	6,500
To 31.12.1994	?	15,000	1,500

Out of drawings Mrs. Sarbasantas purchased ornaments for ₹ 5,000 which she offers to Mr. Sarbasanta for paying loans. These are estimated to fetch ₹ 6,000, ₹ 30,000 loss in 1993 (included in ₹ 75,000 above) was due to speculations.

**Solution:**

In order to find out trading loss for 1994 the following trial balances as well as the capital accounts are to be prepared:

**Trial Balance**

	₹		₹
Freehold Property	1,20,000	Liabilities (already given)	3,50,000
Stock	57,000		
Furniture	7,000		
Debtors	1,05,000		
Bills Receivable	3,000		
Cash	1,000		
Capital ( <i>overdrawn</i> ) ( <i>bal. fig.</i> )	57,000		
	3,50,000		3,50,000

Before preparing the Statement of Affairs and Deficiency Account, we are to calculate the amount of unsecured creditors:

**Unsecured Creditors:**

	₹	₹
Total Liabilities (already given)		3,50,000
Less: Fully secured creditors	74,000	
Partly secured creditors	38,000	
Preferential (claimed)	<u>4,500</u>	<u>1,16,500</u>
		2,33,500
Add: Preferential claims disallowed but treated as unsecured (Bills Receivable expected to rank)	2,500 <u>2,000</u>	<u>4,500</u>
		<u>2,38,000</u>
∴ Gross Liabilities		
Unsecured Creditors	2,38,000	
Add: Liability for bills discounted	<u>25,400</u>	2,63,400



Statement of Affairs of Mr. Sarbasanta  
as at 31<sup>st</sup> December 1994

Gross Liabilities	Liabilities	Expected to Rank	Property and Assets	Book value	Expected to Produce
₹		₹		₹	₹
2,63,400	Unsecured Creditors as per list 'A'		Property as per list 'E'		
			Cash	1,000	1,000
74,000	Fully secured creditors as per list 'B'		Stock-in-trade	57,000	39,000
	Less: Estimated value of security	74,000	Furniture	7,000	3,000
		1,00,000	Debtors as per list 'F'		
		26,000	Good	61,000	61,000
	Surplus transferred to partly secured creditors	-26,000	Doubtful	27,000	20,000
			Bad	17,000	-
38,000	Partly secured creditors as per List 'C'	38,000	Bills of exchange as per list 'G'	3,000	-
	Less: Value of security	26,000	Household Property		
2,000	Preferential creditors as per list 'D'	2,000	Furniture		2,500
	Less: as Per contra	2,000	Life's Policies		6,000
			Wife's ornaments		6,000
			Less: Preferential Creditors		1,38,500
			-per contra		2,000
					1,36,500
					1,13,500
					2,50,000
		2,50,000	Deficiency as per list 'H'		2,50,000

Deficiency Account

	₹	₹		₹	₹
Excess of assets over liabilities (on 1.1.1992)		1,30,000	Loss: (1993 + 1994)		1,42,000
Net private assets:			(45,000 + 97,000)		
Furniture	2,500		Drawings :		33,000
Wife's ornaments	6,000		(8,000 + 10,000 + 15,000)		
Life Policy	6,000	14,500	Loss on Bills Discounted		2,000
Interest on Capital			Loss on Realisation:		
(6,000 + 6,500 + 1,500)		14,000	Freehold Property	20,000	
Profit (1992)		4,000	Stock-in-trade	18,000	
Deficiency as per Statement of Affairs		1,13,500	Furniture	4,000	
			Debtors	24,000	
			Bills Receivable	3,000	69,000
			Speculation loss		30,000
		2,76,000			2,76,000

**Note:** It has been assumed that the ornaments were purchased not out of 'Stridhan'.

**Check Your Progress**

Fill in the blanks:

- In case of \_\_\_\_\_, no distinction is made between private assets and business assets and similarly for liabilities.
- The true financial position can be shown by preparing a sort of \_\_\_\_\_.
- Statement of affairs is prepared under the \_\_\_\_\_ in order to find out the amount of opening or closing capital of the business.
- The excess of the assets over the liabilities as shown by the statement will represent the \_\_\_\_\_ of the firm.
- Balance will be surplus or deficiency which will be included in list \_\_\_\_\_.
- \_\_\_\_\_ creditors are shown on the liabilities side without the amount being shown in the outer column.

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## 9.6 LET US SUM UP

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- Insolvency is also an accounting term that refers to the scenario in which a company's liabilities exceed its assets.
- Firm's assets must first be utilized to pay firm's liabilities and, if there is a surplus, a partner can utilize his share of the surplus to pay his private liabilities.
- Statement of affairs is a statement of capital, liabilities and assets. Statement of affairs is prepared under the single entry system in order to find out the amount of opening or closing capital of the business.
- To prepare statement of affairs is also important because by making statement of affairs we can know what amount of surplus or deficiency in balance.
- When any company becomes bankrupt, at that time, deficiency account is prepared. This account shows the reasons of company's deficiency.

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## 9.7 LESSON END ACTIVITY

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Mr. P of Mumbai, finding himself unable to meet his creditors, has to prepare a Statement of Affairs for which the following particulars are available:

- Leasehold Property, ₹ 1,00,000 estimated to realise, ₹ 90,000.
- Plant and Machinery ₹ 40,000 estimated to realise, ₹ 30,000.
- Stock in Trade, ₹ 20,000 estimated to realise, ₹ 14,000.
- Book Debts, Good ₹ 60,000; Doubtful ₹ 5,000 estimated to realize 50%; Bad, ₹ 14,000.
- Bills in hand, ₹ 3,750.
- Life Policy for ₹ 25,000 whose surrender value is ₹ 5,000 held by the insurance company against a loan of ₹ 2,000.
- Household Furniture, ₹ 3,600; Household Debts, ₹ 2,900.
- Bills Discounted, ₹ 6,000; ₹ 2,000 likely to be dishonoured.
- Loan on mortgage of Leasehold ₹ 50,000; Cash in hand, ₹ 100.
- Bank Overdraft secured by personal guarantee of P's brother and second mortgage on Leasehold, ₹ 50,000.
- Unsecured Creditors, ₹ 1,50,000. Loan from N, ₹ 2,500 secured by a second charge on life policy. Ground Rent on Leasehold for three months accrued; ₹ 250.
- He could not pay his office clerks' (two in number) salaries for six months, ₹ 1,500 and also rates and taxes amounting to ₹ 1,500.

Prepare the Statement of Affairs.

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## 9.8 KEYWORDS

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**Bankruptcy:** Bankruptcy is a legal status of a person or other entity that cannot repay debts to creditors.

**Insolvency:** Insolvency is when an organisation, or individual, can no longer meet its financial obligations with its lender or lenders as debts become due.

**Partnerships:** A partnership is an arrangement in which two or more individuals share the profits and liabilities of a business venture.

**Statement of Affair:** The Statement of Affair is a summary of a Company's assets and liabilities. It states the net book value and amount expected to realise at the date of Insolvency of the business.

## 9.9 QUESTIONS FOR DISCUSSION

1. What is the difference between insolvency of individuals and partnership firms?
2. Discuss Statement of Affairs.
3. How will you prepare Statement of Affairs?
4. Who are Preferential Creditors?
5. Explain Deficiency Account with the help of its pro forma.
6. A filed his petition on 31<sup>st</sup> March, 2012, and his Statement of Affairs was composed of the following figures:

	₹
Creditors for goods	70,000
Loan from Mrs. A	35,000
Bills Payable	15,000
Creditors secured by lien on shares	40,000
Creditors secured by lien on stock	15,000
Liability on Bills Discounted (estimated to rank ₹ 3,000)	17,000
Mortgage on Mill	60,000
Creditors payable in full	3,000
Book Debts—Good	20,000
—Doubtful and Bad (estimated to produce ₹ 2,000)	10,000
Consignments considered good	5,000
Shares (estimated to realise ₹ 16,000)	15,000
Stock (estimated to realise ₹ 40,000)	60,000
Cash at Bankers	100
Bills of Exchange	11,400
Mill (estimated to realise ₹ 61,000)	70,000
Machinery (estimated to realise ₹ 42,000)	45,000
Fixtures (estimated to realise ₹ 1,500)	3,000
Cottage (estimated to realise ₹ 3,000)	6,800

On 1<sup>st</sup> April six years ago, he had a capital of ₹ 50,000. Profits were made totaling ₹ 45,500 in the first four years and losses were incurred totaling ₹ 25,000 in the last two years after allowing ₹ 2,500 per year interest on capital. Withdrawals amounted to ₹ 77,200. Prepare Statement of Affairs and Deficiency Account.

7. Mohan of Agra commenced business on 1<sup>st</sup> April, 2007 with capital of ₹ 3,30,000. He drew on the average ₹ 30,000 per year. His profits for 3 years were ₹ 70,000; he did not prepare proper accounts for the next two years. On 31<sup>st</sup> March, 2012 an adjudication order was made against him. He submits the

following information from which his Statement of Affairs and Deficiency Account are to be prepared:

	₹
Sundry Creditors	2,00,000
Mortgage on Freehold Property	40,000
Creditors secured by Life Policy estimated to be worth ₹ 40,000	1,20,000
Landlord—2 month's rent	2,000
Clerk's salary for two months	12,000
Municipal taxes owing	1,800
Mrs. Mohan's Loan	20,000
Bills Receivable discounted and expected to rank	32,000
Freehold Property (estimated to realise ₹ 2,00,000)	4,00,000
Plant and Machinery, cost ₹ 2,00,000 less depreciation written off ₹ 60,000, estimated to realise ₹ 20,000	
Second mortgage on Freehold Property	1,20,000
Book Debts, good ₹ 60,000, doubtful ₹ 20,000, estimated to realise ₹ 6,000, bad ₹ 5,000	
Fixtures and Fittings cost ₹ 8,000, estimated to realise	3,500
Stock in Trade, cost ₹ 80,000 estimated to realise	55,500
Cash in hand	800

The loan by Mrs. Mohan is out of moneys given to her by Mohan about 5 years ago.

8. On 31st March, 2012 the Balance Sheet of A and B of Kolkata was as follows:

Liabilities	₹	Assets	₹
Trade Creditors	20,900	Machinery	24,000
Bills Payable	30,000	Building	12,000
Bank	18,000	Stock	37,200
Twelve months' rent	1,200	Book Debts	24,000
One month's salaries	1,200	Cash	1,200
Capital:			
A	15,100		
B	<u>12,000</u>		
	27,100		
	<u>98,400</u>		<u>98,400</u>

A owed personally ₹ 10,000 and he had in addition to the interest in the firm, a house which cost ₹ 6,000, furniture ₹ 2,400 and life policies on which he had paid premiums amounting to ₹ 1,200. B owed ₹ 1,880 privately. He had furniture costing ₹ 1,200 and a life policy on which ₹ 3,600 had been paid as premium. The Bank held deeds of A's property and his life policies. It became necessary to call the creditors together.

The partnership assets were valued as follows:

Machinery, ₹ 13,080; Buildings, ₹ 6,000; Book Debts, Good, ₹ 12,000, Doubtful, ₹ 6,000 (estimated to realise 60%) and Bad, ₹ 6,000; Stock, ₹ 20,000.

The firm had in its premises goods belonging to another firm and which were lying for a fairly long time. The book value of such goods was ₹ 7,000; the Official Receiver estimated those at ₹ 4,000.

A's property was considered to be worth ₹ 6,000, his life policies, ₹ 600 and his furniture, ₹ 1,800. B's life policies were worth ₹ 1,800 and his furniture, ₹ 600.

Prepare the various Statement of Affairs and Deficiency Accounts.

**Check Your Progress: Model Answer**

1. Individuals
2. Balance sheet
3. Single entry system
4. Capital
5. H
6. Preferential

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**9 10 SUGGESTED READINGS**

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M. P. Pandikumar, *Accounting & Finance for Managers*, Excel Books, New Delhi.

R. L. Gupta and Radhaswamy, *Advanced Accountancy*.

V. K. Goyal, *Financial Accounting*, Excel Books, New Delhi..

Nitin Balwani, *Accounting & Finance for Managers*, Excel Books, New Delhi.

# UNIT V



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## LESSON

# 10

## ADMISSION OF A PARTNER

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### 10.0 AIMS AND OBJECTIVES

After studying this lesson, you should be able to:

- Make adjustments regarding profit sharing ratio
- Prepare accounts for treatment of goodwill



- Construct adjustments regarding the revaluation of assets & liabilities
- Distinguish between the sacrificing ratio and the gaining ratio
- Understand the accounting treatment of reserves and accumulated profits
- Adjust the capital of each partner if at all desired as per new profit sharing ratio

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## 10.1 INTRODUCTION

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When a business enterprise requires additional capital or managerial help or both for expansion of the business it may admit a new partner to enhance its existing resources. In case of a sole proprietorship, it is converted into a partnership on the admission of a new person as an owner of the business enterprise. According to the Partnership Act, 1932, no new partner can be introduced into a firm without the consent of all the existing partners. On admission of a new partner, the partnership firm is reconstituted with a new agreement.

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## 10.2 ADMISSION OF A PARTNER

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An existing partnership firm may take up expansion/diversification of the business. In that case it may need managerial help or additional capital. An option before the partnership firm is to admit partner/partners, when a partner is admitted to the existing partnership firm; it is called admission of a partner.

According to the Partnership Act 1932, a person can be admitted into partnership only with the consent of all the existing partners unless otherwise agreed upon. On admission of a new partner, the partnership firm is reconstituted with a new agreement. For example, Amit and Sumit are partners sharing profit in the ratio of 5:3. On April 1, 2009 they admitted Neha as a new partner with 1/4th share in the profit of the firm. In this case, with the admission of Neha as partner, the firm stands reconstituted.

As far as sharing of profits is concerned, a new partner is required to bring his share of goodwill which is known as premium as per their agreement. Similar is the position in case of amount of capital when again a new partner is required to bring, depending upon his right in the assets of the existing firm. Thus, we see that there are number of problems which arise because of admission of a new person. The important problems are:

1. Adjustment in Profit sharing Ratio
2. Calculation of Sacrificing Ratio
3. Valuation of Goodwill
4. Revaluation of Assets and Liabilities
5. Adjustment of Reserves and Other Accumulated Profits/Losses
6. Adjustment of Partner's Capital

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## 10.3 ADJUSTMENT IN PROFIT SHARING RATIO

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When a new partner is admitted he/she acquires his/her share in profit from the existing partners. As a result, the profit sharing ratio in the new firm is decided mutually between the existing partners and the new partner. The incoming partner acquires his/her share of future profits either incoming from one or more existing partner. The existing partners sacrifice a share of their profit in the favour of new partner; hence the calculation of new profit sharing ratio becomes necessary.

## 10.4 CALCULATION OF SACRIFICING RATIO

At the time of admission of a partner, existing partners have to surrender some of their share in favour of the new partner. The ratio in which they agree to sacrifice their share of profits in favour of incoming partner is called sacrificing ratio. Some amount is paid to the existing partners for their sacrifice. The amount of compensation is paid by the new partner to the existing partner for acquiring the share of profit which they have surrendered in favour of the new partner.

Sacrificing ratio is calculated as follows:

$$\text{Sacrificing Ratio} = \text{Existing Ratio} - \text{New Ratio}$$

Following cases may arise for the calculation of new profit sharing ratio and sacrificing ratio:

### 10.4.1 Only the New Partner's Share is Given

In this case, it is presumed that the existing partners continue to share the remaining profit in the same ratio in which they were sharing before the admission of the new partner. Then, existing partner's new ratio is calculated by dividing remaining share of the profit in their existing ratio. Sacrificing ratio is calculated by deducting new ratio from the existing ratio.

**Example:** Deepak and Vivek are partners sharing profit in the ratio of 3 : 2. They admit Ashu as a new partner for  $\frac{1}{5}$  share in profit. Calculate the new profit sharing ratio and sacrificing ratio.

**Solution:**

Calculation of new profit sharing ratio:

Let total Profit = 1

New partner's share =  $\frac{1}{5}$

Remaining share =  $1 - \frac{1}{5} = \frac{4}{5}$

Deepak's new share =  $\frac{3}{5}$  of  $\frac{4}{5}$  i.e.,  $\frac{12}{25}$

Vivek's new share =  $\frac{2}{5}$  of  $\frac{4}{5}$  i.e.,  $\frac{8}{25}$

Ashu's Share =  $\frac{1}{5}$

The new profit sharing ratio of Deepak, Vivek and Ashu is:

$$= \frac{12}{25} : \frac{8}{25} : \frac{1}{5} = 12 : 8 : \frac{5}{25} = 12 : 8 : 5$$

So Deepak Sacrificed =  $\frac{3}{5} - \frac{12}{25} = \frac{15}{25} - \frac{12}{25} = \frac{3}{25}$

Vivek Sacrificed =  $\frac{2}{5} - \frac{8}{25} = \frac{10}{25} - \frac{8}{25} = \frac{2}{25}$

Sacrificing Ratio = 3 : 2

Sacrificing ratio of the existing partners is same as their existing ratio.

### 10.4.2 The New Partner Purchases His/Her Share of the Profit from the Existing Partner in a Particular Ratio

In this case, the new profit sharing ratio of the existing partners is to be ascertained after deducting the sacrifice agreed from his share. It means the incoming partner has purchased some share of profit in a particular ratio from the existing partners.

**Example:** Hem and Raj shared profits in the ratio of 5:3. Jolly was admitted as a partner. Hem surrendered  $\frac{1}{5}$  of his share and Raj  $\frac{1}{3}$  of his share in favour of Jolly. Calculate the new profit sharing ratio.

**Solution:**

Hem surrenders  $\frac{1}{5}$  of his share, i.e., =  $\frac{1}{5}$  of  $\frac{5}{8}$  =  $\frac{1}{8}$

Raj surrenders  $\frac{1}{3}$  of his share, i.e., =  $\frac{1}{3}$  of  $\frac{3}{8}$  =  $\frac{1}{8}$

So, sacrificing ratio of Hem and Raj is  $\frac{1}{8} : \frac{1}{8}$  or equal.

Hem's new share =  $\frac{5}{8} - \frac{1}{8} = \frac{4}{8}$

and Raj's new share =  $\frac{3}{8} - \frac{1}{8} = \frac{2}{8}$

Jolly's New share =  $\frac{1}{8} + \frac{1}{8} = \frac{2}{8}$

New profit sharing ratio of Hem's, Raj's and Jolly's is

$$= \frac{4}{8} : \frac{2}{8} : \frac{2}{8} \text{ or } 4 : 2 : 2 \text{ or } 2 : 1 : 1$$

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## 10.5 VALUATION OF GOODWILL

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As and when a new partner is admitted then the first problem with which the firm has to pass, is the valuation of Goodwill. So, it is very much necessary to define Goodwill.

### 10.5.1 Definition of Goodwill

Goodwill is the price of reputation, good name which a firm enjoys. Reputation is earned/ acquired by the business over a period of time. Though, it is very difficult to define goodwill, as it is evident from the following statement of William Pickles, known as father of accountancy. He says that it is easy to describe but difficult to define because goodwill is an intangible asset, but not necessarily fictitious. Thus, we can say that goodwill is a very precious asset which either cannot be seen or touched or felt. Similarly, Dicksee has also defined goodwill as, "*when a man pays for Goodwill, he pays for something which places him in the position of being able to earn more than he would be able to do by his own unaided efforts*". Thus, the capacity of business to earn more profits in the future is what it is meant by the term goodwill. It also distinguishes between an old customer/business and a new customer/business at its first start. According to the Economics of Accountancy (New York), "*Goodwill is the present value of a firm anticipated excess earning*".

The term goodwill means the value of the reputation of a firm in respect of the profit earned in future over and above the normal profit. Goodwill is the result of the efforts made by the existing partners in the past. Therefore, on the eve of the admission, the new partner who is going to acquire the right to share future profits must compensate the existing partners by making payment to them. This amount is called the share of goodwill.

As per Accounting Standard 10(AS-10) that goodwill should be recorded in the books only when some consideration in money has been paid for it. Thus, if a new partner does not bring necessary cash for goodwill, no goodwill account can be raised in the books. He/she should pay for goodwill in addition to his/her contribution for capital.

From accounting point of view, there may be different situations related to treatment of goodwill which are discussed here:

- When the amount of goodwill is paid privately by the new partner.
- When the new partner brings his/her share of goodwill in cash.
- When the new partner does not bring his/her share of goodwill in cash.

**Example:** Your firm earns say ₹ 1200 and the normal profit was expected from your firm ₹ 700. The rate of return is @ 10%. In this case, goodwill is ascertained as under:

$$\begin{aligned}\text{Step 1: Excess profit} &= \text{Actual profit} - \text{Desired normal profit} \\ &= 1200 - 700 = 500\end{aligned}$$

$$\begin{aligned}\text{Step 2: Goodwill} &= 500 \times 100 \div 10 \\ &= ₹ 5000\end{aligned}$$

In other words, goodwill is the value of the reputation of a firm in respect of the profit earned in future over and above the normal profit. It may also be defined as the present value of the capacity to earn future profits. This means that a firm can be said to have goodwill only if it has capacity to earn profit in future. A firm earning only normal profits like similar firms cannot claim to have any goodwill.

### 10.5.2 Necessity of Goodwill (Need for Valuing Goodwill)

Goodwill is valued when it is necessitated. Following are the circumstances when it is necessary to value the amount of goodwill:

1. On the admission of a new partner.
2. On the retirement or death of a partner.
3. On the dissolution of the firm.
4. On the sale of a business to a company.
5. On the amalgamation, merger of a business.
6. When there is a change in the profit sharing ratio.
7. Where there is a change in the constitution of a firm.

### 10.5.3 Factors Affecting Goodwill

Following are the factors which affect goodwill:

1. **Location of Business:** If the business is located at a central place then the amount of goodwill will be higher.
2. **Management of Business:** If the control of management is effective, then profits would be there, resulting in an increase in the amount of goodwill. In other words, if the management is skilled and alert, then only they can economize the expenses, control its cost and save unnecessary wastages etc.
3. **Nature of Business:** The amount of goodwill depends upon the nature of business means type of business, amount of capital employed and degree of risk etc.
4. **Continuity of Business:** How long business is going on? If it is an old business then goodwill will be higher.
5. **Quality:** If a firm is known for the quality of its products the value of goodwill will be high.
6. **Market Situation:** The monopoly condition to earn high profits which leads to higher value of goodwill.
7. **Special Advantages:** The firm has special advantages like importing licenses, long term contracts for supply of material, patents, trademarks, etc., enjoy higher value of goodwill.
8. **Other Factors:** Such as (a) competition in business. (b) Government Policy, (c) Monopoly, (d) Volume of profits. etc.

### 10.5.4 Methods of Valuation of Goodwill

The methods of valuation of goodwill are generally decided by the partners among themselves while preparing partnership deed. The following are the important methods of valuing the goodwill of a firm:

1. Average profit method
2. Super profit method
3. Capitalization method
4. Implied or hidden goodwill
5. Annuity method of super profit

#### *Average Profit Method*

Under this method, the goodwill is valued at agreed number of 'years' purchase of the average profits of the past few years. It is based on the assumption that a new business will not be able to earn any profits during the first few years of its operations. Hence, the person who purchases a running business must pay in the form of goodwill a sum which is equal to the profits he is likely to receive for the first few years. The goodwill is calculated as follows:

$$\text{Value of goodwill} = \text{Average profit} \times \text{Number of year of purchase}$$

For example, the average profits of a firm of say 3 years and the goodwill is to be calculated at 2 years purchase of the average profits works out at ₹ 25,000 and it is assumed that the same profits will be the value of the goodwill will be ₹ 50,000 [₹ 25,000 × 2]. Thus the goodwill is calculated as goodwill = Average profits × Number of years purchase.

**Example:** The profit for the last five years of a firm were as follows year 1999 ₹ 5,00,000; year 2000 ₹ 4,45,000; year 2001 ₹ 4,50,000; year 2002 ₹ 3,98,000 and year 2003 ₹ 4,00,000. Calculate goodwill of the firm on the basis of 4 years purchase of 5 years average profits.

**Solution:**

Years	Profit (₹)
1999	5,00,000
2000	4,45,000
2001	4,50,000
2002	3,98,000
2003	4,00,000
<b>Total</b>	<b>21,93,000</b>

$$\begin{aligned} \text{Average Profit} &= \text{Total profit/No. of years} \\ &= ₹ 21,93,000/5 \\ &= ₹ 4,38,600 \end{aligned}$$

$$\begin{aligned}\text{Goodwill} &= \text{Average Profit} \times \text{No. of years Purchased} \\ &= ₹4,38,600 \times 4 \\ &= ₹17,54,400\end{aligned}$$

### **Super Profit Method**

The goodwill under the super profits method is ascertained by multiplying the super profits by certain number of years' purchase. The steps involved under the method are:

1. Calculate the average profit,
2. Calculate the normal profit on the capital employed on the basis of the normal rate of return.
3. Calculate the super profits by deducting normal profit from the average profits, and
4. Calculate goodwill by multiplying the super profits by the given number of years' purchase.

$$\text{Normal profit} = \text{Capital employed} \times \text{Normal rate of return}/100$$

$$\text{Super Profit} = \text{Actual Profit} - \text{Normal Profit}$$

**Example:** A firm earns profit of ₹ 65,000 on a capital of ₹ 4,80,000 and the normal rate of return in similar business is 10%. Then the normal profit is ₹ 48,000 [10% of the ₹ 4,80,000]. The actual profit is ₹ 65,000.

#### **Solution:**

$$\begin{aligned}\text{Super profit} &= \text{Actual profit} - \text{Normal profit} \\ &= ₹ 65,000 - ₹ 48,000 \\ &= ₹ 17,000\end{aligned}$$

If value of goodwill is calculated by 3 years' purchase of super profit then goodwill is equal to:

$$= ₹ 17,000 \times 3 = 51,000$$

**Example:** The profits by a business for the last five years were: 1997 - ₹ 40,000; 1998 - ₹ 50,000; 1999 - ₹ 55,000; 2000 - ₹ 70,000 and 2001 - ₹ 85,000. The books of business showed that the capital employed on December 31, 2001, is ₹ 5,00,000. You are required to find out the value of goodwill based on 3 years purchase of the super profits of the business, given that the normal rate of return is 10%.

#### **Solution:**

$$\begin{aligned}\text{Normal profit} &= \text{Capital employed} \times \text{Normal rate of return}/100 \\ &= ₹ 5,00,000 \times 10/100 \\ &= ₹ 50,000\end{aligned}$$

$$\begin{aligned}\text{Total profit} &= ₹ 40,000 + ₹ 50,000 + ₹ 55,000 + ₹ 70,000 + ₹ 85,000 \\ &= ₹ 3,00,000\end{aligned}$$

$$\begin{aligned}\text{Average profit} &= ₹ 3,00,000/5 \\ &= ₹ 60,000\end{aligned}$$

$$\begin{aligned} \text{Super Profit} &= \text{Actual Profit} - \text{Normal Profit} \\ &= ₹ 60,000 - ₹ 50,000 \\ &= ₹ 10,000 \\ \text{Goodwill} &= ₹ 10,000 \times 3 \\ &= ₹ 30,000 \end{aligned}$$

Distinction between Actual/Average Profits and Super Profits:

Point of Difference	Actual /Average Profit	Super Profit
Meaning	It is based on No. of yrs. Profit/Losses.	Super Profits are in excess of Normal Profit.
Method of Calculation	Profits/Losses of No. of Yrs. ÷ No. of Yrs.	Super Profit = Average Profits – Normal Profits.
Use of Normal Profits	It is not considered while calculating Average Profits.	It can be calculated only if normal profits are known.
Used as a tool	Actual/Average Profits are used as a tool for calculating goodwill in all the methods of calculating goodwill.	It is used as a tool for calculating super profits and capitalization of super profits methods of calculating goodwill.

### **Capitalization Method**

Goodwill can be calculated by either (a) Capitalization of Average Profits or (b) Capitalization of Super Profits.

(a) **Capitalization of Average Profits:** In this method, the value of goodwill is assumed to be excess of the capital value of average profit over the actual capital employed. The key steps involved in this method are as follows:

(i) Computation of average profit

$$\text{Average Profits} \times 100/\text{Normal Rate of Return}$$

(ii) Computation of capital employed

$$\text{Capital Employed} = \text{Total Assets (excluding goodwill)} - \text{Outside Liabilities}$$

(iii) Computation of goodwill

$$\text{Goodwill} = \text{Capitalised value of profits} - \text{Capital employed}$$

**Example:** A business has earned average profits of ₹ 40,000 during the last few years and the normal rate of return in a similar type of business is 10%. Ascertain the value of goodwill by capitalization method, given that the value of net assets of the business is ₹ 3,10,000.

**Solution:**

$$\text{Capital Employed} = ₹ 3,10,000$$

$$\begin{aligned} \text{Capitalised value of average profit} &= \text{Average profit} \times 100/\text{Normal rate of profit} \\ &= ₹ 40,000 \times 100/10 \\ &= ₹ 4,00,000 \end{aligned}$$

$$\begin{aligned} \text{Goodwill} &= \text{Capitalised value} - \text{Capital employed} \\ &= ₹ 4,00,000 - ₹ 3,10,000 \\ &= ₹ 90,000 \end{aligned}$$

(b) **Capitalisation of Super Profit:** In this method, the value of goodwill is calculated on the basis of super profit method. Following formula is applied for calculation of capital employed:

*Example:* A firm earns a profit of ₹ 25,000 and has invested capital amounting to ₹ 2,20,000. In the same business normal rate of earning profit is 15%. Calculate the value of goodwill with the help of capitalisation of super profit method.

*Solution:*

$$\begin{aligned}
 \text{Actual profit} &= ₹ 25,000 \\
 \text{Normal profit} &= ₹ 2,20,000 \times 10/100 = ₹ 22,000 \\
 \text{Super Profit} &= \text{Actual Profit} - \text{Normal Profit} \\
 &= ₹ 25,000 - ₹ 22,000 \\
 &= ₹ 3,000 \\
 \text{Goodwill} &= \text{Super profit} \times 100/\text{Normal rate of profit} \\
 &= ₹ 3,000 \times 100/15 \\
 &= ₹ 20,000
 \end{aligned}$$

### **Implied or Hidden Goodwill**

Sometimes the value of goodwill is not given; it is inferred or implied from the agreement.

*Example:* If Ram and Shyam are partners in a firm sharing profits and losses in the ratio of 2:1 and their capitals are ₹ 15,000 and ₹ 7,500. They admit Mohan for 1/4th share in the profits who brings ₹ 10,000 as his capital. Calculate the amount of hidden Goodwill.

*Solution:*

$$\begin{aligned}
 \text{The total capital of the firm should be} &= ₹ 10,000 \times 4/1 \\
 &= ₹ 40,000
 \end{aligned}$$

Whereas total capital of the firm is ₹ 32,500 (i.e., ₹ 15,000 + ₹ 7,500 + ₹ 10,000),

Thus the inferred /implied Goodwill is = ₹ 40,000 – ₹ 32,500 = ₹ 7,500.

So that the total capital of the firm becomes ₹ 40,000 because of Mohan who brings ₹ 10,000 as his capital for 1/4 shares in the profits.

### **Annuity Method of Super Profit**

Under this method, normal rate of return and total no. of years are given. Then based on this information, annuity is calculated. If annuity is given, then it is multiplied by super profit resulting in the value of Goodwill.

$$\text{Annuity or } a = \frac{1}{\frac{\left(1 + \frac{r}{100}\right)^n}{\frac{r}{100}}}$$

*Example:* Calculate the value of Goodwill on the basis of terminal annuity for 3 year's purchase of super profits. Average profit is ₹ 13,200 and average capital employed



₹ 80,000. Normal rate of return is 10%. The present value of annuity of ₹ 1 for 3 years is 2.48685.

**Solution:**

	₹
Average Profit	13,200
Normal Profit	8,000
(Capital employed × Rate of return) (80,000 × 10%)	
Super Profit	5,200

Hence, Value of goodwill = Super profit × Present value of annuity  
 = ₹ 5,200 × 2.48685 = ₹ 12931.62

**10.5.5 Goodwill (Premium) Paid Privately**

If the goodwill premium is paid privately by the new partner to the old partners outside the business then the same is not recorded in the books of accounts and hence no journal entry is recorded.

**10.5.6 Goodwill in Case of a New Partner**

Whenever a new partner is admitted, the most important problem is of goodwill, because the partners who agree to sacrifice their share of profit, get something in return which is called as premium to be shared by existing (old) partners in their sacrificing ratio. This premium is paid by the new partner as he gets entitlement of future profits in a firm. Now what is to be decided?

The following are the important problems relating to Goodwill:

- (a) What will be the amount of Goodwill?
- (b) Whether Goodwill is payable in cash? If yes, whether the cash is withdrawn or retained in the business? This is also known as Premium Method of Goodwill.
- (c) Whether Goodwill account is to be opened in the books of the firm? This is also known as Memorandum Method of Goodwill.
- (d) Whether Goodwill account is already there or not?
- (e) Whether Goodwill account is to be shown or not. In other words, it is to be written off.

**10.5.7 Goodwill/Premium brought in Cash by the New Partner and Retained in the Business**

When, the new partner brings his/her share of goodwill in cash, the amount brought in by the new partner is transferred to the existing partner in the sacrificing ratio. If there is any goodwill account in the balance sheet of existing partner, it will be written off immediately in existing ratio among the partners. The journal entries are as follows:

1. For bringing premium (share of goodwill)

Cash/Bank A/c	Dr
	To Goodwill A/c



**Solution:**

**Books of A, B and C**

Date	Particulars	L.F.	Debit Amount (₹)	Credit Amount (₹)
	Bank A/c To C's capital A/c (Cash brought by C for her capital)	Dr.	2,50,000	2,50,000
	A's capital A/c B's capital A/c To Goodwill A/c (Goodwill written off)	Dr. Dr.	32,000 48,000	80,000
	C's capital A/c To A's capital A/c To B's capital A/c (The accounts of A and B are credited for goodwill on C's admission in their sacrificing ratio)	Dr.	36,000	14,400 21,600

**Working Note:**

A and B sacrifice their profit in favour of C in their existing profit sharing ratio i.e., 2 : 3.

Therefore, the sacrificing ratio is 2 : 3.

Value of Goodwill = ₹ 1,80,000

C's share in Profit = 1/5

C's share of Goodwill = ₹ 1,80,000 × 1/5 = ₹ 36,000

## 10.6 REVALUATION OF ASSETS AND LIABILITIES

Whenever a new partner is admitted, the second important problem with which the firm has to pass is the revaluation of assets and liabilities. Revaluation is necessitated because of change in the constitution of the existing firm. In the eyes of law, ceases to exist and a new firm comes into existence after the admission of a new partner, revaluation of assets and liabilities is done in order to arrive at the correct values of assets and liabilities. This may be positive, i.e., increase in values or negative i.e., decrease in values. Whatever may be the net result i.e., increase (profit) or decrease (loss), it is to pass on or distributed to the old (existing) partners in their profit sharing ratio through an account known as revaluation account or profit and loss adjustment account. The nature of this account is of a nominal account. The profit or loss is transferred to capital accounts of the old partners.

At the time of admission of a new partner, it is always desirable to ascertain whether the assets of the firm are shown in books at their current values. In case the assets are overstated or understated, these are revalued. Similarly, a reassessment of the liabilities is also done so that these are brought in the books at their correct values. At times, there may be some unrecorded assets with the business. These are also recorded and similarly if there is any unrecorded liability which the firm has to pay, the same is also recorded. For revaluation of assets and recording of unrecorded assets and for the reassessment of liabilities and recording of unrecorded liabilities the firm prepares an account in its book called Revaluation Account. Any gain or loss on revaluation of assets and reassessment of liabilities is transferred to the capital accounts of the old

partners in their old profit sharing ratio. The revaluation account is credited with increase in the value of assets and decrease in the value of liabilities because it is a gain. Similarly, decrease of assets and increase in the value of liabilities is debited to revaluation account because it is a loss. Unrecorded assets are credited and unrecorded liabilities are debited in the revaluation account. If the revaluation account shows a credit balance then it indicates gain and if there is a debit balance then it indicates loss. Gain on revaluation or loss on revaluation will be transferred to the capital accounts of the old partners in old ratio.

The following journal entries are recorded on revaluation of assets and reassessment of liabilities.

(i) For increase in the value of Assets

Asset A/c                      Dr.  
     To Revaluation A/c

(Increase in the value of Assets)

(ii) For decrease in the value of Asset

Revaluation A/c              Dr.  
     To Asset A/c

(Decrease in the value of Assets)

(iii) For increase in the value of Liabilities

Revaluation A/c              Dr.  
     To Liabilities A/c

(Increase in the value of Liabilities)

(iv) For decrease in the value of Liabilities

Liabilities A/c                Dr.  
     To Revaluation A/c

(Decrease in the value of Liabilities)

(v) For unrecorded Assets

Asset A/c [unrecorded]      Dr.  
     To Revaluation A/c

(Unrecorded asset recorded at actual value)

(vi) For unrecorded Liability

Revaluation A/c              Dr.  
     To Liability A/c [unrecorded]

(Unrecorded Liability recorded at actual value)

(vii) For transfer of gain on revaluation

Revaluation A/c              Dr.  
     To Existing Partner's Capital/Current A/c

(Profit on revaluation transferred to capital account in existing ratio)

(viii) For transfer of loss on revaluation

Existing Partner's Capital/Current A/c      Dr.  
To Revaluation A/c

(Loss on revaluation transferred to capital account in existing ratio)

**Note:** Whatever may be the outcome (result), i.e., profit or loss on revaluation of assets and or liabilities the new partner neither shares the profit nor suffers the loss, it is divisible only amongst the old (existing) partners.

**Pro Forma of Revaluation A/c**

Dr.	Revaluation A/c		Cr.
Particulars	Amount (₹)	Particulars	Amount (₹)
Assets		Assets	
[Decrease in value]		[Increase in value]	
Liabilities		Liabilities	
[Increase in value]		[Decrease in value]	
Liabilities [Unrecorded]		Assets [Unrecorded]	
Profit transferred to		Loss transferred to	
Capital A/c		Capital A/c	
[Individually in existing ratio]		[Individually in existing ratio]	

**Example:** Given below is the Balance Sheet of A and B, who are carrying on partnership business as on March 31, 2003. A and B share profits in the ratio of 2 : 1 Balance Sheet of A and B as at March 31, 2003.

**Balance Sheet of A and B  
as at March 31, 2003**

Liabilities	Amount (₹)	Assets	Amount (₹)
Bills Payable	10,000	Cash in Hand	10,000
Sundry creditors	58,000	Cash at Bank	40,000
Outstanding expenses	2,000	Sundry Debtors	60,000
Capital Accounts:		Stock on Hand	40,000
A      1,80,000		Plant and Machinery	1,00,000
B      1,50,000	3,30,000	Building	1,50,000
	<b>4,00,000</b>		<b>4,00,000</b>

C is admitted as a partner on the date of the balance sheet on the following terms:

1. C will bring in ₹ 1,00,000 as his capital and ₹ 60,000 as his share of goodwill for 1/4<sup>th</sup> share in profits.
2. Plant is to be appreciated to ₹ 1,20,000 and the value of buildings is to be appreciated by 10%.
3. Stock is found overvalued by ₹ 4,000.
4. A provision for bad and doubtful debts is to be created at 5% of debtors.
5. Creditors were unrecorded to the extent of ₹ 1,000.

Record the necessary journal entries and prepare the revaluation account.

**Solution:**

**Books of A, B and C  
Journal**

Date	Particulars	L.F.	Debit Amount (₹)	Credit Amount (₹)
	Cash A/c <span style="float:right">Dr.</span> To C's capital A/c To Goodwill A/c (Cash brought by C for capital and goodwill)		1,60,000	1,00,000 60,000
	Goodwill A/c <span style="float:right">Dr.</span> To A's capital A/c To B's capital A/c (Goodwill brought by C transferred to the capital accounts of A and B in their sacrificing ratio)		60,000	40,000 20,000
	Revaluation A/c <span style="float:right">Dr.</span> To Stock To provision for bad and doubtful debts (Stock depreciated and provision for bad and doubtful debts created on sundry debtors)		7,000	4,000 3,000
	Revaluation A/c <span style="float:right">Dr.</span> To Creditors A/c (Increase in the value of creditors)		1,000	1,000
	Plant and Machinery A/c <span style="float:right">Dr.</span> Buildings A/c <span style="float:right">Dr.</span> To Revaluation A/c (Increase in the value of assets on revaluation)		20,000 15,000	35,000
	Revaluation A/c <span style="float:right">Dr.</span> To A's Capital A/c To B's Capital A/c (Transfer of gain on revaluation to old partners' capital accounts)		27,000	18,000 9,000

**Revaluation Account**

Particulars	Amount (₹)	Particular	Amount (₹)
To Stock on hand	4,000	By Plant and Machinery	20,000
To Provision for Bad and Doubtful Debts	3,000	By Building	15,000
To Creditors	1,000		
To Profits on revaluation transferred to capitals of —			
A      18,000			
B      9,000	27,000		
	35,000		35,000

**Example (Preparation of balance sheet of reconstituted firm):**

Himani and Harsha are partners in a firm. Their Balance Sheet on March 31, 2006 was as follows:

**Balance Sheet of Himani and Harsha  
as on March 31, 2006**

Liabilities	Amount (₹)	Assets	Amount (₹)
Provision for Doubtful Debts		Cash	20,000
Debts	3,000	Sundry Debtors	90,000
Creditors	36,000	Stock	45,000
Bills Payable	15,000	Machinery	41,000
Outstanding Expenses	2,000	Building	1,10,000
Capital:		Goodwill	40,000
Himani	1,70,000		
Harsha	<u>1,20,000</u>		
	2,90,000		
	<u>3,46,000</u>		<u>3,46,000</u>

On April 1, 2006 they admitted Charu as a Partner on the following terms:

1. Charu brings ₹ 90,000 as her share of capital and she is unable to bring any amount for goodwill.
2. Goodwill is valued at 2 Years purchase of the average profit of last 4 years. The Profit of last 4 years amounted to ₹ 20,000; ₹ 30,000; ₹ 30,000; ₹ 40,000 respectively.
3. New Profit sharing ratio between Himani's, Harsha's and Charu are 3 : 2 : 1.
4. Outstanding Expenses to be brought down to ₹ 500.
5. The provision for doubtful debts is to be increased up to 5% on Debtors.
6. Machinery is depreciated by 10% and Stock is valued at ₹ 47,000.

Prepare Revaluation Account, Partners Capital account and opening Balance sheet of the new firm.

**Solution:**

**Revaluation Account**

Dr.			Cr.
Particulars	Amount (₹)	Particulars	Amount (₹)
To Provision for Doubtful Debts	1,500	By Outstanding Expenses	1,500
To Machinery	4,100	By Stock	2,000
		By Loss on revaluation transferred to Himani's Capital A/c 1,050	
		Harsha's Capital A/c <u>1,050</u>	2,100
	<u>5,600</u>		<u>5,600</u>

### Capital Account

Dr.							Cr.
Particulars	Himani (₹)	Harsha (₹)	Charu (₹)	Particulars	Himani (₹)	Harsha (₹)	Charu (₹)
To Goodwill A/c	20,000	20,000	-	By Balance b/d	1,70,000	1,20,000	-
To Revaluation A/c (loss)	1,050	1,050	-	By Charu's Capital A/c	-	10,000	-
To Harsha's Capital	-	-	10,000	By Bank A/c	-	-	90,000
To Balance c/d	1,48,950	1,08,950	80,000				
	<b>1,70,000</b>	<b>1,30,000</b>	<b>90,000</b>		<b>1,70,000</b>	<b>1,30,000</b>	<b>90,000</b>

#### Balance Sheet of Himani, Harsha and Charu as on March 31, 2007

Liabilities	Amount (₹)	Assets	Amount (₹)
Provision for Doubtful Debts	4500	Cash	20000
Creditors	36000	Bank	90000
Bills Payable	15000	Sundry Debtors	90000
Outstanding Expenses	500	Stock	47000
Capital:		Machinery	36,900
Himani	1,48,950	Building	110000
Harsha	1,08,950	Charu's Current Account	10000
Charu	90,000		
	<b>4,03,900</b>		<b>4,03,900</b>

#### **Working Note:**

(i) Valuation of Goodwill:

$$\text{Total Profit} = ₹ 20,000 + ₹ 30,000 + ₹ 30,000 + ₹ 40,000$$

$$\text{Average Profit} = ₹ 1,20,000/4$$

$$= ₹ 30,000$$

$$\text{Goodwill} = ₹ 30,000 \times 2 = ₹ 60,000$$

$$\text{Charu's Share of Goodwill} = ₹ 60,000 \times 1/6 = ₹ 10,000$$

(ii) Computation of sacrificing ratio:

$$\text{Sacrificing Ratio} = \text{Existing Ratio} - \text{New Ratio}$$

$$\text{Himani's} = 1/2 - 3/6 = 0$$

$$\text{Harsha's} = 1/2 - 2/6 = 1/6$$

#### **Memorandum Revaluation A/c**

At the time of admission of a partner after revaluation of assets and liabilities, if all the partners do not want to show the revised value of assets and liabilities in their new balance sheet, then under such circumstances the revaluation A/c is reopened, which is known as Memorandum revaluation A/c. In such case, all entries passed through revaluation account are reversed. For example, if revaluation A/c was debited and



plant A/c was credited earlier now the plant A/c would be debited and revaluation A/c would be credited. Subsequently, a new revaluation A/c comes into existence which is known as Memorandum Revaluation A/c. The memorandum revaluation A/c is closed by transferring the balance to all the partners including new one in new profit sharing ratio.

The given below is the pro forma of Memorandum Revaluation A/c:

**Pro Forma of Memorandum Revaluation Account**

Decrease in Assets		Increase in Assets	
Increase in Liabilities		Decrease in Liabilities	
Unrecorded Liabilities		Unrecorded Assets	
Outstanding Expenses		Accrued Incomes	
Profit : A's Capital A/c		Loss: A's Capital A/c	
B's Capital A/c	XXX	B's Capital A/c	XXX
Decrease in Assets		Increase in Assets	
Increase in Liabilities		Decrease in Liabilities	
Unrecorded Liabilities		Unrecorded Assets	
Outstanding Expenses		Accrued Incomes	
Profit : A's Capital A/c		Loss: A's Capital A/c	
B's Capital A/c		B's Capital A/c	
C's Capital A/c		C's Capital A/c	

**Example:** A and B are partners in a firm sharing profits in the ratio 2 : 1. C is admitted into the firm with 1/4<sup>th</sup> share in profits. He will bring in ₹ 30,000 as capital and capitals of A and B are to be adjusted in the profit sharing ratio. The Balance sheet of A and B as on March 31, 2002 (before C's admission) was as under:

**Balance Sheet of A and B  
as on March 31, 2002**

Liabilities	Amount (₹)	Assets	Amount (₹)
Creditors	8,000	Cash in hand	2,000
Bills Payable	4,000	Cash at bank	10,000
General Reserve	6,000	Sundry debtors	8,000
Capital: A 50,000		Stock on Hand	10,000
B 32,000	82,000	Furniture	5,000
		Machinery	25,000
		Building	40,000
	1,00,000		1,00,000

Other terms of agreement are as under:

- (i) C will bring in ₹ 12,000 as his share of goodwill.
- (ii) Building was valued at ₹ 45,000 and Machinery at ₹ 23,000.
- (iii) A provision for bad debts is to be created @ 6% on debtors.

The partners decide to keep the value of the assets and liabilities the same and hence their book values will not change due to the above adjustments. Show the necessary ledger accounts and prepare the balance sheet after C's admission.

**Solution:**

**Memorandum Revaluation A/c**

Particulars	Amount (₹)	Particulars	Amount (₹)
To Machinery (₹ 25,000 – ₹ 23,000)	2,000	By Building (₹ 45,000 – ₹ 40,000)	5,000
To Provision for bad and doubtful debts (6% of ₹ 8,000)	480		
To Profit on revaluation A/c			
A                   1,680			
B                   840	2,520		
	5,000		5,000
To Machinery	2,000	By Building	5,000
To Provision for bad and doubtful debts	480		
To Partners Capital A/c – Loss on Revaluation			
A – 2/4 of ₹ 2520 = ₹ 1260			
B – 1/4 of ₹ 2520 = ₹ 630			
C – 1/4 of ₹ 2520 = ₹ 630	2,520		
	5,000		5,000

**Partner's Capital A/c**

Particulars	A(₹)	B(₹)	C(₹)	Particulars	A(₹)	B(₹)	C(₹)
To Revaluation A/c – loss	1,260	630	630	By Balance b/d	50,000	32,000	–
To Balance c/d	62,420	38,210	29,370	By Cash A/c	–	–	30,000
				By Premium	8,000	4,000	–
				By Profit on revaluation	1,680	840	–
				By General reserve	4,000	2,000	–
	63,680	38,840	30,000		63,680	38,840	30,000

**Balance Sheet of A, B and C as at March 31, 2002  
(After Admission)**

Liabilities	Amount (₹)	Assets	Amount (₹)
Creditors	8,000	Building	40,000
Bills Payable	4,000	Machinery	25,000
Capital:		Furniture	5,000
A                   62,420		Stock in Hand	10,000
B                   38,210		Sundry Debtors	8,000
C                   29,370	1,30,000	Cash at Bank	
		(₹ 10,000 + ₹ 30,000 + ₹ 12,000)	52,000
		Cash in Hand	2,000
	1,42,000		1,42,000

**Working Note:**

1. Computation of New Profit Sharing Ratio

C's share of profit = 1/4



They agreed to admit Misra as partner with effect from 1<sup>st</sup> January 2007 with  $\frac{1}{4}$  share in profits on the following terms:

- Misra will bring in capital to the extent of  $\frac{1}{4}$ <sup>th</sup> of the total capital of the new firm after all adjustments have been made.
- Buildings are to be appreciated by ₹ 14,000 and Plant to be depreciated by ₹ 7,000.
- The provision on debtors to be raised to ₹ 1,000.
- Goodwill of the firm has been valued at ₹ 21,000.

Prepare the Revaluation Account, Partner's Capital Accounts and Balance Sheet of the firm immediately after Misra's admission.

**Revaluation Account**

Particulars	₹	Particulars	₹
To Plant	7,000	By Buildings	14,000
To Provision on Debtors (1000 – 300)	700		
To Profit on Revaluation	6,300		
	<b>14,000</b>		<b>14,000</b>

**Partners' Capital Accounts**

Particulars	Jain	Gupta	Misra	Particulars	Jain	Gupta	Misra
	(₹)	(₹)	(₹)		(₹)	(₹)	(₹)
To Balance c/d	85,600	71,700	52,433	By Balance b/d	70,000	60,000	–
				By Revaluation a/c (Profit)	3,600	2,700	–
				By Goodwill	12,000	9,000	–
				By Cash a/c <sup>(1)</sup>	–	–	52,433
	<b>85,600</b>	<b>71,700</b>	<b>52,433</b>		<b>85,600</b>	<b>71,700</b>	<b>52,433</b>

**Working Notes:**

- Calculation of Misra's share of capital

Capital's of Jain and Gupta

	₹ 85,600
	+ ₹ 71,700
	1,57,300

Which is equal to  $1 - \frac{1}{4} = \frac{3}{4}$  share, hence the full capital of the firm would be =  $1,57,300 \times \frac{4}{3}$  = ₹ 2,09,732

=  $2,09,732 \times \frac{1}{4}$  = ₹ 52,433

**Balance Sheet of Jain, Gupta and Misra  
(as on 1<sup>st</sup> January, 2007)**

Liabilities	₹	Assets	₹
Sundry Creditors	20,000	Cash (2)	67,233
Bills Payable	3,000	Debtors	20,500
Bank Overdraft	17,000	(-) Provision	1,000
Capital:		Stock	20,000
Jain	85,600	Plant	40,000
Gupta	71,700	(-) Dep.	7,000
Misra	52,433	Building	75,000
	2,09,733	(+) Appreciation	14,000
		Goodwill	21,000
	<b>2,49,733</b>		<b>2,49,733</b>

**Cash Account**

Particulars	₹	Particulars	₹
To Balance b/d	14,800	By Balance c/d (2)	67,233
To Misra Capital A/c	52,433		
	<b>67,233</b>		<b>67,233</b>

**Example:** Balance Sheet of A, B and C sharing profits and losses in the ratio of 3:2:1 is given below:

Liabilities	₹	Assets	₹
A's Capital	4,00,000	Bank	40,000
B's Capital	4,00,000	Debtors	2,00,000
C's Capital	2,00,000	Less: Provision for Doubtful debts	3,000
Contingency Reserve	1,20,000	Stock	2,03,000
Trade Creditors	1,80,000	Furniture	30,000
		Machinery	5,30,000
		Building	3,00,000
	<b>13,00,000</b>		<b>13,00,000</b>

It was decided to admit D into partnership on the following terms and conditions.

- (i) New profit sharing ratio between A, B, C and D will be 3:3:2:2.
- (ii) Goodwill of the firm is valued at ₹ 3,00,000. D brings his share of goodwill in cash which is credited to the old partners.
- (iii) D brings ₹ 1,50,000 as his share of capital.
- (iv) Contingency reserve is not required any more.
- (v) Provision for bad and doubtful debts to be raised to 5 % on debtors.
- (vi) Machinery is revalued at ₹ 5,00,000 and Building is revalued at ₹ 3,67,000.

Prepare Revaluation A/c, Capital A/c's of A, B, C and D, and the Balance Sheet of the firm after D's admission. Also show the calculations regarding goodwill.

**Solution:**

**Revaluation Account**

Dr.		Cr.	
Particulars	₹	Particulars	₹
To Provision for doubtful debts	7,000	By Building	67,000
To Machinery	30,000		
To Profit T/f to:			
A's Cap. A/c	15,000		
B's Cap. A/c	10,000		
C's Cap. A/c	5,000		
	<u>67,000</u>		<u>67,000</u>

**A's Account**

Dr.		Cr.	
Particulars	₹	Particulars	₹
To Balance c/d	5,35,000	By Balance b/d	4,00,000
		By Revaluation A/c	15,000
		By Reserve	60,000
		By D's Capital A/c	51,429
		By C's Capital A/c	8,571
	<u>5,35,000</u>		<u>5,35,000</u>

**B's Account**

Dr.		Cr.	
Particulars	₹	Particulars	₹
To Balance c/d	4,60,000	By Balance b/d	4,00,000
		By Revaluation A/c	10,000
		By Reserve	40,000
		By D's Capital A/c	8,571
		By C's Capital A/c	1,429
	<u>4,60,000</u>		<u>4,60,000</u>

**C's Account**

Dr.		Cr.	
Particulars	₹	Particulars	₹
To A's Capital A/c	8,571	By Balance b/d	2,00,000
To B's Capital A/c	1,429	By Revaluation A/c	5,000
To Balance c/d	2,15,000	By Reserve	20,000
	<u>2,25,000</u>		<u>2,25,000</u>

**D's Account**

Dr.		Cr.	
Particulars	₹	Particulars	₹
To A's Capital A/c	51,429	By Bank A/c	2,10,000
To B's Capital A/c	8,571	(1,50,000 + 60,000)	
To Balance c/d	1,50,000		
	<b>2,10,000</b>		<b>2,10,000</b>

**Balance Sheet**  
as on .....

Dr.		Cr.	
Liabilities	₹	Assets	₹
Trade Creditors	1,80,000	Bank	2,50,000
A's Capital A/c	5,35,000	Debtors	2,00,000
B's Capital A/c	4,60,000	Less: Provision	10,000
C's Capital A/c	2,15,000	Stock	2,03,000
D's Capital A/c	1,50,000	Furniture	30,000
		Machinery	5,00,000
		Building	3,67,000
	<b>15,40,000</b>		<b>15,40,000</b>

**Working Notes**

(i) Value of goodwill being D's share =  $2/10 \times ₹ 3,00,000 = ₹ 60,000$

A and B both are sacrificing in the ratio 6:1 whereas C is gaining 1/30. thus, C is required to bring ₹ 10,000 as goodwill being 1/30 of ₹ 3,00,000 to be shared by A and B in the ratio of 6:1 i.e., ₹ 8,571 and ₹ 1,429.

(ii) I. Balance of A's capital A/c ₹ 5,35,000

[₹ 4,00,000 + ₹ 15,000 + ₹ 60,000 + ₹ 51,429 + ₹ 8,571]

Opening Balance    Profit on Rev.    Share of Profit    Amt. of goodwill    Goodwill paid a/c

II. Balance of B's capital a/c ₹ 4,60,000

[₹ 4,00,000 + ₹ 10,000 + ₹ 40,000 + ₹ 8,571 + ₹ 1,429 ]

**Example:** The Balance sheet of A and B as on 31<sup>st</sup> March, 2006 is given below:

Liabilities	₹	Assets	₹
A's Capital	60,000	Freehold Property	20,000
B's Capital	30,000	Furniture	6,000
General Reserve	24,000	Stock	12,000
Creditors	16,000	Debtors	80,000
		Cash	12,000
	<b>1,30,000</b>		<b>1,30,000</b>

A and B share profits and losses in the ratio of 2:1. They agree to admit P into the firm subject to the following terms and conditions:

- (a) P will bring in ₹ 21,000 of which ₹ 9,000 will be treated as his share of goodwill to be retained in the business.
- (b) P will be entitled to 1/4<sup>th</sup> share of profits of the firm.
- (c) A reserve for bad and doubtful debts is to be created at 3% of the debtors.
- (d) Furniture is to be depreciated by 5%.
- (e) Stock is to be revalued at ₹ 10,500.

Prepare Revaluation Account, Capital Accounts and Opening Balance Sheet of the new firm.

**Solution:**

**Revaluation Account**

Particulars	₹	Particulars	₹
To Reserve for doubtful debts @ 3% on dis.	2,400	By Loss on revaluation transferred to	
To Furniture	300	A	2,800
To Stock	1,500	B	1,400
	<b>4,200</b>		<b>4,200</b>

**Capital Account of Partners**

Particulars	A (₹)	B (₹)	P (₹)	Particulars	A (₹)	B (₹)	P (₹)
To Revaluation a/c (loss)	2,800	1,400	—	By Balance	60,000	30,000	—
To Balance c/d	79,200	39,600	12,000	By Bank	—	—	—
				By Bank (Goodwill)	6,000	3,000	12,000
				(-) Reserve	16,000	8,000	—
	<b>82,000</b>	<b>41,000</b>	<b>12,000</b>		<b>82,000</b>	<b>41,000</b>	<b>12,000</b>

**Balance Sheet after Admission of P**

Liabilities	₹	Assets	₹
A's capital	79,200	Freehold property	20,000
B's capital	39,600	Furniture	5,700
P's capital	12,000	Stock	10,500
Creditors	16,000	Debtors	80,000
		(-) Reserve	2,400
		Cash <sup>(1)</sup>	33,000
	<b>1,46,800</b>		<b>1,46,800</b>

**Working Notes:**

	₹
(1) Cash balance as per B/S	12,000
+ Cash brought in by P	21,000
Total	<u>33,000</u>



**Example:** The Balance sheet of A and B, carrying on business in partnership and sharing profits in proportions of 2/3 and 1/3 stood on 30<sup>th</sup> June, 2006 as follows:

Liabilities	₹	Assets	₹
A's Capital A/c	1,02,900	Cash in Hand	4,500
B's Capital A/c	73,500	Stock	54,000
Creditors	23,600	Debtors	36,000
Bills Payable	500	Furniture	6,000
		Plant & Machinery	1,00,000
	<b>2,00,500</b>		<b>2,00,500</b>

On 1<sup>st</sup> July, 2006 they agreed to take C into partnership, giving him 1/5<sup>th</sup> share of profits on the following terms:

1. The goodwill of the firm is to be valued at two year's purchase of profit calculated on the average of the last three years profit amounting to ₹ 40,000, ₹ 30,000, and ₹ 44,075.
2. C brings his share of goodwill in cash, which is retained in the business.
3. C also brings in capital in proportion to his profit sharing ratio arrangements.

**Show**

1. Goodwill calculation
2. New Profit sharing ratio
3. C's capital A/c
4. Journal entries

**Solution:**

1. **Goodwill calculation**

Profit for 3 year (given)	₹
I year	40,000
II year	30,000
III year	<u>44,075</u>
<b>Total</b>	<b>1,14,075</b>

Hence Average Profits = Total Profit ÷ 3 = 1,14,075 ÷ 3 = ₹ 38,025

Hence Goodwill = 2 Year's purchase of profit = 2 × 38,025 = ₹ 76,050

2. **New profit sharing ratio**

Old partners. i.e.. A and B profit sharing ratio (given)

2/3 = and 1/3 OR 2:1

C's Share of profit (promised) = 1/5

then share of profit left for A and B = 1 - 1/5 = 4/5

If old partners want to retain the same old ratio between A and B

Then A's share of profit = 2/3 of 4/5 = 8/15

B's share of profit = 1/3 of 4/5 = 4/15

C's share of profit = 1/5 or 3/15

## 3. C's Capital A/c

Date	Particulars	JF	₹	Date	Particulars	JF	₹
					By Cash A/c		47,902

## 4. Journal Entries

S.No	Particulars	L.F.	₹	₹
1.	Cash A/c Dr. To A's Capital A/c To C's Capital A/c Cash brought in by C for his capital & goodwill		63,112	47,902 15,210
2.	C's Capital A/c Dr. To A's Capital A/c To B's Capital A/c Goodwill brought in by C is distributed by A and B in their sacrificing ratio		15,210	10,140 5,070

**Working Note**

C's capital in proportion to his profit sharing ratio

Capitals of A and B (given) ₹ 1,02,900 + ₹ 73,500 = ₹ 1,76,400 + Amount of goodwill credited ₹ 15,210 = ₹ 1,91,610

So when  $\frac{4}{5} = 1,91,610$

Then total =  $1,91,610 \times \frac{5}{4}$

$\frac{1}{5} = 1,91,610 \times \frac{5}{4} \times \frac{1}{5}$

= ₹ 47,902

Sometimes the capital of existing partners is also adjusted as per capital of the new partner. For example, if A and B are partners sharing profits and losses in the ratio of 3:2 and C is admitted for  $\frac{1}{5}$  which he takes equally from A and B. He brings ₹ 10,000 as capital whereas capitals of A and B after adjustment amount ₹ 20,000 and ₹ 12,000. If the capital accounts are to be adjusted, according to new partner's capital A/c, A and B are required to have ₹ 40,000 being  $\frac{4}{5}$  share. Naturally, they will be required to bring additional capital accordingly. This is clearly explained in the following example.

**Example:** The following is the Balance Sheet of A, B and C sharing profits and losses in the proportion of 6:5:3 respectively.

Liabilities	₹	Assets	₹
Creditors	18,900	Cash	1,890
Bills Payable	6,300	Debtors	26,460
General Reserve	10,500	Stock	29,400
Capital:		Furniture	7,350
A	35,400	Buildings	45,150
B	29,850	Goodwill	5,250
C	14,550		
	79,800		
	<b>1,15,500</b>		<b>1,15,500</b>

They agreed to take D into partnership and gave him  $\frac{1}{5}$  the share on the following terms:

1. That furniture should be reduced by ₹ 920 and stock by 10 %.

2. That a provision of ₹ 1,320 be made for outstanding repair bills.
3. That the value of buildings should be brought upto ₹ 59,850.
4. That the value of Goodwill should be brought upto ₹ 14,070.
5. That D should bring in ₹ 14,700 as his capital.
6. That after making the above adjustments, the capital accounts of the old partners be adjusted on the basis of the proportion of D's capital to his share in the business. Actual cash to be paid off or brought in by the old partners as the case may be.

Give Journal entries.

Show the Balance Sheet of the new firm.

Show working neatly.

**Solution:**

**Journal Entries**

S.No.	Particulars	L.F.	Dr ( ₹ )	Cr ( ₹ )
1.	Revaluation A/c <span style="float: right;">Dr.</span> To Furniture A/c To Stock A/c To Prov. for Repair Bills Furniture & Stock depreciated and Prov. for repair bills made		5,180	920 2,940 1,320
2.	Land & Building <span style="float: right;">Dr.</span> To Revaluation A/c Appreciation in Land & Buildings (₹ 59,850 – 45,150)		14,700	14,700
3.	Revaluation A/c <span style="float: right;">Dr.</span> To A's Capital A/c To B's Capital A/c To C's Capital A/c (Profit on revaluation transferred)		9,520	4,080 3,400 2,040
4.	General Reserve A/c <span style="float: right;">Dr.</span> To A's Capital A/c To B's Capital A/c To C's Capital A/c (Gen. Reserve balance transferred)		10,500	4,500 3,750 2,250
5.	Goodwill A/c <span style="float: right;">Dr.</span> To A's Capital A/c To B's Capital A/c To C's Capital A/c Goodwill brought upto (₹ 14,070 – 5,250 = 8,820)		8,820	3,780 3,150 1,890
6.	Cash A/c <span style="float: right;">Dr.</span> To D's Capital A/c Cash brought in by D for his share capital		14,700	14,700
7.	Cash A/c <span style="float: right;">Dr.</span> To C's Capital A/c Additional Cash brought in by C		1,320	1,320
8.	A's Capital's A/c <span style="float: right;">Dr.</span> B's Capital's A/c <span style="float: right;">Dr.</span> To Cash A/c Extra cash paid off to the partners.		3,660 3,400	7,060

## Cash Account

Particulars	₹	Particulars	₹
To Balance b/d	1,890	By A's Capital A/c	3,660
To D's Capital A/c	14,700	By B's Capital A/c	3,400
To C's Capital A/c	1,320	By Balance C/d	10,850
	<b>17,910</b>		<b>17,910</b>

Balance Sheet of New firm  
as on.....

Liabilities	₹	Assets	₹
Creditors	18,900	Cash in Hand	10,850
Prov. for Repair Bills	1,320	Debtors	26,460
Bills Payable	6,300	Stock	26,460
Capital:		Furniture	6,430
A	44,100	Buildings	59,850
B	36,750	Goodwill	14,070
C	22,050		
D	14,700		
	<b>1,17,600</b>		
	<b>1,44,120</b>		<b>1,44,120</b>

## Working Notes:

- (1) Future Profit Sharing Ratio: D is admitted for  $\frac{1}{8}$ , hence remaining share for A, B and C is  $1 - \frac{1}{8} = \frac{7}{8}$  and if they want to maintain their old sharing ratio namely 6:5:3 then A's share would be  $\frac{3}{8}$  or  $\frac{6}{16}$  B's share =  $\frac{7}{8}$  of  $\frac{5}{14} = \frac{5}{16}$  and C's share  $\frac{7}{8}$  of  $\frac{3}{14} = \frac{3}{16}$  and D's share =  $\frac{1}{8}$  or  $\frac{2}{16}$ . Thus partner's new profit sharing ratio = 6:5:3:2.
- (2) Profit on Revaluation: General Reserve and Goodwill (additional sum) are divided amongst old partners in their old profit sharing ratio namely 6:5:3.
- (3) Partner's capital is determined on the basis of D's Capital which is 14,700 for  $\frac{1}{8}$ th share, hence to capital will be ₹ 1,17,600 i.e., for A ₹ 44,100, B ₹ 36,750, C ₹ 22,050 and D ₹ 14,700.

## Partner's Capital Account

Particulars	A (₹)	B (₹)	C (₹)	D (₹)	Particulars	A (₹)	B (₹)	C (₹)	D (₹)
To Cash A/c	3,660	3,400	—	—	By Balance b/d	35,400	29,850	14,550	—
To Balance c/d	44,100	36,750	22,050	14,700	By Profit on Revaluation	4,080	3,400	2,040	—
					By Gen. Reserve A/c	4,500	3,750	2,250	—
					By Goodwill A/c	3,750	3,150	1,890	—
					By Cash A/c	—	—	1,320	14,700
	<b>47,760</b>	<b>40,150</b>	<b>22,050</b>	<b>14,700</b>		<b>47,760</b>	<b>40,150</b>	<b>22,050</b>	<b>14,700</b>

## 10.8 ADJUSTMENT OF PARTNER'S CAPITAL

Sometime, at the time of admission, the partners' agree that their capitals be adjusted in proportion to their profit sharing ratio. For this purpose, the capital accounts of the existing partners are prepared, making all adjustments, on account of goodwill, general-reserve, revaluation of assets and resettlement of liabilities. The actual capital



Asha's share in New Capital =  $2,00,000 \times 5/10 = ₹ 1,00,000$

Boby's share in New Capital =  $2,00,000 \times 3/10 = ₹ 60,000$

On comparing Asha's adjusted capital with the new capital we find that Asha brings ₹ 16,000 [₹ 1,00,000 – ₹ 84,000] or the amount may be debited to her current account.

On comparing the Boby's adjusted capital with the new capital, we find that Boby is to withdraw ₹ 12,400 [₹ 72,400 – ₹ 60,000] or the amount may be credited to his current account.

### 10.8.2 When the Capital of the New Partner is Calculated in Proportion to the Total Capital of the New Firm

Sometimes the capital of the new partner is not given. He/she is required to bring an amount proportionate to his/her share of profit. In such a case, new partner's capital will be calculated on the basis of adjusted capital of the existing partners.

**Example:** The capital account of Sumit and Anu show the balance after all adjustments and revaluations are ₹ 90,000 and ₹ 60,000 respectively. They admit Rohit as a new partner for 1/4 share in the profits. Rohit's capital is calculated as follows:

Total share = 1

Rohit's share in the profit = 1/4

Remaining share =  $1 - 1/4 = 3/4$

3/4 share of profit combined capital of Sumit and Anu = ₹ 90,000 + ₹ 60,000 = ₹ 1,50,000

Total Capital of the firm = ₹ 1,50,000  $\times$  4/3 = ₹ 2,00,000

Rohit's capital for 1/4 share of profits = ₹ 2,00,000  $\times$  1/4 = ₹ 50,000

Rohit brings in ₹ 50,000 as his Capital

**Example:** Manoj and Hema are partner sharing profit and losses in the ratio of 7 : 3. On March 31, 2006, their Balance Sheet was as follows:

**Balance Sheet of Manoj and Hema  
as on March 31, 2006**

Liabilities		Amount (₹)	Assets		Amount (₹)
Capital:			Bank		12,000
Manoj	88,000		Sundry Debtors		45,000
Hema	<u>64,000</u>	1,52,000	Bills Receivable		30,000
Sundry Creditors		32,000	Stock		35,000
Bills Payable		38,000	Investment		13,000
Reserve		18,000	Machinery		40,000
			Building		45,000
			Goodwill		20,000
		2,40,000			2,40,000

They admit Tarun into partnership on the following terms:

- (i) Stock is revalued at ₹ 40,000.
- (ii) Building, Machinery and Investment are depreciated by 12%.
- (iii) Prepaid Insurance is ₹ 1,000.
- (iv) Tarun brings ₹ 40,000 as his capital and ₹ 12,000 for goodwill for 1/6 share of profit of the firm.

(v) Capital of the partners shall be proportionate to their profit sharing ratio.  
Adjustment of Capitals to be made by Cash.

Prepare Revaluation Account, Partners' Capital Account, Cash Account and Balance Sheet of the new firm.

**Solution:**

**Revaluation Account**

Dr.		Cr.	
Particulars	Amount (₹)	Particulars	Amount (₹)
To Building	5,400	By Stock	5,000
To Machinery	4,800	By Prepaid Insurance	1,000
To Investment	1,560	By Loss transferred to:	
		Manoj's capital	4,032
		Hema's capital	1,728
	11,760		5,760
			11,760

**Capital Account**

Dr.				Cr.			
Particulars	Manoj ₹	Hema ₹	Tarun ₹	Particulars	Manoj ₹	Hema ₹	Tarun ₹
Goodwill	14,000	6,000	—	Balance b/d	88,000	64,000	—
Revaluation A/c (loss)	4,032	1,728	—	General Reserve	12,600	5,400	—
				Goodwill A/c	8,400	3,600	—
Bank A/c	—	5,272	—	Bank A/c	—	—	40,000
Balance c/d	1,40,000	60,000	40,000	Bank A/c (Profit)	49,032	—	—
	1,58,032	73,000	90,000		1,58,032	73,000	90,000

**Balance Sheet of Manoj, Hema and Tarun  
as on March 31, 2006**

Liabilities	Amount ₹	Assets	Amount ₹
Bills Payable	38,000	Bank	1,07,760
Sundry creditors	32,000	Bills Receivable	30,000
Partners' Capitals A/c:		Sundry Debtors	45,000
Manoj	1,40,000	Stock	40,000
Hema	60,000	Investment	11,440
Tarun	40,000	Prepaid Insurance	1,000
	2,40,000	Machinery	35,200
		Building	39,600
	3,10,000		3,10,000

## Bank Account

Dr.

Cr.

Particulars	Amount (₹)	Particulars	Amount (₹)
To Balance b/d	12,000	By Hema's Capital A/c	5,272
To Manoj's Capital A/c	49,032	By Balance c/d	1,07,760
To Goodwill A/c	12,000		
To Tarun's Capital A/c	40,000		
	1,13,032		1,13,032

**Working Note:**

## (a) Calculation of New profit Sharing Ratio:

Total Profit = 1

Tarun gets =  $1/6$

Remaining Profit =  $1 - 1/6 = 5/6$  share by Manoj and Hema in their existing profit sharing ratio.

Manoj's new share =  $5/6 \times 7/10 = 7/12$

Hema's new shares =  $5/6 \times 3/10 = 3/12$

New profit sharing ratio of Manoj, Hema and Tarun

=  $7/12 : 3/12 : 1/6$  or  $7 : 3 : 2$ .

## (b) Adjustment of Capital:

Tarun brought capital for  $1/6$  share = ₹ 40,000

Total Capital of the firm = ₹ 40,000 ×  $6/1$  = ₹ 2,40,000

Manoj's Capital = ₹ 2,40,000 ×  $7/12$  = ₹ 1,40,000

Hema's Capital = ₹ 2,40,000 ×  $3/12$  = ₹ 60,000

Tarun's Capital = ₹ 2,40,000 ×  $2/12$  = ₹ 40,000

**Check Your Progress**

Fill in the blanks:

1. According to the Partnership Act, 1932, no new partner can be introduced into a firm without the \_\_\_\_\_ of all the existing partners.
2. The new partner acquires his share in profits from the \_\_\_\_\_.
3. The ratio in which the old partners agree to sacrifice their share of profit in favour of the incoming partner is called \_\_\_\_\_.
4. For revaluation of assets and recording of unrecorded assets and for the reassessment of liabilities and recording of unrecorded liabilities the firm prepares an account in its book called \_\_\_\_\_.
5. Gain on revaluation or loss on revaluation will be transferred to the \_\_\_\_\_ of the old partners in old ratio.
6. Decrease of assets and increase in the value of liabilities is \_\_\_\_\_ to revaluation account.



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## 10.9 LET US SUM UP

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- When a business enterprise requires additional capital or managerial help or both for expansion of the business it may admit a new partner to supplement its existing resources.
- According to the Partnership Act 1932, no new partner can be introduced into a firm without the consent of all the existing partners.
- The new partner acquires his share in profits from the old partners.
- The ratio in which the old partners agree to sacrifice their share of profit in favour of the incoming partner is called sacrificing ratio.
- The term goodwill means the value of the reputation of a firm in respect of the profit earned in future over and above the normal profit.
- On the eve of the admission, the new partner who is going to acquire the right to share future profits must compensate the existing partners by making payment to them.
- For revaluation of assets and recording of unrecorded assets and for the reassessment of liabilities and recording of unrecorded liabilities the firm prepares an account in its book called Revaluation Account.
- Gain on revaluation or loss on revaluation will be transferred to the capital accounts of the old partners in old ratio.
- Any accumulated profit or reserve appearing in the balance sheet at the time of admission of a new partner, are credited in the existing partner's capital account in existing profit sharing ratio. If there is any loss, the same will be debited to the existing partner in the existing ratio.
- Sometime, at the time of admission, the partners' agreed that their capitals are adjusted to the proportionate to their profit sharing ratio. The partners may decide to calculate the capitals which are to be maintained in the new firm either on the basis of new Partner's Capital and his profit sharing ratio or on the basis of the existing partner's capital accounts.

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## 10.10 LESSON END ACTIVITY

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Talk to the owners of five such business organisations which are doing good business and have built up good reputation in the market. Write against each firm the factors that have contributed to its goodwill.

Name of the Firm	Nature of Business	Factors contributing to the goodwill of the Firm

## 10.11 KEYWORDS

**Goodwill:** The term goodwill means the value of the reputation of a firm in respect of the profit earned in future over and above the normal profit.

**Revaluation a/c:** For revaluation of assets and recording of unrecorded assets and for the reassessment of liabilities and recording of unrecorded liabilities the firm prepares an account in its book called Revaluation Account.

**Sacrificing ratio:** The ratio in which the old partners agree to sacrifice their share of profit in favour of the incoming partner is called sacrificing ratio.

## 10.12 QUESTIONS FOR DISCUSSION

1. State the meaning of sacrificing ratio.
2. Discuss the meaning of goodwill.
3. Explain the methods of valuation of goodwill.
4. Define 'Revaluation Account'. Why assets and liabilities are revalued at the time of admission of a new partner?
5. Describe the treatment of accumulated profit or losses and reserves at the time of admission of a new partner.
6. Discuss the calculation of the proportionate capital of the new partner in case of admission of a partner.
7. A and B are partners sharing profit in the ratio of 5 : 3 is admitted to the partnership for 1/4 share of future profit. Calculate the new profit sharing ratio and sacrificing ratio.
8. Rohit and Meena are partners sharing and losses in the ratio of 7 : 3. Rohit surrenders 1/7 of his share and Meena surrenders 1/3 of his share in favour of Teena, a new partner. Calculate the new profit sharing ratio.
9. A firm has earned ₹ 3,00,000 as average profit for the last few year. Normal rate of return in the class of business is 15%. Find out goodwill according to Capitalisation of Super profit, if the value of net assets amounted to ₹ 16,00,000.
10. The following is the Balance Sheet of Tarun and Ashima sharing profit and losses in the ratio of 2 : 1.

Liabilities		Amount (₹)	Assets		Amount (₹)
Capital:			Cash		12,000
Tarun	50,000		Sundry Debtors		60,000
Ashima	<u>40,000</u>	90,000	Stock		12,000
Sundry creditors		20,000	Furniture		6,000
			Building		20,000
		1,10,000			1,10,000

They agreed to admit Sunita into partnership on the following terms:

- (a) Sunita to pay ₹ 9,000 as Goodwill.
- (b) Sunita bring ₹ 11,000 as her Capital for 1/4 share of profit in the business.
- (c) Building and furniture to be depreciated at 5%. Stock is reduced by ₹ 1,600 and Bad Debt Reserve ₹ 1,300 to be provided for.

Prepare necessary ledge account and balance sheet after admission.

11. George and Henry are partners sharing profits in the ratio of 3 : 2. They decided to admit David as a new partner and to share future profits and losses equally. David brings in ₹ 50,000 as his capital. Goodwill of the firm is valued at ₹ 60,000. Record the necessary journal entries—
  - (a) When no goodwill appears in books
  - (b) When goodwill appears at ₹ 50,000
  - (c) When goodwill appears at ₹ 1,00,000
12. Explain the methods of valuation of goodwill.
13. X and Y are partners sharing profits and losses in proportion of 3 : 1. They admit a new partner Z whom they give  $\frac{1}{4}$ <sup>th</sup> share in profits. Calculate new profit sharing ratio.
14. John and Mike were partners in a firm sharing profits in 3:1 ratio. They admitted Wahid as a new partner for  $\frac{1}{6}$ <sup>th</sup> share in the profits of the firm. Wahid acquired his share from John and Mike in the ratio 2 : 1. Calculate the new profit sharing ratio of John, Mike and Wahid.

**Check Your Progress: Model Answer**

1. Consent
2. Old partners
3. Sacrificing ratio
4. Revaluation Account
5. Capital accounts
6. Debited

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**10.13 SUGGESTED READINGS**

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- M. P. Pandikumar, *Accounting & Finance for Managers*, Excel Books, New Delhi.
- R. L. Gupta and Radhaswamy, *Advanced Accountancy*.
- V. K. Goyal, *Financial Accounting*, Excel Books, New Delhi.
- Nitin Balwani, *Accounting & Finance for Managers*, Excel Books, New Delhi.

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## LESSON

# 11

## RETIREMENT OF A PARTNER

### CONTENTS

- 11.0 Aims and Objectives
- 11.1 Introduction
- 11.2 Computation of New Profit Sharing Ratio and Gaining Ratio
- 11.3 Adjustment Regarding Goodwill
- 11.4 Revaluation of Assets and Liabilities
- 11.5 Accounting Treatment of Undistributed Profit
- 11.6 Computation of Partner's Interest
- 11.7 Mode of Payment
  - 11.7.1 Payment in Lump Sum
  - 11.7.2 Payment in Installments
- 11.8 Let Us Sum Up
- 11.9 Lesson End Activity
- 11.10 Keywords
- 11.11 Questions for Discussion
- 11.12 Suggested Readings

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### 11.0 AIMS AND OBJECTIVES

After studying this lesson, you should be able to:

- Compute gaining ratio
- Make adjustments regarding goodwill
- Construct revaluation A/c
- Illustrate accounting treatment of undistributed profit
- Compute retiring partner's interest
- Illustrate the lump sum and installment methods of claim settlement

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### 11.1 INTRODUCTION

An outgoing partner means a partner who has retired from a firm. The firm is reconstituted by the remaining partners. Section 32 contemplates three ways in which a partner may retire from the firm, viz., (i) he may retire at any time with the consent of all other partners; (ii) where there is an agreement between the partners about retirement, a partner may retire in accordance with the terms of that agreement; (iii) where the partnership is at will, a partner may retire by giving to his partners a notice of his intention to retire. Section 32 clearly comprehends a situation where a

partner may retire without dissolving the firm. The current lesson discussed about the computation of retiring partner's claim for settlement of his/her account. The key methods used for claim settlement are lump sum and installment method. The claim of the retiring or deceased partner usually consists of his capital as on the date of retirement or death less drawings (if any) plus his share of goodwill in the firm plus his share in the accumulated profits of the firm (if any) less his share of accumulated loss (if any) plus (minus) his share in the profit (loss) and revaluation of assets and liabilities of the firm and such other things. The outgoing partner's account is settled as per terms of partnership deed, i.e., in lump sum immediately or in various installments with/without interest as agreed or partly cash immediately and partly in installments at the agreed intervals.

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## 11.2 COMPUTATION OF NEW PROFIT SHARING RATIO AND GAINING RATIO

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As soon as a partner retires the profit sharing ratio of the continuing partners get changed. At the time of retirement or death of a partner, the share of retiring/deceased partner is acquired by existing partners, on the basis of agreement among them. In the absence of information, the continuing partners take the retiring partner's share in their profit sharing ratio or in an agreed ratio. The ratio in which retiring partner's share is distributed amongst continuing partners is known as "gaining ratio".

$$\text{Gain of continuing partner} = \text{New share} - \text{Old share}$$

**Example:** Sita, Rita and Raj are partners sharing profits in the ratio of 5:3:2. Due to some personal reasons Sita retires from the partnership. Calculate the new profit sharing ratio and gaining ratio of remaining partners.

**Solution:**

### 1. Calculation of new profit sharing ratio

In order to calculate new ratio of Rita and Raj, it is assumed that Sita's share of  $\frac{5}{10}$  will be taken up by Rita and Raj in their old profit sharing ratio.

$$\text{Rita's new share} = \frac{3}{10} + \left(\frac{5}{10} \times \frac{3}{5}\right) = \frac{3}{10} + \frac{15}{50} = \frac{30}{50}$$

$$\text{Raj's new share} = \frac{2}{10} + \left(\frac{5}{10} \times \frac{2}{5}\right) = \frac{2}{10} + \frac{10}{50} = \frac{20}{50}$$

Therefore, the new profit sharing ratio is 3:2

### Calculation of gaining ratio

$$\text{Gaining ratio} = \text{New share} - \text{Old share}$$

$$(i) \text{ Rita's gain} = \frac{3}{5} - \frac{3}{10} = \frac{3}{10}$$

$$(ii) \text{ Raj's gain} = \frac{2}{5} - \frac{2}{10} = \frac{2}{10}$$

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## 11.3 ADJUSTMENT REGARDING GOODWILL

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At the time of retirement or death of a partner the retiring partner is entitled to his share of goodwill because the goodwill has been earned by the firm with the efforts of the existing partners. The valuation of goodwill will be done as per the agreement among the partners. It is possible that company will earn some profit in near future because of the existing goodwill of the company. Therefore, the retiring/deceased partner should be compensated for the same by the continuing partners in their gaining ratio. For this purpose, the retiring/deceased partner's capital will be credited.

In this case, the following journal entry is recorded:

Remaining partner's capital A/c (in the gaining ratio) Dr

To Retiring/deceased partner's capital A/c

(Retiring partner's share of goodwill adjusted to remaining partners in the gaining ratio)

### What is Hidden Goodwill?

If the firm has agreed to settle the account of retiring/deceased partner by paying him a lump-sum amount, then amount paid to him in excess of his capital and share in reserves/revaluation account etc., shall be treated as his share of goodwill. For example, A, B and C are partners. C retires his capital account, after making adjustments for reserves and profit on revaluation exists at 80,000. A and B have agreed to pay him ₹ 1,00,000 in full settlement of his claim. It implies that ₹ 20,000 is C's share in the goodwill of the firm. This will be treated by debiting ₹ 20,000 in A & B's capital account in their gaining ratio and crediting C's capital account.

**Example:** A, B and C are partners sharing profits in the ratio 5 : 3 : 2. A retires and goodwill is valued at 54,000. New profit sharing ratio of continuing partners will be equal. Pass the necessary journal entry.

**Solution:**

### Journal

Date	Particulars	L.F.	Debit Amount (₹)	Credit Amount (₹)
	B's Capital A/c Dr.		10,800	
	C's Capital A/c Dr.		16,200	
	To A's Capital A/c (Share of A's goodwill credited to his capital A/c)			27,000

### Working Notes:

#### Calculation of Gaining Ratios

Gain of partner = New share – Old share

B's Old share =  $\frac{3}{10}$

B's new share =  $\frac{1}{2}$

B's gain =  $\frac{1}{2} - \frac{3}{10} = \frac{2}{10}$

C's Old share =  $\frac{2}{10}$

C's new share =  $\frac{1}{2}$

C's gain =  $\frac{1}{2} - \frac{2}{10} = \frac{3}{10}$

Therefore, gaining ratio is 2: 3

**Example:** S, U and R are partners sharing profits in the ratio of 3: 2: 1. U wants to retire due to personal problems. For this purpose goodwill is valued at two years purchase of average super profits of last three years, the profit for the last three years are as under:

1st year : ₹ 36,600

2nd year : ₹ 43,600

3rd year : ₹ 48,800

The normal profits for similar firms are ₹ 34,000. Record, necessary entry for goodwill on retirement of U.

**Solution:**

**Books of S, U and R**

**Journal**

Date	Particulars	L.F.	Debit Amount (₹)	Credit Amount (₹)
	S's Capital A/c Dr. R's Capital A/c Dr. To U's Capital A/c (Share of U's goodwill credited to his capital A/c)		4,500 1,500	6,000

**Working Notes:**

$$U's \text{ share of goodwill} = ₹ 18,000 \times 2/6 = ₹ 6,000$$

$$\text{Average profits} = (₹ 36,600 + ₹ 43,600 + ₹ 48,800)/3 = ₹ 43,000$$

$$\text{Super profits} = \text{Average profits} - \text{Normal profits}$$

$$= ₹ 43,000 - 34,000 = ₹ 9,000$$

$$\text{Goodwill} = \text{Super profits} \times \text{No. of years purchase}$$

$$= ₹ 9,000 \times 2 = ₹ 18,000$$

## 11.4 REVALUATION OF ASSETS AND LIABILITIES

In case of retirement or death of a partner, the assets and liabilities of the firm should be revalued in the same way as at the time of admission of a partner. At the time of retirement/death, some of the assets or liabilities may not have been shown at their current values. To ascertain the net profit and loss on revaluation of assets and liabilities Revaluation A/c is prepared.

The following journal entries are passed for the revaluation of assets and liabilities:

(i) *For increase in the value of assets*

Asset A/c	Dr.
To Revaluation A/c	
(Increase in the value of assets)	

(ii) *For decrease in the value of asset*

Revaluation A/c	Dr.
To Asset A/c	
(Decrease in the value of assets)	

(iii) *For increase in the value of liabilities*

Revaluation A/c	Dr.
To Liabilities A/c	
(Increase in the value of liabilities)	

(iv) *For decrease in the value of liabilities*

Liabilities A/c	Dr.
To Revaluation A/c	
(Decrease in the value of liabilities)	

(v) **For unrecorded assets**

Asset A/c [unrecorded] Dr.  
 To Revaluation A/c  
 (Unrecorded asset recorded at actual value)

(vi) **For unrecorded liability**

Revaluation A/c Dr.  
 To Liability A/c [unrecorded]  
 (Unrecorded liability recorded at actual value)

(vii) **For transfer of gain on revaluation**

Revaluation A/c Dr.  
 To All Partner's Capital A/c (Old ratio)  
 (Profit on revaluation transferred to capital account in old profit sharing ratio)

(viii) **For transfer of loss on revaluation**

All Partner's Capital Dr.  
 To Revaluation A/c  
 (Loss on revaluation transferred to capital account in existing ratio)

**Example:** X, Y and Z are partners sharing profit in the ratio 1 : 2 : 3. X retires from the partnership. In order to settle his claim, the following revaluation of assets and liabilities was agreed upon:

- (i) The value of Machinery is increased by ₹ 15,000.
  - (ii) The value of Investment is increased by ₹ 2,000.
  - (iii) A provision for outstanding bill standing in the books at ₹ 1,000 is now not required.
  - (iv) The value of Land and Building is decreased by ₹ 12,000.
- Give journal entries and prepare Revaluation account.

**Solution:**

Date	Particulars	L.F.	Debit Amount (₹)	Credit Amount (₹)
	Machinery A/c Dr. Investments A/c Dr. Provision for Outstanding Bill Dr. To Revaluation A/c (Increase in value of Assets and reduction in provision)		15,000 2,000 1,000	18,000
	Revaluation A/c Dr. To Land and Building A/c (Decrease in value of assets)		12,000	12,000
	Revaluation A/c Dr. To X's Capital A/c To Y's Capital A/c To Z's Capital A/c (Profit on revaluation credited to all partners' capital A/c in old profit sharing ratio i.e., 1 : 2 : 3)		6,000	1,000 2,000 3,000



• Revaluation A/c

Dr.		Cr.	
Particulars	Amount (₹)	Particulars	Amount (₹)
To Land and Building	12,000	By Machinery	15,000
To Profit transferred to:		By Investments	2,000
X's capital      1,000		By Provision for outstanding bill	1,000
Y's capital      2,000			
Z's capital <u>3,000</u>	6,000		
	<b>18,000</b>		<b>18,000</b>

### 11.5 ACCOUNTING TREATMENT OF UNDISTRIBUTED PROFIT

At the time of retirement or death of a partner, the amount of undistributed profits (losses), funds and reserves as shown in the Balance Sheet of the firm belongs to all the partners and is transferred to their capital accounts in old profit sharing ratio.

For the purpose, the following journal entries are recorded:

(i) *For distribution of undistributed profit and reserve*

Reserves A/c Dr.

Profit and loss A/c (Profits i.e., credit balance) Dr.

To All partners' capital A/c (individually)

(Reserves and undistributed profit transferred to partner's capital A/c in old profit sharing ratio)

(ii) *For distributing losses among all partners in the old ratio*

All Partners, Capital A/c Dr.

To P&L A/c (accumulated losses, i.e., debit balance)

To Deferred Revenue Expenditure A/c

The surplus available on some specific funds like workmen's compensation fund or investment.

(Surplus available on workmen's compensation fund and investment fluctuation fund transferred to partner's capital A/c in old profit sharing ratio)

**Example:** X, Y and Z are partners sharing profits in proportion of 3 : 2 : 1. X decides to retire from the partnership. On the date of her retirement, firm's abstract Balance Sheet was as under. Pass the necessary entry to treat the profit and loss A/c in balance sheet.

**Balance Sheet**  
as at .....

Liabilities	Amount (₹)	Assets	Amount (₹)
Capital:		Cash	14,000
X      10,000		Profits and Loss	6,000
Y      6,000			
Z <u>4,000</u>	20,000		
	<b>20,000</b>		<b>20,000</b>

**Solution:**

**Books of X, Y and Z**

Date	Particulars	L.F.	Debit Amount (₹)	Credit Amount (₹)
	X's Capital A/c Dr.		3,000	
	Y's Capital A/c Dr.		2,000	
	Z's Capital A/c Dr.		1,000	
	To Profit and loss A/c			6,000
	(Loss of 6,000 divided among all partners in their profit sharing ratio i.e., 3 : 2 : 1)			

**11.6 COMPUTATION OF PARTNER'S INTEREST**

When a partner retires from business, his claim against the firm is determined by preparing his capital account incorporating therein all the adjustments in respect of his share of goodwill, accumulated profits or losses, profit/loss on revaluation of assets and liabilities, etc. Now the settlement of the claim depends on the provisions of the partnership deed. If nothing is given in the problem to be solved in respect of settlement of claim, the amount of claim is usually transferred to the Retiring partner's Loan Account for which the following entry is passed:

Retiring Partner's Capital A/c Dr  
 To Retiring Partner's Loan A/c

The retiring partners' claim consists of:

Particulars	
<b>A. Items to be Added</b>	
• The credit balance of Capital Account	_____
• His/her share in the Goodwill of the firm	_____
• His/her share in the Revaluation Profit	_____
• His/her share in General Reserve and Accumulated Profit	_____
• Interest on Capital	_____
<b>Total</b>	_____
<b>B. Items to be Deducted</b>	
• His/her share in the Revaluation loss	_____
• His/her Drawings and Interest on Drawings up to the date of retirement	_____
• His/her share of any accumulated losses	_____
• Loan taken from the firm	_____
<b>Total</b>	_____
Retiring Partner's Interest (A – B)	_____

**Example:** X, Y and Z are partners sharing profits in the ratio of 2 : 2 : 1 respectively. Their balance sheet as on December 2010 was as follows:

Liabilities		Amount (₹)	Assets		Amount (₹)
Bills Payable		16,000	Cash at Bank		68,000
Sundry Creditors		42,000	Bills Receivable		10,000
Loan from X		1,00,000	Sundry Debtors		30,000
Reserve Fund		20,000	Stock		45,000
Capital:			Furniture		10,000
X	60,000		Machinery		60,000
Y	50,000		Buildings		80,000
Z	<u>27,000</u>	1,37,000	Goodwill		12,000
		<b>3,15,000</b>			<b>3,15,000</b>

Z retires from business as on January 1, 2010. For the purpose of retirement of Z, the assets and liabilities of the firm are revalued as follows:

- (i) Stock 20% less; Furniture at ₹ 6,000
  - (ii) Machinery at 75% of book value
  - (iii) Building at ₹ 1,60,000
  - (iv) A provision of 10% is to be made for doubtful debts
  - (v) The goodwill of the firm is estimated to be worth 60,000
  - (vi) A bill for repairs of building 8,000 was unpaid and was not recorded in the books.
- Ascertain the claim of Z against the firm by preparing his Capital Account.

**Solution:**

1. **Preparation of Revaluation A/c**

**Revaluation A/c**

Particulars	Amount (₹)	Particulars	Amount (₹)
To Stock	9,000	By Building	80,000
To Furniture	4,000		
To Machinery	15,000		
To Provision for Doubtful Debts	3,000		
To Outstanding Repair	8,000		
To Capital A/c (Share of profit)			
X – 2/5	16,400		
Y – 2/5	16,400		
Z – 1/5	<u>8,200</u>		
	<b>80,000</b>		<b>80,000</b>

2. **Calculation of Z's share of Goodwill:** Goodwill of the firm is estimated to be ₹ 60,000. But in the Balance Sheet of the firm is already showing the goodwill at ₹ 12,000. Hence, it should be increased by ₹ 48,000 and the amount should be credited to all the three partners in their profit sharing ratios. Hence Z's share of goodwill is ₹ 48,000 × 1/5 = ₹ 9,600.

3. **Z's share of Reserve Fund:** There is a Reserve Fund of ₹ 20,000 in the Balance Sheet which represents accumulated profits. Z's share is ₹ 20,000 × 1/5 = ₹ 4,000.

4. **Preparation of Z's capital A/c**

Particulars	Amount (₹)	Particulars	Amount (₹)
To Z's Loan A/c	48,800	By Revaluation A/c	8,200
		By Goodwill A/c	9,600
		By Reserve Fund	4,000
		By Balance	27,000
	48,800		48,800

As nothing is given in the questions as regards the settlement of the claim, the amount due to Z on his retirement is transferred to his Loan Account.

## 11.7 MODE OF PAYMENT

The outgoing partner's account is settled as per terms of partnership deed, i.e., in lump sum immediately or in various installments with/without interest as agreed or partly cash immediately and partly in installments at the agreed intervals.

### 11.7.1 Payment in Lump Sum

If the full amount of claim is payable to the retiring partner on the date of retirement as per agreement, the amount will not be transferred to Loan Account but will be paid in cash or by cheque.

The following journal entry is made for disposal of the amount payable to the retiring partner:

Retiring Partner's Capital A/c	Dr.
To Cash/Bank A/c	

(Amount paid to the retiring partner)

**Example:** Ram, Shyam and Mohan are partners sharing profit in the ratio of 3 : 2 : 1. Their balance sheet as on December 31, 2006 is as under:

**Balance Sheet**  
as on December 31, 2006

Liabilities	Amount (₹)	Assets	Amount (₹)
Creditors	80,000	Building	1,80,000
Bills Payable	26,000	Plant	1,40,000
General Reserve	24,000	Motor Car	40,000
Capital:		Stock	1,00,000
Ram           1,60,000		Debtors	63,000
Shyam        1,20,000		Less: Provision for Bad Debts	3,000
Mohan <u>1,20,000</u>	4,00,000	Cash at Bank	10,000
	5,30,000		5,30,000

Shyam retires on that date on the following terms:

- (a) The Goodwill of the firm is valued at ₹ 60,000.
- (b) Stock and Building to be appreciated by 10%.
- (c) Plant is depreciated by 10%.

(d) Provision for Bad debts is increased up to ₹ 5,000.

(e) Shyam's share of goodwill adjusted through remaining partners' capital account.

The amount due to Shyam is paid out of the fund brought in by Ram and Mohan for that purpose in their new profit sharing ratio. Shyam is paid full amount.

Prepare Revaluation Account and Partner's Capital account.

**Solution:**

Suppose the gaining ratio of Ram and Mohan will remains 3 : 1.

(a) Gaining ratio = 3 : 1.

$$\text{Ram gets} = 2/6 \times 3/4 = 1/4$$

$$\text{Ram's new share} = 3/6 + 1/4 = 3/4$$

$$\text{Mohan gets } 2/6 \times 1/4 = 1/12$$

$$\text{Mohan's new share} = 1/6 + 1/12 = 3/12 = 1/4$$

New profit sharing ratio between Ram and Mohan is

$$= 3/4 : 1/4$$

$$= 3 : 1.$$

(b) Shyam's Share of goodwill

$$₹ 60,000 \times 2/6 = ₹ 20,000$$

The following journal entry will be passed for goodwill:

Ram's Capital A/c	Dr.	₹ 15,000	
Mohan's Capital A/c	Dr.	₹ 5,000	
			20,000
		To Shyam's Capital A/c	

(Shyam's share of goodwill debited to remaining partners' capital A/c)

**Revaluation A/c**

Particulars	Amount (₹)	Particulars	Amount (₹)
To Provision for Bad debts	2,000	By Stock	10,000
To Plant	14,000	By Building	18,000
To Profit transferred to Capital Accounts:			
Ram	6,000		
Shyam	4,000		
Mohan	<u>2,000</u>		
	28,000		28,000

**Capital A/c**

Dr.

Cr.

Particulars	Ram (₹)	Shyam (₹)	Mohan (₹)	Particulars	Ram (₹)	Shyam (₹)	Mohan (₹)
To Capital	15,000	—	5,000	By Balance b/d	1,60,000	1,20,000	1,20,000
To Bank	—	1,52,000	—	By General Reserve	12,000	8,000	4,000
To Balance c/d	2,77,000	—	1,59,000	By Revaluation (Profit)	6,000	4,000	2,000
				By Ram Capital	—	15,000	—
				By Mohan Capital	—	5,000	—
				By Bank	1,14,000	—	38,000
	<b>2,92,000</b>	<b>1,52,000</b>	<b>1,64,000</b>		<b>2,92,000</b>	<b>1,52,000</b>	<b>1,64,000</b>

### 11.7.2 Payment in Installments

In this case, the amount due to retiring partner is paid in installments. In the absence of any agreement, section 37 of the Indian Partnership Act, 1932 is applicable.

As per the Sec 37 of Indian Partnership Act, 1932, outgoing partner is at liberty to receive either interest @ 6% p.a., till the date of payment or the share of profits which has been earned with his money.

An installment consists of two parts:

- (i) Principal Amount of installment due to retiring partner.
- (ii) Interest at an agreed rate.

Interest due on loan amount is credited to retiring partners' loan account. Installment inclusive of interest then is paid to the retiring partner as per schedule agreed upon.

(i) ***On part payment in cash and balance transferred to his/her loan account***

Retiring Partner's Capital A/c	Dr.
To Cash/Bank A/c	
To Retiring Partner's Loan A/c	

(Part payment made and balance transferred to loan A/c)

(ii) ***Total amount due transferred to loan A/c***

Retiring Partner's Capital A/c	Dr.
To Retiring Partner's Loan A/c	

(Total amount due transferred to loan A/c)

(iii) ***For interest due***

Interest on loan A/c	Dr.
To Retiring Partners' Loan A/c	

(Interest due on loan)

(iv) ***For payment of installment***

Retiring Partners' Loan A/c	Dr.
To Cash/Bank A/c	

(Installment inclusive of interest paid)

**Example:** Taking the figures of the pervious example, assuming that he is paid 40% of the amount due immediately and the balance in three equal yearly installments. The interest payable is 12% p.a.

**Solution:**

The amount due to Mohan = ₹ 1,52,000

Amount paid immediately = ₹ 1,52,000 × 40/100 = ₹ 60,800

Amount of three equal installments = ₹ 1,52,000 – ₹ 60,800 × 3  
= ₹ 91,200 ÷ 3 = ₹ 30,400

1st Installment at the end of 1st Year = ₹ 30,400 + ₹ 10,944  
= ₹ 41,344

$$\begin{aligned}\text{Interest @ 12\% pa.} &= ₹ 91,200 \times 12/100 \\ &= ₹ 10,944\end{aligned}$$

$$\begin{aligned}\text{2nd Installment at the end of 2nd Year} &= ₹ 30,400 + ₹ 7,296 \\ &= ₹ 37,344\end{aligned}$$

$$\begin{aligned}\text{Interest @ 12\% pa.} &= ₹ 60,800 \times 12/100 \\ &= ₹ 7,296\end{aligned}$$

$$\begin{aligned}\text{3rd Installment at the end of 3rd Year} &= ₹ 30,400 + ₹ 3,648 \\ &= ₹ 34,048\end{aligned}$$

$$\begin{aligned}\text{Interest @ 12\% pa.} &= ₹ 30,400 \times 12/100 \\ &= ₹ 3,648\end{aligned}$$

### Check Your Progress

Fill in the blanks:

1. At the time of retirement or death of a partner, the share of retiring/deceased partner is acquired by \_\_\_\_\_ partners.
2. The ratio in which retiring partner's share is distributed amongst continuing partners' is known as \_\_\_\_\_.
3. Section 37 of the Indian Partnership Act says that outgoing partner is at liberty to receive either interest @ \_\_\_\_\_ p.a. till the date of payment or the share of profits which has been earned with his money.
4. At the time of retirement or death of a partner the amount of undistributed profits (losses), funds and reserves as shown in the Balance Sheet of the firm belongs to all the partners and is transferred to their capital accounts in \_\_\_\_\_ sharing ratio.
5. The \_\_\_\_\_ available on some specific funds will be transferred to capital accounts of all the partners in their old ratio.
6. \_\_\_\_\_ clearly comprehends a situation where a partner may retire without dissolving the firm.

## 11.8 LET US SUM UP

- Section 32 clearly comprehends a situation where a partner may retire without dissolving the firm.
- As soon as a partner retires the profit sharing ratio of the continuing partners get changed.
- At the time of retirement or death of a partner, the share of retiring/deceased partner is acquired by existing partners, on the basis of agreement among them.
- The ratio in which retiring partner's share is distributed amongst continuing partners' is known as "gaining ratio".
- At the time of retirement or death of a partner the retiring partner is entitled to his share of goodwill.
- If the firm has agreed to settle the account of retiring/deceased partner by paying him a lump-sum amount, then amount paid to him in excess of his capital and share in reserves/valuation account etc., shall be treated as his share of goodwill.

- In case of retirement or death of a partner the assets and liabilities of the firm should be revalued in the same way as at the time of admission of a partner.
- At the time of retirement or death of a partner the amount of undistributed profits (losses), funds and reserves as shown in the Balance Sheet of the firm belongs to all the partners and is transferred to their capital accounts in old profit sharing ratio.
- The outgoing partner's account is settled as per terms of partnership deed, i.e., in lump sum immediately or in various installments with/without interest as agreed or partly cash immediately and partly in installments at the agreed intervals.
- When a partner retires from business, his claim against the firm is determined by preparing his capital account incorporating therein all the adjustments in respect of his share of goodwill, accumulated profits or losses, profit/loss on revaluation of assets and liabilities, etc.
- If nothing is given in the problem to be solved in respect of settlement of claim, the amount of claim is usually transferred to the Retiring partner's Loan Account.
- If the full amount of claim is payable to the retiring partner on the date of retirement as per agreement, the amount will not be transferred to Loan Account but will be paid in cash or by cheque.
- In the absence of any agreement, section 37 of the Indian Partnership Act, 1932 is applicable, which says that outgoing partner is at liberty to receive either interest @ 6% p.a. till the date of payment or the share of profits which has been earned with his money.
- An installment consists of two parts:
  - (i) Principal Amount of installment due to retiring partner.
  - (ii) Interest at an agreed rate.
- Interest due on loan amount is credited to retiring partners' loan account.
- Installment inclusive of interest then is paid to the retiring partner as per schedule agreed upon.

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## 11.9 LESSON END ACTIVITY

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Prepare the pro forma of capital account with a suitable example.

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## 11.10 KEYWORDS

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**Gaining Ratio:** The ratio in which retiring partner's share is distributed amongst continuing partners is known as "gaining ratio".

**Hidden Goodwill:** If the firm has agreed to settle the account of retiring/deceased partner by paying him a lump-sum amount, then amount paid to him in excess of his capital and share in reserves/revaluation account etc., shall be treated as his share of goodwill.

**Revaluation A/c:** For revaluation of assets and recording of unrecorded assets and for the reassessment of liabilities and recording of unrecorded liabilities the firm prepares an account in its book called Revaluation Account.

**Annuity:** Annual Payment of the claim of a retiring or deceased partner.

**Executors:** The representatives of the deceased partner who are entitled to claim his share.



## 11.11 QUESTIONS FOR DISCUSSION

1. Define gaining ratio.
2. Explain the accounting treatment of goodwill on retirement of a partner.
3. A, B and C were partners in a firm sharing profit in the ratio of 7 : 6 : 7. B retired and his share was divided equally between A and C. Calculate the new profit sharing ratio of A and C.
4. Madhu, Surabhi and Nikhil are partners without any partnership deed. Madhu retire, calculate future ratio of continuing partners if they agreed to acquire her share (i) in the ratio 5 : 3 (ii) equally. Also mention their gaining ratio.
5. A, B and C are partners in a firm sharing profits in the ratio of 2 : 1 : 1. They took out a policy in 2002 of ₹ 1,40,000. On 21<sup>st</sup> March, 2003 B died. The surrender value of the policy appearing in the books on that date was ₹ 20,000. Record necessary journal entries to close the joint life policy in the year of death of B, if premium paid was treated (i) as business expenses and (ii) as an asset.
6. Rita, Puneeta and Gita are partners sharing profits in the ratio of 1 : 2 : 3. Rita retires on the date of balance sheet on the following terms:
  - (a) A computer costing ₹ 40,000 which was not recorded earlier, to be recorded now.
  - (b) A liability of compensation towards an employee for ₹ 16,000 has also been finalised for payment.

Record necessary entries to record the above arrangement.

7. R, S and M were carrying on business in partnership sharing profits in the ratio of 3 : 2 : 1, Notes respectively. On March 31, 1999, Balance Sheet of the firm stood as follows:

- **Balance Sheet**  
as at March 31, 1999

Liabilities	Amount (₹)	Assets	Amount (₹)
Sundry Creditors	16,000	Building	23,000
Capital:		Debtors	7,000
R     20,000		Stock	12,000
S     7,500		Patents	8,000
M <u>12,000</u>	40,000	Bank	6,000
	<b>56,000</b>		<b>56,000</b>

Shyam retired on the above mentioned date on the following terms:

- (a) Buildings to be appreciated by ₹ 8,800.
- (b) Provision for bad debts be made @ 5% on debtors.
- (c) Goodwill of the firm be valued at ₹ 9,000.
- (d) ₹ 5,000 be paid to S immediately and the balance due to him treated as a loan carrying interest @ 6% per annum.

Record necessary journal entries and prepare the balance sheet of the reconstituted firm.

8. The Balance Sheet of A, B and C who were sharing the profits in proportion to their capitals stood as on March 31, 2003.

**Balance Sheet**  
**as at March 31, 1999**

Liabilities	Amount (₹)	Assets	Amount (₹)
Bills Payable	6,250	Land and Building	12,000
Sundry Creditors	10,000	Customers	10,500
Reserve Funds	2,750	Less: Reserve	<u>500</u>
Capitals:		Bills Receivable	7,000
A     20,000		Stock	15,500
B     15,000		Plant and Machinery	11,500
C <u>15,000</u>	50,000	Bank Balance	13,000
	<b>69,000</b>		<b>69,000</b>

B retired on the date of balance sheet and the following adjustments were made:

- (a) Stock was depreciated by 10%.
- (b) Factory buildings were appreciated by 12%.
- (c) Reserve for doubtful debts be created up to 5%
- (d) Reserve for legal charges to be made at ₹ 265.
- (e) The goodwill of the firm fixed at ₹ 10,000.
- (f) The capital of the new firm be fixed at ₹ 30,000. The continuing partners decide to keep their capitals in the new profit sharing ratio of 3 : 2.

Record journal entries and prepare the initial balance sheet of reconstituted firm after transferring the balance in B's capital account to his loan account.

9. Distinguish between sacrificing and gaining ratio.
10. Why do firms revalue assets and reassess their liabilities on retirement or on the event of death of a partner?
11. List the various claims of retiring partner.
12. Illustrate the methods of settling the claims of retiring partner.
13. A retires from business on 1<sup>st</sup> January, 2004. His total claim against the firm works out to ₹ 91,000 on that date. The partners have agreed to allow 20% interest on the unpaid balance per annum and settle his claim in three equal annual installments including interest. Prepare A's Loan Account.
14. Calculate the total amount due to X, who is retiring from the partnership:
  - (a) Credit balance in X capital account 50,000.
  - (b) X's share of goodwill 5,000
  - (c) General reserve balance shown in Balance sheet 10,000
  - (d) Profit on Revaluation of Assets/liabilities 3,000
  - (e) Interest on drawings 500.
  - (f) X share in the profit of the firm 2/3
15. Illustrate the lump sum payment method for settling the claims of retiring partner.
16. Ashu, Ashmita and Metu are partners sharing profits in the ratio of 4 : 3 : 2. Ashu retires, assuming Ashmita and Metu will share profits in future in the ratio 5 : 3, determine the gaining ratio.

**Check Your Progress: Model Answer**

1. Existing
2. Gaining ratio
3. 6%
4. Profit
5. Surplus
6. Section 32

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**11.12 SUGGESTED READINGS**

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M. P. Pandikumar, *Accounting & Finance for Managers*, Excel Books, New Delhi.

R. L. Gupta and Radhaswamy, *Advanced Accountancy*.

V. K. Goyal, *Financial Accounting*, Excel Books, New Delhi.

Nitin Balwani, *Accounting & Finance for Managers*, Excel Books, New Delhi.

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## LESSON

# 12

## DEATH OF A PARTNER

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### 12.0 AIMS AND OBJECTIVES

After studying this lesson, you should be able to:

- Illustrate the accounting treatment on death of a partner
- Compute the share of profit up to the death of the partner
- Record the transactions for settlement of executor's A/c
- Define joint life policy
- Illustrate the accounting treatment for joint life policy
- Prepare the accounts for individual life policies

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### 12.1 INTRODUCTION

Partnership stands dissolved on the death of a partner. The rights of the legal representatives of the deceased partner depend on the provisions of the partnership deed. The claim of the deceased partner is determined as per the provisions of the partnership deed which is normally purchased by the surviving partners and they continue to carry on the business as usual. The claim of the deceased partner is either paid immediately or transferred to Loan Account in the name of his legal

representatives. The claim is usually determined on the same basis as that of a retired partner taking into account his share in the accumulated profits of the firm, goodwill, profit/loss on revaluation of assets/liabilities and so on.

## 12.2 ACCOUNTING TREATMENT ON DEATH OF A PARTNER

The key difference between the retirement and death of partner is that normally the retirement takes place at the end of an accounting period whereas death can occur at any time. Hence, in the case of death of a partner his claim shall include:

- share in the profits of the firm up to the date of death
- interest on his capital up to the date of death
- share in the proceeds of joint life policy (if any) in addition to his share in the accumulated profits
- goodwill, etc.

Section 37 of the Partnership Act provides that if the amount is not paid immediately, the executors of the deceased partner would be entitled, at their choice, to receive interest @ 6% p.a. from the date of death to the date of actual payment or a share in the profits of the firm earned during that period in the proportion in which the amount due to the deceased partner bears to the total capital employed. This section is also applicable in the case of retirement of a partner.

On the death of a partner, the accounting treatment regarding goodwill, revaluation of assets and reassessment of liabilities, accumulated reserves and undistributed profit are similar to that of the retirement of a partner.

The deceased partners' claim consists of:

Particulars	
<b>A. Items to be Credited</b>	
• The amount standing to the credit to the capital account of the deceased partner	-
• Interest on capital, if provided in the partnership deed up to the date of death	-
• Share of goodwill of the firm	-
• Share of undistributed profit or reserves	-
• Share of profit on the revaluation of assets and liabilities	-
• Share of profit up to the date of death	-
• Share of Joint Life Policy	-
<b>Total</b>	-
<b>B. Items to be Deducted</b>	
• His/her share in the Revaluation loss	-
• His/her Drawings and Interest on Drawings up to the date of retirement	-
• His/her share of any accumulated losses	-
• Loan taken from the firm	-
<b>Total</b>	-
<b>Deceased Partner's Claim (A – B)</b>	-

## 12.3 ASCERTAINMENT OF SHARE OF PROFIT UP TO THE DEATH OF PARTNER

If the death of a partner occurs during the year, the representatives of the deceased partner are entitled to his/her share of profits earned till the date of his/her death. Such profit is ascertained by any of the following methods:

- Time Basis
- Turnover or Sales Basis

### 12.3.1 On the Basis of Time

There are two methods used in ascertainment of profit on the basis of time:

1. **On the basis of average profit of certain years:** Under this method, the calculation of profit is based on the average annual profit for the past few years say, 3 to 5 years. Then, the profit for the proportionate period is found out.

*Example:* X, Y and Z are partners sharing profits equally. Z dies on April 30, 2004. The accounts of the firm are closed on Dec. 31. The profits for the past 3 years are: 2001 - ₹ 35,000; 2002 - ₹ 40,000 and 2003 - ₹ 60,000. Calculate the Z's share of profit from 1st April to 30th April 2004.

*Solution:*

The average profit for the past three years:  $(₹ 35,000 + ₹ 40,000 + ₹ 60,000) \div 3 = ₹ 45,000$

Profit for 4 months up to April 30, 2004 =  $4/12 \times ₹ 45,000 = ₹ 15,000$

Z's share of Profit =  $₹ 15,000 \times 1/3 = ₹ 5,000$

2. **On the basis of last year's profit:** Calculation of profit is based on the last year's profit

*Example:* The total profit of previous year is ₹ 3,60,000 and a partner dies three months after the close of previous year, the profit of three months is:

=  $₹ 3,60,000 \times 3/12 = ₹ 90,000$

If the deceased partner took 2/10 share of profit, his/her share of profit till the date of death is:

$₹ 90,000 \times 2/10 = ₹ 18,000$

### 12.3.2 On the Basis of Turnover

Under this method, the share of profit is calculated on the basis of the profit and the total sales of the last year. Thereafter, the profit up to the date of death is estimated on the basis of the sale of the last year.

Profit is assumed to be earned uniformly at the same rate.

*Example:* A, B and C are partners sharing profits and losses in the ratio of 2 : 1 : 1. B dies on March 1, 2004. Sales for the year 2004 amount to ₹ 80,000, out of which ₹ 25,000 are for a period from January 1, 2004 to March 1, 2004. The profit for the year is ₹ 40,000. Calculate B's share of profit.

*Solution:*

The Profit up to the date of B's death =  $25,000 \div 80,000 \times 40,000 = 12,500$

B's share =  $12,500 \times 1/4 = 3,125$



(iv) Interest on capital is provided at 9% p.a.

(v) On 1<sup>st</sup> July 2007 her drawings account showed a balance of ₹ 20,000.

(vi) ₹ 25,950 are to be paid immediately to her executor and the balance is transferred to her Executors Loan Account.

Prepare Nutan's Capital Account and Nutan's Executor's Account as on 1<sup>st</sup> July 2007.

**Solution:**

(i) Valuation of Goodwill:

Total Profit = ₹ 25,000 + ₹ 20,000 + ₹ 40,000 + ₹ 35,000 = ₹ 1,20,000

Average Profit = ₹ 1,20,000/4 = ₹ 30,000

Hence, Goodwill at 2½ year's purchase = ₹ 30,000 × 2½ = ₹ 75,000

Nutan's share of goodwill = ₹ 75,000 × 5/10 = ₹ 37,500

It is adjusted into the Capital Accounts of Sumit and Shiba in the gaining ratio of 3 : 2 i.e., ₹ 22,500 and ₹ 15,000 respectively.

(ii) Share of Profit payable to Nutan [up to the date of death] = ₹ 35,000 × 6/12 × 5/10 = ₹ 8,750

(iii) Nutan's Share of Reserve Fund = ₹ 15,000 × 5/10 = ₹ 7,500

(iv) Interest on Nutan's Capital = ₹ 60,000 × 9/100 × 6/12 = ₹ 2,700

**Revaluation Account**

Dr.		Cr.	
Particulars	Amount (₹)	Particulars	Amount (₹)
To Plant	4,000	By Building	10,000
To Profit transferred to		By Stock	5,000
Nutan Capital	5,500		
Sumit Capital	3,300		
Shiba Capital	2,200		
	11,000		
	15,000		15,000

**Nutan's Capital Account**

Dr.		Cr.	
Particulars	Amount (₹)	Particulars	Amount (₹)
To Drawings	20,000	By Balance b/d	60,000
To Nutan's Executor's	1,01,950	By Reserve fund	7,500
		By Sumit's Capital (Goodwill)	15,000
		By Shiba's Capital (Goodwill)	22,500
		By Profit and Loss (Suspense)	8,750
		By Revaluation A/c	5,500
		By Interest on Capital	2,700
	1,21,950		1,21,950



## Nutan's Executor's Accounts

Dr.		Cr.	
Particulars	Amount (₹)	Particulars	Amount (₹)
To Bank	25,950	By Nutan's Capital	1,01,950
To Nutan's Executor's Loan Transfer	76,000		
	1,01,950		1,01,950

## 12.5 JOINT LIFE POLICY

The term Joint Life Policy means an insurance policy taken out by the partnership firm on the joint lives of all the partners. The amount of such a policy is payable by the Insurance Company either on death of any partner or on maturity whichever is earlier. The main objective behind taking out such a policy by the partnership firm is to mobilise funds to settle the claims of the deceased partner in case of death of a partner without affecting the Working Capital of the business. If any one of the partners covered by such a policy expires, the policy gets matured immediately and with the amount recovered from Insurance Company, the claim of the deceased partner is settled. However, it is important to note here that the profit arising out of such a policy should always be distributed to all the partners including the deceased partner in their profit-sharing ratio.

### What is Surrender Value?

Surrender Value (SV) is the amount payable by an insurance company on the surrender/discontinuation of joint life policy before the date of maturity. However, the surrender value keeps on increasing with the successive payment of premium.

## 12.6 ACCOUNTING TREATMENT FOR JOINT LIFE POLICY

There are two ways to record the Joint Life Policy transactions by the firm:

- Treated as an expense of firm:** Under this method, the premium paid is treated as a business expense. The premium is chargeable to the profit and loss account.

Accounting entries in the books of the firm will be as follows:

- For payment of premium:*

Joint life policy premium	Dr.
To Bank A/c	

- For transfer of premium paid to profit and loss account at the end of the year:*

Profit and loss A/c	Dr.
To Joint life policy premium	

On the maturity of the policy, if the death takes place before the due date of the premium, the premium will not be paid in the year of death. This would imply that entry for payment of premium would not be recorded. On maturity, the insurance policy will be surrendered to register the claim with the insurance company and sum assured will be collected.

For this, following entries are to be recorded:

- On the death of partner, for making claim with the insurance company*

Insurance Company/Insurance claim receivable A/c	Dr.
To Joint Life Policy	

(ii) *For Claim duly received from Insurance Co. on the date of receipt*

Bank A/c  
Dr.  
To Insurance Co./Insurance claim receivable A/c

(iii) *Claim due will be distributed among existing partners (including outgoing)*

Joint life policy  
Dr.  
To All partner's capital A/c (individually)

2. **When premium paid is treated as an asset at an amount equal to the surrender value of joint life policy:** In such a case, Joint Life Policy Account will appear in the books of the firm which must be shown as an asset in the Balance Sheet at its present value i.e., surrender value.

Following accounting entries are to be recorded in this case:

(i) *1st Year: On the date when policy is taken and premium is paid.*

Joint Life Policy  
Dr.  
To Bank A/c

(ii) *At the end of first year, the joint life policy account will show the balance which is equal to its surrender value. The difference between the premium paid and surrender value will be transferred to profit and loss account.*

Profit and loss A/c  
Dr.  
To Joint Life Policy

Amount = Surrender value in the previous year + Premium paid during the current year – Surrender value in the current year

Second year and onwards, the entries (i) and (ii) shall be repeated until the last year.

In the last year, i.e., the year of death, entry no. (i) will be recorded only if death takes place after the due date of premium and entry no. (ii) will not be recorded at all.

(iii) *On maturity of policy or in the event of death, entry for making the insurance claim will be:*

Insurance company A/c  
Dr.  
To Joint Life Policy

(iv) *On the date of receipt when insurance company pays the insurance claim due:*

Bank A/c  
Dr.  
To Insurance Company

(v) *Balance standing in Joint Life Policy account is distributed among all partners in profit sharing ratio.*

Balance in Joint Life Policy account – Total claim due – (Surrender value of the policy in the previous year + Premium paid during the current year)

**Example:** Jatin, Gagan and Kiran are equal partners have taken a Joint Life Policy of ₹ 60,000 on June 30, 1999 paying annual premium of ₹ 6,000. Surrender values for: 1999 - NIL; 2000 - ₹ 3,000; 2001 - ₹ 6,000; 2002 - ₹ 10,000; Gagan dies on July 3, 2002.

Record necessary entries for the year 2002:

- (i) If premium paid is transferred to profit and loss account every year.
- (ii) If premium paid is treated as an asset. Also prepare Joint Life Policy account for 2002.

**Solution:**

- (i) If premium paid is transferred to profit and loss account every year.

**Books of Jatin, Gagan and Kiran  
Journal**

Date 2002	Particulars	L.F.	Debit Amount (₹)	Credit Amount (₹)
Jun. 30	Joint Life Policy premium Dr. To Bank A/c (Premium paid on due date)		6,000	6,000
Jul. 3	Insurance company A/c Dr. To Joint life policy (On death, policy claim registered with insurance company)		60,000	60,000
Jul. 3	Joint Life Policy Dr. To Jatin's capital A/c To Gagan's capital A/c To Kiran's capital A/c (Policy claim received credited to partner in their profit sharing ratio)		60,000	20,000 20,000 20,000
Dec. 31	Profit and loss A/c Dr. To Joint Life Policy premium (Premium paid transferred to profit and loss account)		6,000	6,000

*Note:* It is assumed that the claim registered with insurance company will be received in due course of time.

- (ii) If premium paid is treated as an asset. Also prepare Joint Life Policy account for 2002.

**Books of Jatin, Gagan and Kiran  
Journal**

Date 2002	Particulars	L.F.	Debit Amount (₹)	Credit Amount (₹)
Jun. 30	Joint Life Policy Dr. To Bank A/c (Premium paid on due date)		6,000	6,000
July 3	Insurance Company A/c Dr. To Joint Life Policy (On death, policy claim registered with insurance company)		60,000	60,000
July 3	Joint Life Policy Dr. To Jatin's capital A/c To Gagan's capital A/c To Kiran's capital A/c (Balance in joint life policy account distributed to partners, i.e., 60,000 (6,000 × 6000) in profit sharing ratio)		48,000	16,000 16,000 16,000

### Joint Life Policy Account

Dr.

Cr.

Date 2003	Particulars	J.F.	Amount (₹)	Date 2003	Particulars	J.F.	Amount (₹)
Jan. 1	To Balance b/c		6,000*	July 3	By Insurance Co.		60,000
July 3	To Bank		6,000				
	To Jatin's capital		16,000				
	To Gagan's capital		16,000				
	To Kiran's capital		16,000				
			<b>60,000</b>				<b>60,000</b>

\* This amount is the balance of Joint Life Policy Account on the date of death, which is the surrender value of Joint Life Policy of previous year to the death, i.e., year 2001.

#### 12.6.1 Joint Life Policy Reserve A/c

When premium paid on joint life policy is treated as capital expenditure then a reserve may also be created equal to the surrender value. Then the joint life policy will be shown at its surrender value on the asset side of the Balance Sheet and Joint Life Policy Reserve account will be shown at the same amount on the liability side of the balance sheet. If on the admission of a partner it is decided not to show these two accounts in the books of accounts in future then these accounts will be closed by debiting joint life policy reserve account and crediting joint life policy account.

The following journal entry will be recorded.

Joint Life Policy Reserve A/c

Dr.

To Joint Life Policy

**Example:** On the admission of Rohit on April 1, 2003 in the firm of Ram and Shyam there existed a balance of ₹ 40,000 each in the joint life policy account and joint life policy reserve account. It was decided that these accounts will not be shown in the books of the new firm. Record the necessary journal entry for the same.

**Solution:**

#### Books of Ram, Shyam and Rohit

##### Journal

Date	Particulars	L.F.	Dr (₹)	Cr (₹)
April 1	Joint Life Policy Reserve A/c To Joint Life Policy (Joint life policy and joint life policy reserve accounts closed on Rohit's admission)	Dr.	40,000	40,000

**Example:** A, B, and C sharing profits and losses in the ratio 2 : 1 : 1 have taken a joint life policy for ₹ 100,000 with an annual premium of ₹ 1,000 on 1<sup>st</sup> January 2000. The surrender values estimated for the policy were:

31<sup>st</sup> Dec. 2000 - Nil;

31<sup>st</sup> Dec. 2001 - ₹ 300;

31<sup>st</sup> Dec. 2002 - ₹ 750

31<sup>st</sup> Dec. 2003 - ₹ 1,250

C died on 10<sup>th</sup> February 2003. The Insurance Company settled the claim on 15<sup>th</sup> Feb, 2003. Pass necessary journal entries and related ledger accounts keeping treating the

surrender value of the insurance policy as asset and maintaining a reserve against the policy.

**Solution:**

**First Year**

Date	Particulars	L.F.	Dr (₹)	Cr (₹)
Jan 1, 2000	Joint Life Policy A/c Dr. To Cash (Premium paid on the joint life policy)		1,000	1,000
31 <sup>st</sup> Dec., 2000	P and L Appropriation A/c Dr. To Joint Life Policy Reserve Account (Reserve created for the premium payment)		1,000	1,000
31 <sup>st</sup> Dec., 2000	Joint Life Policy Reserve Account A/c Dr. To Joint Life Policy Account (Balances in reserve and policy accounts eliminated by mutual transfer)		1,000	1,000

**Note:** There is no surrender value in the first year in the above example.

**Second Year**

Date	Particulars	L.F.	Dr (₹)	Cr (₹)
Jan 1, 2001	Joint Life Policy A/c Dr. To Cash (Premium paid on the policy)		1,000	1,000
31 <sup>st</sup> Dec., 2001	P&L Appropriation A/c Dr. To Joint Life Policy Reserve Account (Reserve created for the premium payment)		1,000	1,000
31 <sup>st</sup> Dec., 2001	Joint Life Policy Reserve Account A/c Dr. To Joint Life Policy Account (Both JLP and Reserve reduced to the surrender value by mutual elimination)		700	700

**Note:** Here the premium payment is 1,000, but Joint life policy and JLP reserve accounts will appear at 300 on the either side of the Balance Sheet.

**Third Year**

Date	Particulars	L.F.	Dr (₹)	Cr (₹)
Jan 1, 2002	Joint Life Policy A/c Dr. To Cash (Premium paid on the policy)		1,000	1,000
31 <sup>st</sup> Dec., 2002	P&L Appropriation A/c Dr. To Joint Life Policy Reserve Account (The reserve created against premium payment)		1,000	1,000
31 <sup>st</sup> Dec., 2002	Joint Life Policy Reserve Account A/c Dr. To Joint Life Policy Account (Both JLP and Reserve reduced to the surrender value by mutual elimination)		550	550

## Fourth Year

Date	Particulars	L.F.	Dr (₹)	Cr (₹)
Jan. 1. 2003	Joint Life Policy A/c Dr. To Cash (Premium paid on the policy)		1,000	1,000
10 <sup>th</sup> Feb. 2003	Insurance Claim A/c Dr. To Joint Life Policy Reserve Account (Insurance Claim credited to policy account)		1,00,000	1,00,000
10 <sup>th</sup> Feb. 2003	Joint Life Policy Reserve A/c Dr. To Joint Life Policy Account (Reserve account closed by transfer to policy account) Note: You can transfer the reserve directly to the capital accounts of partners.		750	750
10 <sup>th</sup> Feb. 2003	Joint Life Policy A/c Dr. To A's Capital To B's Capital To C's Capital (Joint Life policy closed by transfer to capital accounts)		1,00,000	39,600 39,600 19,800
15 <sup>th</sup> Feb. 2003	Bank A/c Dr. To Insurance Claim (Insurance claim settled)		1,00,000	1,00,000

## Joint Life Policy Account

Date	Particulars	Amount	Date	Particulars	Amount
1 <sup>st</sup> Jan. 2000	To Cash	1,000	31 <sup>st</sup> Dec. 2000	By JLP Reserve A/c	1,000
		1,000			1,000
1 <sup>st</sup> Jan. 2001	To Cash	1,000	31 <sup>st</sup> Dec. 2001	By JLP Reserve A/c	700
				By Balance c/d	300
		1,000			1,000
1 <sup>st</sup> Jan. 2002	To Balance b/d	300	31 <sup>st</sup> Dec. 2002	By JLP Reserve A/c	550
31 <sup>st</sup> Dec. 2002	To Cash	1,000		By Balance c/d	750
		1,300			1,300
1 <sup>st</sup> Jan. 2003	To Balance b/d	750	10 <sup>th</sup> Feb. 2003	By JLP Reserve	750
	To Cash	1,000		By Insurance Claim	1,00,000
10 <sup>th</sup> Feb. 2003	To A's Capital	39,600			
	To B's Capital	39,600			
	To C's Capital	19,800			
		1,00,750			1,00,750

**Joint Life Policy Reserve Account**

Date	Particulars	Amount	Date	Particulars	Amount
31 <sup>st</sup> Dec. 2000	To JLP Amount	1,000	31 <sup>st</sup> Dec. 2000	By P and L Appropriation	1,000
		1,000			1,000
31 <sup>st</sup> Dec. 2001	To JLP Account	700	31 <sup>st</sup> Dec. 2001	By P and L Appropriation	1,000
	To Balance c/d	300			1,000
		1,000			
31 <sup>st</sup> Dec. 2002	To JLP Account	550	1 <sup>st</sup> Jan. 2002	By Balance b/d	300
	To Balance c/d	750	31 <sup>st</sup> Dec. 2002	By P and L Appropriation	1,000
		1,300			1,300
10 <sup>th</sup> Feb. 2003	To JLP Account	750	1 <sup>st</sup> Jan. 2003	By Balance b/d	750
		750			750

**12.7 INDIVIDUAL LIFE POLICIES**

The firm may decide to take the insurance policy separately for each of the partners on their lives. For such insurance policies, if premium is paid by the firm, being a transaction of business, it becomes an asset of the firm. Whenever death of any partner occurs, policy matures, the firm makes a claim to the insurance company and claim so received is distributed among all the partners in the profit sharing ratio. The heir of deceased partner will be entitled to the proportionate share in the policy of deceased. Further, surrender values of the policies of other partners will be distributed among all the partners (including heir of deceased) in their profit sharing ratio. The Joint Life Policy will be shown in the Balance Sheet at its surrender value.

*Example:* X, Y and Z are partners in the ratio of 5 : 3 : 2. X died on 14<sup>th</sup> Aug. 2002. The firm had taken insurance policies on the lives of the partners, premium being charged to profit and loss account every year.

**The Policy amount and surrender value (on 14.08.2002)**

Particulars	Policy Amount (₹)	Surrender Value (₹)
Life Insurance Policies:		
X	60,000	25,000
Y	90,000	35,000
Z	60,000	15,000

Work out the amount payable to X's legal representatives regarding insurance policies. Record necessary journal entries.

**Solution:****Books of X, Y and Z**

Date	Particulars	L.F.	Dr (₹)	Cr (₹)
Aug.14	Insurance Company A/c To life policy (Claim for the policy registered)	Dr.	60,000	60,000
Aug.14	Bank A/c To insurance company A/c (Policy amount received on X's death)	Dr.	60,000	60,000
Aug.14	Life policy A/c To X's A/c To Y's A/c To Z's A/c (Amount of life policy transferred to capital A/c)	Dr.	60,000	30,000 18,000 12,000
Aug.14	Y's capital A/c Z's capital A/c To X's capital A/c (X's share credited to him in gaining ratio of 3 : 2)	Dr. Dr.	15,000 10,000	25,000

**Working Notes:**

- Surrender value of policies of Y and Z = ₹ 35,000 + ₹ 15,000 = ₹ 50,000
- X's share = ₹ 50,000 × 5/10 = ₹ 25,000.

**Check Your Progress**

Fill in the blanks:

- The rights of the legal representatives of the deceased partner depend on the provisions of the \_\_\_\_\_.
- Share of Joint Life Policy should be \_\_\_\_\_ in deceased partner's capital A/c.
- Interest on drawing due from deceased partner till the date of the death is \_\_\_\_\_ to his capital account.
- Under \_\_\_\_\_ method the calculation of profit is based on the average annual profit for the past few years say, 3 to 5 years.
- The profit can be calculated on the basis of \_\_\_\_\_.
- Claim received under individual life policy is distributed among all the partners in the \_\_\_\_\_ ratio.

**12.8 LET US SUM UP**

- The rights of the legal representatives of the deceased partner depend on the provisions of the partnership deed.
- The claim of the deceased partner is either paid immediately or transferred to Loan Account in the name of his legal representatives.



- The claim is usually determined on the same basis as that of a retired partner taking into account his share in the accumulated profits of the firm, goodwill, profit/loss on revaluation of assets/liabilities and so on.
- The key difference between the retirement and death of partner is that normally the retirement takes place at the end of an accounting period whereas death can occur at any time.
- If the death of a partner occurs during the year, the representatives of the deceased partner are entitled to his/her share of profits earned till the date of his/her death.
- Under this average profit method the calculation of profit is based on the average annual profit for the past few years say, 3 to 5 years.
- The profit can be calculated on the basis of last year's profit.
- Under turnover method, the share of profit is calculated on the basis of the profit and the total sales of the last year.
- After the death of a partner the total amount due to him is transferred to his executor's account and paid off as per the provisions of the partnership deed immediately or in installments together with interest on the unpaid balance.
- For the purpose of ensuring liquidity in the firm to settle the claim of the retiring/deceased partner an assurance policy is taken up by the partners on their lives collectively.
- The insurance company agrees to pay the sum assured (i.e., the amount for which the policy has been taken) to the firm on the maturity date.
- Maturity date is the date of death of any of the partners or the date on which the term of the policy expires, whichever is earlier.
- The firm in turn agrees to pay to the insurance company the amount of premium periodically.
- The amount of premium payable will be same in each of the years.
- Surrender Value (SV) is the amount payable by an insurance company on the surrender/discontinuation of joint life policy before the date of maturity.
- However, the surrender value keeps on increasing with the successive payment of premium.
- The firm may decide to take the insurance policy separately for each of the partners on their lives.
- Under individual life policy the heir of deceased partner will be entitled to the proportionate share in the policy of deceased.
- Further, surrender values of the policies of other partners will be distributed among all the partners (including heir of deceased) in their profit sharing ratio.

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## 12.9 LESSON END ACTIVITY

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X, Y and Z are partners sharing profits in the ratio of 3 : 2 : 1. Z dies on 31<sup>st</sup> May 2006. Sales for the year 2005-2006 amounted to ₹ 4,00,000 and the profit on sales is ₹ 60,000. Accounts are closed on 31 March every year. Sales from 1<sup>st</sup> April 2006 to 31<sup>st</sup> May 2006 is ₹ 1,00,000.

Calculate the deceased partner's share in the profit up to the date of death.

## 12.10 KEYWORDS

**Executors:** The representatives of the deceased partner who are entitled to claim his share.

**Gaining Ratio:** The ratio of the continuing partners inter se which has been purchased by them from the retiring or deceased partner.

**Joint Life Policy:** An insurance policy taken by the partnership firm on the joint lives of all the partners.

**Surrender Value:** Amount receivable from the insurance company on surrendering the policy before maturity.

## 12.11 QUESTIONS FOR DISCUSSION

- Accounting treatment in the event of death of the partner is on the same lines as that of the retirement of a partner except a few. What are those exceptions?
- A, B and C are partners sharing in the ratio of 5 : 3 : 2. B dies on June 30, 2002 i.e., three months after closing of the books Profits for three years:
 

2000 : ₹ 25,000

2001 : ₹ 20,000

2002 : ₹ 15,000

Find out B's share of profit on the date of death if as per terms of the agreement he was entitled to profit (i) on the basis of immediately preceding year's profits to the date of death (ii) on the basis of average profit of the preceding three years to the date of death.
- X, Y and Z are partners sharing profit in the ratio of 2 : 2 : 1. X dies on July 1, 2002 whereas books of accounts are closed on March 31<sup>st</sup> every year. Sales for the year 2001 amounts to ₹ 4,00,000 and that from April 1 to June 30, 2002 to ₹ 1,50,000. The profit for the year 2001 were calculated as ₹ 40,000. Calculate X's share of profits in the firm for 2002 on the basis of sales.
- Following is the Balance Sheet of the Pon, Kon and Bon as on March 31, 2003. They shared profits in the ratio of their capital.

**Balance Sheet  
as at March 31, 2003**

Liabilities	Amount (₹)	Assets	Amount (₹)
Sundry Creditors	4.600	Land and Building	23.400
Reserve	5.400	Plant and Machinery	13.000
Capital Account:		Stock	4.700
Pon     24.000		Sundry Debtors	6.500
Kon     12.000		Cash at Bank	5.600
Bon     8.000	44.000	Cash in Hand	800
	<b>54,000</b>		<b>54,000</b>

Pon died on June 30, 2003. Under the terms of partnership the executors of a deceased partner were entitled to:

- (a) Amount standing to the credit of the Partner's Capital Account.

- (b) Interest on Capital at 12% per annum.
- (c) Share of goodwill on the basis of four year's purchase of three year's average profits.
- (d) Share of Profit from the closing of the last financial year to the date of death on the basis of the last year's profit. Profit for the years 2001, 2002 and 2003 were respectively ₹ 8,000, ₹ 12,000 and ₹ 7,000.

Record the necessary journal entries and draw up Pon's account to be rendered to his executors and his executor's account, presuming that they are paid by raising bank loan.

5. M, N and C are in partnership, sharing profit in the proportion of 2/3, 1/6 and 1/6 respectively. To clear the dues of deceased partner an assurance was effected on their lives jointly for ₹ 10,000 without profit, at an annual premium of ₹ 650 to provide liquidity to the firm. C died on June 30, 2002, three months after the annual accounts had been prepared. In accordance with the partnership agreement, his share of the profits to the date of death was estimated on the basis of the profits for the preceding year. The agreement also provided for interest on capital at 10% per annum and also for goodwill, which was to be brought into account at two years' purchase of the average profits for the last three years, prior to charging the above mentioned insurance premiums. but after charging interest on capital. C's capital on March 31, 2002, stood at ₹ 10,000 and drawings from then to the date of death amounted to ₹ 2,000. The net profits of the business for the three preceding years amounted ₹ 3,350, ₹ 4,150 and ₹ 4,050, respectively, after charging interest on capital and insurance premiums. The premiums paid on policy are written off to Profit and Loss Account. You are instructed to prepare C's capital account as at the date of death and also prepare C's Executor's account.
6. Mansi and Puneet are in partnership sharing profits and losses 3 : 2. They insure their lives jointly for ₹ 75,000 at an annual premium of ₹ 4,400 charged to the business. Puneet dies three months after the date of the last Balance Sheet. According to the partnership deed, the legal representatives of Puneet are entitled to the following payments:
- (a) His capital as per the last Balance Sheet.
  - (b) Interest on above capital at 8% per cent per annum to date of death.
  - (c) His share of profit to date of death calculated on the basis of last three years profits.

His drawings are to bear interest at an average rate of 1 per cent on the amount irrespective of the period.

The net profits for the last three years, after charging insurance premium, were ₹ 20,000, ₹ 25,000 and ₹ 30,000 respectively. Puneet's capital as per balance sheet was ₹ 40,000 and his drawing to date of death were ₹ 2,000.

Draw Puneet account to be rendered to his representatives.

Pass the necessary journal entries for the settlement of executor's A/c.

7. Prepare the Proforma of capital A/c and explain the key elements.

9. Following is the balance sheet of Tony, Sony and Romy as on March 31, 2003

Liabilities	Amount (₹)	Assets	Amount (₹)
Sundry Creditors	16,000	Bills Receivable	16,000
General Reserve	16,000	Furniture	22,600
Capital Account:		Stock	20,400
Tony     30,000		Sundry Debtors	22,000
Sony     20,000		Cash at Bank	18,000
Romy     20,000	70,000	Cash in Hand	3,000
	<b>1,02,000</b>		<b>1,02,000</b>

Sony died on June 30, 2003. Under the terms of the partnership deed, the executors of a deceased partner were entitled to:

- Amount standing to the credit of the partner's capital account.
- Interest on capital at 5% per annum.
- Share of goodwill on the basis of twice the average of the past three years' profit. and
- Share of profit from the closing of the last financial year to the date of death on the basis of the last three year's profit.

Profits for 2001, 2002 and 2003 were ₹12,000, ₹16,000 and ₹14,000 respectively. Profits were shared in the ratio of capitals. Record the necessary journal entries and draw up Sony's Account to be rendered to his executors.

- List the key items that should be debited and credited to calculate the claim of deceased partner.
- Why the Joint Life Policy is needed? What are the different ways of treating Joint Life Policy in accounts?
- What is the objective of taking a joint life policy by the partners?
- What is the accounting treatment of the claim received on account of joint life policy from insurance company on the event of death of a partner?
- What is surrender value?
- Madhu and Shyam who shared profits in the ratio of 3 : 2 took out a Joint Life Policy on May 14, 1999 for ₹ 60,000. The annual premium was ₹ 8,500. The surrender value of the policy was: 1999 - NIL; 2000 - ₹ 4,500; 2001 - ₹ 8,000; and 2002 - ₹ 12,000. Madhu died on Nov 14, 2002 and the amount of the policy was received on Dec.1, 2002. The books are closed on December 31 each year. Give journal entries assuming that the firm treats premium paid as asset and maintains a Joint Life Policy Account at its surrender value. Also prepare Joint Life Policy account.
- Mahesh and Raj sharing profit in the ratio of 2 : 3, took out a Joint Life Policy on July 1, 1999 of ₹ 80,000 for paying annual premium of ₹ 8,000. The surrender values were 1999 - NIL; 2000 - ₹ 4,200; 2001 - ₹ 7,500; 2002 - ₹ 12,000. Raj died on March 18, 2002 and claim was received. Books are closed on calendar year basis. Prepare Joint Life Policy Account.
- Illustrate the different ways for accounting treatment of Joint Life Policy.

18. State the difference between joint life policy and individual life policy with a suitable example.
19. Pass necessary entries on maturity of the policy.
20. Prepare the proforma of Joint Life Policy A/c.

**Check Your Progress: Model Answer**

1. Partnership deed
2. Credited
3. Debited
4. Average profit
5. Last year's profit
6. Profit sharing

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**12.12 SUGGESTED READINGS**

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- M. P. Pandikumar, *Accounting & Finance for Managers*, Excel Books, New Delhi.
- R. L. Gupta and Radhaswamy, *Advanced Accountancy*.
- V. K. Goyal, *Financial Accounting*, Excel Books, New Delhi.
- Nitin Balwani, *Accounting & Finance for Managers*, Excel Books, New Delhi.

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## LESSON

# 13

## DISSOLUTION OF A PARTNER

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### 13.0 AIMS AND OBJECTIVES

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After studying this lesson, you should be able to:

- Distinguish between the Dissolution of Partnership and Firm
- Illustrate the Settlement of Accounts
- Discuss Garner v/s Murray Rule including Insolvency of Firm
- Define Piecemeal Distribution

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### 13.1 INTRODUCTION

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In the present lesson, you will study about the dissolution of partnership and firms. The lesson discusses about the dissolution of partnership and firm, settlement of accounts and accounting treatment. Section 39 of the Indian Partnership Act, 1932 provides that the dissolution of partnership between all the partners of a firm is called the "dissolution of the firm". It follows that if the dissolution of partnership is not between all the partners, it would not amount to "dissolution of firm", but it would nevertheless be "dissolution of partnership". Thus, dissolution of firm always implies

dissolution of partnership, but dissolution of partnership need not lead to dissolution of firm. Dissolution of partnership may involve merely a change in the relation of the partners and not the dissolution of the firm.

For example, where A, B and C were partners in a firm and C died or was adjudged insolvent, the partnership firm would come to an end; but if the partners had agreed that the death, retirement, insolvency of the partner would not dissolve the firm on the happening of these contingencies, the 'partnership' would certainly come to an end although the 'firm' or as the Act calls it, a 'reconstituted firm', might continue under the same name. Thus, a reconstitution of a firm involves a change in the relation of partners whereas in the case of dissolution of firm, there is complete severance of relationship between all partners.

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## 13.2 DISSOLUTION OF PARTNERSHIP AND FIRM

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Dissolution of partnership is different from the dissolution of a firm. As we discussed earlier that dissolution of partnership does not demand dissolution of the firm but dissolution of the firm means the dissolution of partnership.

### 13.2.1 Dissolution of Partnership

Dissolution of the partnership (owing to retirement, death or bankruptcy of a partner), merely involves change in the relation of the partners but it does not end the firm. The dissolution of partnership can be understood from the following points:

1. Dissolution of partnership means a contract among the partners to dissolve the partnership. This is because of the changes in the constitution of the partnership.
2. Partnership is created at will; similarly it can be wound up voluntarily.
3. If partnership is dissolved, the firm will not dissolve if the other partners desire to continue.
4. Dissolution of partnership requires the revaluation of assets and liabilities.
5. In dissolution of partnership the final settlement of accounts is not required.

### 13.2.2 Dissolution of Firm

On dissolution of the firm, the business of the firm stops its affairs and winds up by selling the assets and by paying the liabilities and discharging the claims of the partners. The dissolution of partnership among all partners of a firm is called dissolution of the firm.

The different methods of dissolution are as follows:

- (i) **By mutual consent:** Section 40 provides that a firm may, at any time, be dissolved with the consent of all the partners. This applies to all cases whether the firm is for a fixed period or otherwise.
- (ii) **By agreement:** Section 40 of the said act also provides for the dissolution of a firm in accordance with a contract between the partners. The contract providing for dissolution may have been incorporated in the partnership deed itself or in a separate agreement.
- (iii) **By the insolvency of all the partners but one:** If all the partners, or all the partners but one becomes insolvent, there is dissolution of the firm. Section 41 of the said act calls this as compulsory dissolution.
- (iv) **By business becoming illegal:** Section 41 provides that a firm is dissolved by the happening of any event which makes it unlawful for the business of the firm to be

carried on or for the partners to carry it on in partnership. But, if the partnership relates to more than one adventure, the illegality of one or more of them does not prevent the lawful adventure from being carried on by the firm.

- (v) **Partners becoming alien enemies:** Section 41 of the act also covers cases of partnership between persons some of whom become alien enemies by a subsequent declaration of war. In such a case partnership is dissolved, because trading with an alien enemy is against public policy. Section 41 covers cases of compulsory dissolution of firm by operation of law.
- (vi) **By notice of dissolution of partnership at will:** Section 43 provides that where the partnership is at will, a partner may give a notice in writing to the other partners of his intention to dissolve the firm. The notice must state the intention to dissolve the firm and be in writing. The firm is dissolved as from the date mentioned in the notice as the date of dissolution, or if no date is mentioned then from the date of communication of the notice.
- (vii) **Dissolution by Court (s.44):** At the suit of a partner, the court may dissolve a firm on any of the following grounds:
  - (a) *If a partner has become of unsound mind:* The application in this case may be made by any of the partners or by the next friend of the insane partner. In the case of insanity of a dormant partner, the court will not order dissolution, unless a very special case is made out for dissolution.
  - (b) *Permanent incapacity of a partner:* The court may order for dissolution of partnership, if a partner becomes permanently incapable of performing his duties as a partner. The application for dissolution, in such a case, may be made by any of the partners and not by the incapacitated partner. However, where a partner is attacked with paralysis which, on evidence, is found to be curable, dissolution may not be granted.
  - (c) *Misconduct of a partner affecting the business:* If a partner is guilty of conduct which is likely to affect prejudicially the carrying on of the business of the firm, the court may order dissolution. For example, A partner of a mercantile firm is engaged in speculation in cotton. This act may be regarded as a sufficient ground for dissolution of the firm.
  - (d) *Wilful and persistent disregard of partnership agreement by a partner:* If a partner wilfully and persistently commits a breach of the partnership agreement regarding management, or otherwise conducts himself in such a way that is not reasonably practicable for the other partners to carry on business in partnership with him, the court may order dissolution.
  - (e) *Transfer of interest or share by a partner:* If a partner transfers, in any way (e.g., by sale, mortgage or charge), his whole interest in the partnership to a third party (outsider) or allows his share to be charged in execution of a decree against him or allows the same to be sold for arrears of land revenue or for charges recoverable as land revenue, the court may dissolve the partnership.
  - (f) The court can also dissolve partnership where the business of the firm cannot be carried on save at a loss. The court can order dissolution even though the partnership is for a fixed period [Rehmat-un-nisa-v. Price, 42 Bom. 380].
  - (g) *Just and equitable:* The court can order dissolution on any other ground which in the opinion of the court is a fit ground for dissolution of partnership. Dissolution on this ground has been granted in case of deadlock in the



management, disappearance of the substratum of the business, partners not on speaking terms, etc.

**Table 13.1: Distinction between Dissolution of Partnership and Dissolution of Firm**

<b>Dissolution of Partnership</b>	<b>Dissolution of Firm</b>
A partnership is dissolved when a new partner is admitted or an old partner retires or dies.	A firm is dissolved by the partners mutually or by the court.
The business of the firm is not terminated.	The dissolution of the firm means the termination of Partnership business.
In the event of dissolution of partnership, assets and liabilities are revalued and new balance sheet is drawn.	In the event of dissolution of firm, assets are realized and liabilities are paid off.
Revaluation Account is prepared to ascertain the profit/loss on revaluation.	Realization Accounts prepared to ascertain the profit or loss on realization.
The dissolution of a partnership will create a new partnership.	The dissolution of a firm will not create a new partnership.

### 13.3 SETTLEMENT OF ACCOUNTS

Usually the Deed of Partnership contains an accounting clause according to which the final accounts between partners are settled. In the absence of such an agreement, s.48 provides as follows:

- The losses, including losses on capital, must be paid, first from profits, next out of capital and lastly, if necessary, by contribution of each partner in proportion to his share in profits.
- The assets of the firm, including sums contributed by partners to make up deficiency of capital, shall be applied as follows: (a) in paying debts of the firm to outsiders; (b) in paying each partner rateably for advances made by him to the firm as distinct from capital; (c) in paying each partner, rateably, amount due for capital contribution, and (d) the residue in paying each partner in accordance with his share in the profits of the firm.
- If a partner becomes insolvent or otherwise cannot pay his share of the contribution, the solvent partners must share rateably the available assets (including their own contribution to the capital deficiency), i.e., the available assets will be distributed in proportion to their original capital. This is called the rule in *Garner v. Murray (1904) Ch. 57*.

#### 13.3.1 Treatment of Firm's Debts and Private Debts

Under section 49 of the Indian Partnership Act, the following provisions shall apply in case a of firm's debts and private debts:

- The creditors of the firm (third party liabilities) should be paid out of the assets of the firm. If there is any surplus, it will be divided among the partners as per their claims which can be utilised for paying the private liabilities of the partners.
- Similarly, the private creditors of partners should be first paid out of the private assets of partners and if there is any surplus, it can be utilised for paying off the partnership debts.

#### 13.3.2 Accounting Treatment of Assets and Liabilities

As we discussed earlier that in case of dissolution of a partnership firm the business activities of a firm comes to an end and the firm gets dissolved. As soon as the partners decide to discontinue the business of the firm, it becomes necessary to settle

its accounts. For this purpose, all the assets have to be sold and the liabilities are to be paid off. For this purpose a separate account called 'Realisation Account' is opened.

***How to Prepare Realisation A/c?***

Realisation is an account in which assets excluding cash in hand and bank are transferred at their book value and all external liabilities are transferred at their book. The following entries are passed in the books to record the disposal of assets and discharge of liabilities:

1. ***For Transfer of assets:***

Realization A/c	Dr.
To Sundry Assets A/c	

(Transfer of assets)

It is to be noted that the following items on the assets side of the Balance Sheet are not transferred to the Realisation Account:

- (a) (i) Undistributed loss (i.e., Debit Balance of Profits and Loss account)
- (ii) Fictitious assets or deferred revenue expenditures such as preliminary expenses;
- (b) Cash in hand, and Cash at Bank, will be the opening balance of the Cash/Bank account.
- (c) Provisions and reserves against assets should be closed by crediting the Realisation Account.

2. ***For Transfer of Liabilities:***

External Liabilities A/c	Dr.
To Realization A/c	

(Transfer of external liabilities)

3. ***Treatment of Accumulated Reserves and Profit/loss***

All the balance of Reserve or Undistributed Profit, Reserve fund or other reserves are transferred to partner's capital account in their profit sharing ratio. The following entries are to be passed:

Reserve A/c	Dr.
Profit and Loss A/c	Dr.
Any Other fund A/c	Dr.
To Partner's Capital A/c	

(Transfer of profit and reserves)

4. ***For Sale of Assets***

Cash/Bank A/c	Dr.
To Realization A/c	

(Sale of assets)

5. ***For assets taken over by the partner***

Partner's Capital A/c	Dr.
To Realization A/c	

(Assets taken over by partner)



3. Expenses on dissolution amounted to 1,200 and were paid by partner B.
4. A typewriter, completely written off in the books of accounts, was sold for 400.
5. Loss on Realization 7,000 was to be distributed between A and B in the ratio of 5 : 2.

**Solution:****Journal Entries**

Sr. No.	Particulars	L.F.	Dr (₹)	Cr (₹)
1	Realization A/c To Cash/Bank A/c (Payment of bank loan)	Dr.	10,000	10,000
2	B's Capital A/c To Realization A/c (Stock taken over by partner A)	Dr.	5,000	5,000
3	Realization A/c To A's Capital A/c (Expenses on dissolution paid by partner B)	Dr.	1200	1200
4	Cash A/c To Realization A/c (Typewriter completely written off was sold for ₹ 400.)	Dr.	400	400
5	A's Capital A/c B's Capital A/c To Realization A/c (Loss on realization was distributed between A and B.)	Dr. Dr.	5000 2000	7000

**13.3.3 Treatment of Goodwill**

Section 55 provides that in settling the accounts of a firm after dissolution, goodwill shall, subject to contract between the partners, be included in the assets and it may be sold either separately or along with other property of the firm. Where the goodwill of a firm is sold after dissolution, a partner may carry on a business competing with that of the buyer and he may advertise such business but subject to agreement between him and the buyer, he may not (a) use the firm's name; (b) represent himself as carrying on business of the firm; or (c) solicit the custom of persons who were dealing with the firm before its dissolution.

Any partner may, upon the sale of goodwill of a firm, make an agreement with the buyer that such partner will not carry on any business similar to that of the firm within a specified period or within specified local limits. Such an agreement shall be void if the restrictions imposed are unreasonable.

There is nothing special in treatment of goodwill on dissolution of a firm. On dissolution of a firm:

- If goodwill appears in the Balance Sheet, it is treated like any other asset and is transferred to realization account.
- If goodwill does not appear in the balance sheet, no entry is passed for this.
- If something is realized or Goodwill is purchased by any one of the partners, then either Cash Account is debited or Partner's Capital A/c is debited and Realization Account is credited.



Assets were realized as follows:

Leasehold land	₹ 1,44,000
Furniture	₹ 45,000
Stock	₹ 81,000
Plant	₹ 96,000
Sundry debtors	₹ 21,000

The creditors were paid ₹ 51,000 in full settlement. Expenses of realization amounted to ₹ 6,000.

Show the ledger accounts to record the dissolution measures.

**Solution:**

**Books of X and Y**

Particulars	₹	Particulars	₹
To Sundry Assets		By Creditors	54,000
Sundry Debtors	24,000	By Loan	80,000
Plants	94,000	By Bank	
Stock	84,000	Sundry Debtors	21,000
Leasehold land	1,20,000	Plants	96,000
Furniture	<u>50,000</u>	Stock	81,000
To Bank A/c		Leasehold land	1,44,000
Creditors	51,000	Furniture	<u>45,000</u>
Loan	80,000		3,87,000
Realisation Exp.	<u>6,000</u>		
To profit on realisation			
X	6,000		
Y	<u>6,000</u>		
	3,72,000		
	1,37,000		
	12,000		
	<u>5,21,000</u>		<u>5,21,000</u>

**Partner's Capital Account**

Particulars	X (₹)	Y (₹)	Particulars	X (₹)	Y (₹)
To Bank A/c	1,36,000	1,36,000	By Balance b/d	1,20,000	1,20,000
			By Reserve fund	10,000	10,000
			By Profit on realization A/c	6,000	6,000
	<u>1,36,000</u>	<u>1,36,000</u>		<u>1,36,000</u>	<u>1,36,000</u>

**Bank Account**

Particulars	₹	Particulars	₹
To Balance b/d	22,000	By Realization A/c	1,37,000
To Realization A/c	3,87,000	By X's Capital A/c	1,36,000
		By Y's Capital A/c	1,36,000
	<u>4,09,000</u>		<u>4,09,000</u>

**Example:** The following is the Balance Sheet of Ram and Gopal as on 31<sup>st</sup> March, 2006.

Liabilities		₹	Assets		₹
Creditors		38,000	Bank		11,500
Mrs. Ram's Loan		10,000	Stock		6,000
Mrs. Gopal's Loan		15,000	Debtors		19,000
Reserve		5,000	Furniture		4,000
Capital			Plant		28,000
A	10,000		Investment		10,000
B	<u>8,000</u>	18,000	Profit and Loss A/c		7,500
		<b>86,000</b>			<b>86,000</b>

The firm was dissolved on 31<sup>st</sup> March, 2006 on the following terms:

1. A agreed to take the Investments at 8,000 and to pay off Mrs. Ram's Loan.
2. Other Assets were realized as follows:
  - Stock ₹ 5,000
  - Debtors ₹ 18,500
  - Furniture ₹ 4,500
  - Plant ₹ 25,000
3. Expenses on realization amounted to ₹ 1,600.
4. Creditors agreed to accept ₹ 37,000.

The profits and losses were shared in the ratio of 2:1. You are required to prepare realization A/c, Partner's capital A/c and Bank A/c.

**Solution:**

**Realization Account**

Particulars	₹	Particulars	₹
To Stock	6,000	By Creditors	38,000
To Debtors	19,000	By Mrs. Ram's Loan	10,000
To Furniture	4,000	By Mrs. Gopal's Loan	15,000
To Plant	28,000	By Ram's Capital A/c	
To Investment	10,000	(Investment)	8,000
To Ram's Capital A/c (Mrs. Ram's Loan)	10,000	By Bank	
To Bank (Expenses)	1,600	Stock	5,000
To Bank (Creditors)	37,000	Debtors	18,500
To Bank (Mrs. Gopal's Loan)	15,000	Furniture	4,500
		Plant	25,000
		By Loss on realization A/c	
		Ram's Capital	4400
		Gopal's Capital	<u>2200</u>
			6,600
	<b>1,30,600</b>		<b>1,30,600</b>

### Partner's Capital Account

Particulars	Ram (₹)	Gopal (₹)	Particulars	Ram (₹)	Gopal (₹)
To Realization A/c	8,000	-	By Balance b/d	10,000	8,000
To Profit and Loss A/c	5,000	2,500	By Mrs. Ram's Loan A/c	10,000	-
To Loss on realization A/c	4,400	2,200	By Reserve A/c	3,333	1,667
To Bank A/c	5,933	4,967			
	<b>23,333</b>	<b>9,667</b>		<b>23,333</b>	<b>9,667</b>

### Bank Account

Particulars	₹	Particulars	₹
To Balance b/d	11,500	By Creditors A/c	37,000
To Realization A/c	53,000	By Mrs. Gopal's Loan	15,000
		By Realization A/c (Cash Exp.)	1,600
		By Ram's Capital A/c	5,933
		By Gopal's Capital A/c	4,967
	<b>64,500</b>		<b>64,500</b>

## 13.4 GARNER V/S MURRAY RULE INCLUDING INSOLVENCY OF FIRM

In case one partner or more than one partners are insolvent and the remaining (solvent) are required to compensate the loss (deficiency) of insolvent partner/s, the problem arises as how to compensate that deficiency or in what ratio the solvent partners are required to compensate.

This deficiency is to be compensated in two ways: (1) This deficiency is to be shared by solvent partners in their profit sharing ratio like other business losses, or (2) to be shared according to Garner vs. Murray rule. According to this rule, the loss is to be shared among the solvent partners in the ratio of their opening capitals.

### *Examples illustrating the ruling in Garner vs. Murray:*

1. A, B and C were partners, sharing profits and losses equally, with capital contribution of ₹ 30,000, ₹ 15,000 and ₹ 3,000, respectively. On dissolution it is found that, after paying the debts of the firm and advances made by the partners, the assets are ₹ 21,000. Thus, the deficiency comes to ₹ 27,000 (i.e., total capital – assets), which is to be met by the partners equally. Now the total assets available are ₹ 48,000. This amount will be distributed rateably among the partners. However, in actual practice it will not be necessary for A and B to pay ₹ 9,000 each in cash but notional adjustment may be made so that C, whose capital contribution was only ₹ 3,000 will have to pay ₹ 6,000. Now the total assets available for distribution between A and B would be ₹ 21,000 + ₹ 6,000 = ₹ 27,000, A getting ₹ 21,000 and B ₹ 6,000.
2. Sometimes it so happens that one or more of the partners is insolvent and so cannot contribute anything towards the deficiency. Thus, in the above case if C is insolvent and nothing can be recovered from him, the assets will be distributed as follows: A and B will bring in their share of deficiency, increasing the assets from ₹ 21,000 to ₹ 39,000. The total assets would be distributed between A and B in their capital ratio, i.e., 2:1. A will get ₹ 26,000 and B ₹ 13,000. Thus, A on the whole will lose ₹ 13,000 and B ₹ 11,000. This settlement of accounts is in accordance with the rule laid down in Garner vs. Murray. From the calculations it is obvious that the remaining partners are suffering loss in accordance with the



amount of capital contributed. Thus, A suffers more loss than B even though they are sharing profits and losses equally.

3. The principle enunciated above will also apply if C in the case mentioned in illustration above, though not insolvent, fails to contribute his share of the deficiency. Out of the total amount of ₹ 21,000, A will get ₹ 17,000 and B ₹ 4,000. The court will pass a decree for ₹ 4,000 in favour of A against C and for ₹ 2,000 in favour of B against C.

**Example:** Long, Short and Thin were carrying on business in partnership sharing profits and losses in the ratio of 3 : 2 : 1 respectively. They decided to dissolve the firm on 31<sup>st</sup> December, 2006 on which date their Balance Sheet stood as follows:

Liabilities	₹	Assets	₹
Creditors	47,000	Land and Buildings	57,000
Long's Loan A/c	10,000	Stock	50,000
Capital Accounts		Debtors	50,000
Long 90,000		Cash	3,000
Short 10,000		Profit and Loss A/c	1,500
Thin 10,000	1,10,000	Short's Current A/c	2,000
Long's Current A/c	1,500	Thin's Current A/c	5,000
	<b>1,68,500</b>		<b>1,68,500</b>

Land and Buildings were sold for 40,000 and Stock and Debtors realized 30,000 and 42,000 respectively. The Goodwill was sold for 600, the expenses of realization amounted to 1,200. Thin is insolvent and a final dividend of 50 paise a rupee is received from his estate in full settlement.

Prepare the necessary accounts closing the books of the firm applying the ruling given in Garner vs. Murray.

**Solution:**

#### Realization Account

Particulars	₹	Particulars	₹
By Sundry Assets:		By Sundry Creditors	47,000
Land and Buildings	57,000	By Cash A/c	
Stock	50,000	Sale of Land and Buildings	40,000
Debtors	50,000	Stock	30,000
To Cash (Expenses)	1,200	Debtors	42,000
To Cash (Sundry Creditors)	47,000	Goodwill	600
		By Loss on Realization	
		Long 22,800	
		Short 15,200	
		Thin 7,600	45,600
	<b>2,05,200</b>		<b>2,05,200</b>

## Partner's Capital Accounts

Particulars	Long (₹)	Short (₹)	Thin (₹)	Particulars	Long (₹)	Short (₹)	Thin (₹)
To Profit and Loss A/c	750	500	250	By Balance b/d	90,000	10,000	10,000
To Short's Current A/c	-	2,000	-	By Long's Current A/c	1,500	-	-
To Thin's Current A/c	-	-	5,000	By Cash A/c	-	7,842	1,425
To Loss on Realization	22,800	15,200	7,600	By Long's Capital A/c	-	-	1,283
To Thin's Capital	1,283	142	-	By Short's Capital A/c	-	-	142
To Cash A/c	66,667	-	-				
	<b>91,500</b>	<b>17,842</b>	<b>12,850</b>		<b>91,500</b>	<b>17,842</b>	<b>12,850</b>

## Cash Account

Particulars	₹	Particulars	₹
To Balance	3,000	By Realization (Expenses)	1,200
To Realization (Sale of assets)	1,12,600	By Sundry Creditors	47,000
To Short's Capital	7,842	By Long's Loan A/c	10,000
To Thin's Capital	1,425	By Long's Capital A/c	66,667
	<b>1,24,867</b>		<b>1,24,867</b>

**Example:** The following is the Balance sheet of A, B and C on December 31, 2007:

Liabilities	₹	Assets	₹
Creditors	20,000	Cash	6,000
Reserve Fund	15,000	Stock	20,000
A's Capital	25,000	Plants and Tools	20,000
B's Capital	15,000	Sundry Debtors	10,000
		Bills Receivable	10,000
		C's Capital Overdrawn	9,000
	<b>75,000</b>		<b>75,000</b>

C is insolvent but his estate pays 2,000. It is decided to wind up the partnership. The assets realized as follows:

	(₹)
Sundry Debtors	7,500
Bills Receivable	7,000
Stock	16,000
Plant & Tools	14,000
The cost of winding up came to	2,500

Give accounts to close the books of the firm taking the capitals as fixed.

**Solution:**

**Dissolution A/c**

Particulars	₹	Particulars	₹
To Stock	20,000	By Sundry Debtors	7,500
To Plant and Tools	20,000	To Bills Receivable	7,000
To Sundry Debtors	10,000	To Stock	16,000
To Bill Receivables	10,000	To Plant and Tools	14,000
To Cash (cost of winding up)	2,500	To Loss on Dissolution	
		A           6,000	
		B           6,000	
		C <u>6,000</u>	18,000
	<b>62,500</b>		<b>62,500</b>

**Partner's Current A/c**

Particulars	A (₹)	B (₹)	C (₹)	Particulars	A (₹)	B (₹)	C (₹)
To Loss on Dissolution	6,000	6,000	6,000	By Reserve Fund	5,000	5,000	5,000
To C's Capital A/c	-	-	9,000	By Cash A/c	-	-	2,000
To C's Current A/c (1)	5,000	3,000	-	By A's Current A/c	-	-	5,000
				By B's Current A/c	-	-	3,000
				By Cash A/c	6,000	4,000	-
	<b>11,000</b>	<b>9,000</b>	<b>15,000</b>		<b>11,000</b>	<b>9,000</b>	<b>15,000</b>

**Cash A/c**

Particulars	₹	Particulars	₹
To Balance b/d	6,000	By Expenses of winding up	2,500
To C's Current A/c	2,000	By Creditors A/c	20,000
To A's Current A/c	6,000	By A's Capital A/c	25,000
To B's Current A/c	4,000	By B's Capital A/c	15,000
To Realization A/c (Dissolution A/c)			
Sundry Debtors A/c	7,500		
Bills Receivable A/c	7,000		
Stock A/c	16,000		
Plants and Tools A/c	14,000		
	<b>62,500</b>		<b>62,500</b>

**13.5 PIECEMEAL DISTRIBUTION**

As we discussed in the previous section it was assumed that all the assets were realized on the date of dissolution and accounts settled on the same date. However, the process of realizing the assets takes a long time and cash is distributed as and when it is realized. Such a process of gradual distribution of money is known as "Piecemeal Distribution".

The following are the key methods for distribution of cash under piecemeal distribution:

1. **Proportionate Capital Method:** If the capitals of the partners are in the ratio of their profit sharing arrangement, then each of them is paid out according to his capital ratio at each distribution. If the capitals of the partners are not in the profit sharing ratio then the first cash available (after making payment of outside liabilities and loans due to the partners) for distribution amongst the partners should be paid to those partners whose capitals are more than their profit sharing ratio so as to bring their capitals to their profit sharing levels. After this the cash available is distributed amongst all partners according to their profit sharing ratio.

The unpaid balance of capital accounts will represent loss on realization and this loss will be exactly in their profit sharing ratio.

*Example:* A, B and C are partners having capital of ₹20,000; ₹10,000 and ₹5,000. The profit sharing ratio of A, B and C is 2:2:1 respectively. Calculate the surplus capital.

Statement Showing Surplus Capital

	A	B	C
Profit sharing ratio	2	2	1
Actual Capital	20,000	20,000	5,000
Capital's of partner's on the basis of C's capital (C is having the least capital)	10,000	10,000	10,000
Surplus Capital	10,000	-	-

*Note:* After paying the surplus capital to A, the remaining capital should be distributed among all the partners among their capital sharing ratio of 2:2:1.

2. **Maximum Loss Method:** An alternative method of piecemeal distribution amongst partner is to calculate the maximum possible loss on every realization after the outside liabilities and the partners' loan has been paid. The amount available for distribution amongst partners is compared with the total amount of capital payable to the partners and the maximum loss is ascertained on the assumption that in future assets will not realize any amount. The maximum possible loss so ascertained is deducted from the capital balances of the partners in their profit and loss sharing ratio and the balance left in the capital account after deducting the maximum possible loss will be the amount payable to the partner.

If a partner's share of maximum possible loss is more than the amount standing to the credit of his capital account, he should be treated as insolvent and his deficiency should be debited to the capital accounts of the solvent partners in the proportion of their capitals which stood on the dissolution date as stated under the Garner v/s. Murray Rule. The amount standing to the credit of the partners after debiting their share of maximum loss and their share of insolvent partners' deficiency will be equal to the cash available for the distribution amongst the partners.

This process of maximum possible loss is repeated on each realization till all the assets are disposed.

*Example:* The partners A, B and C have called you to assist them in winding up the affairs of their partnership on 30<sup>th</sup> June, 2005. Their Balance Sheet as on that date is given on next page.

Liabilities	₹	Assets	₹
Sundry Creditors	17,000	Cash at Bank	6,000
Capital Accounts:		Sundry Debtors	22,000
A     67,000		Stock in trade	14,000
B     45,000		Plant and Equipment	99,000
C <u>31,500</u>	1,43,500	Loan-A	12,000
		Loan-B	7,500
	<b>1,60,500</b>		<b>1,60,500</b>

- (1) The partners share profit and losses in the ratio of 5:3:2.
- (2) Cash is distributed to the partners at the end of each month.
- (3) A summary of liquidation transactions are as follows:

**July 2005**

- ₹ 16,500 - collected from Debtors; balance is uncollectable.
- ₹ 10,000 - received from sale of entire stock.
- ₹ 1,000 - liquidation expenses paid.
- ₹ 8,000 - cash retained in the business at the end of the month.

**August 2005**

- ₹ 1,500 – liquidation expenses paid. As part payment of his Capital, C accepted a piece of equipment for ₹ 10,000 (book value ₹ 4,000).
- ₹ 2,500 – cash retained in the business at the end of the month.

**September 2005**

- ₹ 75,000 – received on sale of remaining plant and equipment.
- ₹ 1,000 – liquidation expenses paid. No cash retained in the business.

Prepare a schedule of cash payments as of September 30, showing how the cash was distributed.

**Solution:**

**Statement showing Distribution of Cash**

	Creditors		Capitals		
	₹	₹	A(₹)	B(₹)	C(₹)
Balance Due		17,000	55,000	37,500	31,500
July					
Balance available	6,000				
Realisation less expenses and cash retained	17,000				
Amount available and paid	23,500	17,000			6,500
Balance due		-	55,000	37,500	25,000
August					
Opening balance	8,000				
Expenses paid and balance carried forward	4,000				
Available for distribution	4,000				
Cash paid to 'B' and					
Equipment given to C			-	4,000	10,000
(Excess paid to 'C' ₹ 7,333)					

Contd..

September				
Opening balance	2,500		55,000	33,500
Amount realized less expenses	74,000			15,000
Amount paid to partner	76,500		41,500	25,400
			13,500	8,100
				5,400

**Working Note:**

**(i) Highest Relative Capital Basis**

	A ₹	B ₹	C ₹
Scheme of payment for July			
Balance of Capital Accounts	67,000	45,000	31,500
Less: Loans	12,000	7,500	
	55,000	37,500	31,500
Profit sharing ratio	5	3	2
Capital Profit sharing ratio	11,000	12,500	15,750
Capital in profit sharing ratio taking			
A's Capital as base	55,000	33,000	22,000
Excess of C's Capital and B's Capital		4,500	9,500
Excess of C's Capital over B		(9,500-3,000)	6,500

**(ii) Scheme of distribution of available cash**

	A	B	C
Scheme of payment for September			
Balance of Capital Accounts	55,000	33,500	15,000
Profit Sharing Ratio	5	3	2
Capital/Profit sharing Ratio	11,000	11,167	7,500
Capital in profit sharing ratio taking			
C's Capital as base	37,000	22,500	15,000
Excess of A's Capital and B's Capital	17,500	11,000	
Excess in profit sharing Ratio taking			
A's excess as base	17,500	10,500	
Excess	-	500	-
Payment ₹ 500		(500)	
Balance of Excess	17,500	10,500	
Payments ₹ 28,000	(17,500)	(10,500)	
Balance	37,500	22,500	15,000
Payments ₹ (76,500 - ₹ 28,500) ₹ 48,000	(24,000)	(14,000)	(9,600)
Loss	13,500	8,100	5,400
Total payment ₹ 76,500	41,500	25,400	9,600

**Example:** The following is the Balance Sheet of A. B. C on 31<sup>st</sup> December, 2005 when they decided to dissolve the partnership:

Liabilities	₹	Assets	₹
Creditors	2,000	Sundry Assets	48,500
A's Loan	5,000	Cash	500
Capital Accounts:			
A	15,000		
B	18,000		
C	9,000		
	<b>49,000</b>		<b>49,000</b>

The assets realized the following sums in instalments:

I	1,000
II	3,000
III	3,900
IV	6,000
V	<u>20,100</u>
	<u>34,000</u>

The expenses of realization were expected to be ₹ 500 but ultimately amounted to 400 only. Show how at each stage the cash received should be distributed between partners. They share profits in the ratio of 2:2:1.

**Solution:**

First of all, the following table will be constructed to show the amounts available for distribution among the various interests:

**Statement showing Realization and Distribution of Cash Payments**

	Realization (₹)	Creditors (₹)	Partners' Loan (₹)	Partners' Capitals (₹)
1. After taking into account cash balance and amount set aside for expenses	1,000	1,000	-----	-----
2.	3,000	1,000	2,000	-----
	3,900	-----	3,000	900
	6,000	-----	-----	6,000
Including saving in expenses	20,100	-----	-----	20,100
	<b>34,000</b>	<b>2,000</b>	<b>5,000</b>	<b>27,000</b>

To ascertain the amount distributable out of each installment realized among the partners, the following table will be constructed:

**Statement of Distribution on Capital Account**

	Total (₹)	A(₹)	B(₹)	C(₹)
<b>(1) Calculation to determine the mode of distribution of 900</b>				
Balance	42,000	15,000	18,000	9,000
Less: Possible loss, should remaining assets prove to be worthless	41,100	16,440	16,440	8,220
Deficiency of A's capital written off against those of B and C in the ratio of their capital, 18,000 : 9,000 (Garner vs. Murray)	+900	- 1,440	+ 1,560	+ 780
Manner in which the first ₹900 should be distributed			960	480
<b>(2) Distribution of 6,000</b>			+ 600	+ 300
Balance after making payment of amount shown in step (1)				
Less:	41,100	15,000	17,400	8,700
Possible Loss assuming remaining asset to be valueless	35,100	14,040	14,040	7,020
Balance available and to be distributed	6,000	960	3,360	1,680
<b>(3) Distribution of ₹ 20,100</b>				
Balance after making payment of amount shown in step (2)	35,100	14,040	14,040	7,020
Less: Possible loss, assuming remaining assets to be valueless	15,000	6,000	6,000	3,000
Manner of distribution of ₹ 20,100	20,100	8,040	8,040	4,020
<b>Summary:</b>				
Balance	42,000	15,000	18,000	9,000
Total amounts paid	27,000	9,000	12,000	6,000
<b>Loss</b>	15,000	6,000	6,000	3,000

**Check Your Progress**

Fill in the blanks:

1. Dissolution of partnership does not demand dissolution of the \_\_\_\_\_.
2. Dissolution of partnership requires the \_\_\_\_\_ of assets and liabilities.
3. A process of gradual distribution of money is known as \_\_\_\_\_.
4. The unpaid balance of \_\_\_\_\_ will represent loss on realisation and this loss will be exactly in their profit sharing ratio.
5. If a partner's share of maximum possible loss is more than the amount standing to the credit of his capital account, he should be treated as \_\_\_\_\_.
6. In case when the business becomes illegal there will be \_\_\_\_\_ of the firm.



### 13.6 LET US SUM UP

- The dissolution of a firm implies the discontinuance of the partnership business and separation of economic relation between the partners.
- In the case of a dissolution of a firm, the firm closes its business altogether and realizes all its assets and settles all liabilities.
- The payment is made to the creditors, first out of profits and assets realized, next out of the contributions made by the partners in their profit sharing ratio.
- When the final payment is made to the partners for their due share, the books of the firm are closed.
- The Realization Account is prepared to record the transactions relating to sale and realization of assets and settlement of creditors.
- Any profit or loss arising out of this process is shared by the partners in their profit sharing ratio.
- Partners are paid off in the final settlement, if any sum is due to them. At the end Cash/Bank Account is closed by making payment to partners.
- The process of realizing the assets takes a long time and cash is distributed as and when it is realized.
- Such a process of gradual distribution of money is known as “Piecemeal Distribution”.
- If the capitals of the partners are in the ratio of their profit sharing arrangement, then each of them is paid out according to his capital ratio at each distribution.
- Maximum Loss Method is an alternative method of piecemeal distribution amongst partner is to calculate the maximum possible loss on every realization after the outside liabilities and the partners’ loan has been paid.

### 13.7 LESSON END ACTIVITY

Take any practical example of a firm dissolution from the market and analyse it.

### 13.8 KEYWORDS

**Dissolution:** Dissolution means the undoing or breaking of a bond tie.

**Realization A/c:** The account in which all the assets and liabilities of the dissolved firm are transferred.

**Revaluation A/c:** Revaluation account is prepared when the firm is constituted.

### 13.9 QUESTIONS FOR DISCUSSION

1. Dissolution of partnership does not demand dissolution of the firm but dissolution of the firm means the dissolution of partnership. Discuss.
2. A, B, C and D are partners sharing 4:3:2:1. Their position statement was as follows:

Liabilities	₹	Assets	₹
Bank Loan	20,000	Cash	1,500
Creditors	40,000	Building	44,000
A's Capital	30,000	Stock	60,000
B's Capital	20,000	C's Capital	3,500
		D's Capital	1,000
	<b>1,10,000</b>		<b>1,10,000</b>

The firm is dissolved. All assets realized ₹82,000. All outside liabilities paid ₹58,500 in full satisfaction. Outstanding creditors are also paid ₹500. The expenses of dissolution are ₹600. D becomes insolvent and C paid only ₹3,000. Prepare ledger accounts to close the books of the firm.

3. D, E and F were partners. Their profit sharing ratio was 3:2:1. They dissolved their firm. The Balance Sheet on that date was as follows:

Liabilities	₹	Assets	₹
D's Capital	34,000	Plant	30,000
E's Capital	23,000	Machine	13,850
F's Capital	1,500	Stock and Debtors	25,200
E's Capital	1,000	Cash	6,550
Bills Payable	7,550		
Profit and Loss Account	8,550		
	<b>75,600</b>		<b>75,600</b>

Assets were sold for ₹ 50,100. Realization expenses were ₹ 300. F became insolvent and only ₹ 512 were received from him.

Prepare necessary ledger accounts following the rule of Garner vs. Murray's Case.

4. A, B and C sharing profit as 6:2:2 decided to dissolve their firm on 31-12-2007 when their position was as follows:

Liabilities	₹	Assets	₹
Capital		Sundry	5,100
A	8,250	Stock	2,340
B	3,000	Furniture	300
C	<u>2,100</u>	Debtors	7,260
Sundry creditors	1,800	Less: Provision for doubtful debts	<u>360</u>
Loan	450	Cash in hand	960
	<b>15,600</b>		<b>15,600</b>

It was agreed that:

- A is to take furniture at ₹ 240 debtors amounting to ₹ 6,000 at ₹ 5,160 and also the creditors at their book value.
- B agreed to take over stock at ₹ 2,100 and a part of the sundry assets at ₹ 2,160 (being book value less 10%).
- C agreed to take remaining sundry assets at 90% if their book value less 30 as allowance. He also assumed the responsibility for the payment of loan together with accrued interest of 9 (not recorded in the books).
- Dissolution expenses amounted to 181.
- The remaining debtors were sold to a Debt collecting Agency at 50% of the book value. Close the books of the firm with the help of ledger account.

5. P, Q and R were partners in a firm sharing profits in the ratio of 1:2:2. Their Balance Sheet on 31<sup>st</sup> December 2006 was as follows:

**Balance Sheet of P, Q and R  
as on 31<sup>st</sup> December 2006**

Liabilities	Amount (₹)	Assets	Amount (₹)
Accounts payable A/c	15,000	Land and building A/c	47,000
Bank overdraft A/c	12,000	Office equipment A/c	8,000
Q's loan A/c	18,000	Stock A/c	56,000
Joint life insurance		Accounts receivable A/c	18,000
Policy reserve	15,000	Joint life insurance policy A/c	15,000
Capitals:		Bank A/c	16,000
P      20,000			
Q      40,000			
R <u>40,000</u>	1,00,000		
	<u>1,60,000</u>		<u>1,60,000</u>

Partners agreed to dissolve the firm on that date. You are given the following information about dissolution:

- (a) The Joint Life Insurance Policy was surrendered for 9,000
- (b) Office equipment were accepted by a creditor for 7,000 in full settlement. The remaining creditors were paid in full by cheques.
- (c) Assets realized as follows:
 

Land and Buildings	₹ 1,20,000
Stock	₹ 40,000
Accounts Receivable	₹ 15,000
- (d) Other liabilities were paid in full.
- (e) Dissolution expenses amounted to ₹ 3,000

You are required to prepare realization account, bank account and capital of the partners.

The following Balance Sheet of A, B, C and D as on 31.3.2006 is presented to you.

Liabilities	(₹)	Assets	(₹)
Creditors	20,000	Sundry Assets	30,000
B's Loan	5,000	Cash at Bank	1,000
Capitals		P and L A/c	15,000
A's	10,000	Drawings:	
B's	6,000	B	2,000
C's	6,000	C	2,000
D's	3,000		
	<u>50,000</u>		<u>50,000</u>

They shared profits and losses in the ratio of 2:3:3: 2 respectively. The position of partners on the date of dissolution was as follows:

Particulars	Private Estate	Private Liabilities
A	10,000	15,000
B	20,000	6,000
C	5,000	4,000
D	8,000	9,000

The assets realized 26,000 and expenses of dissolution came to 1,000. Prepare ledger accounts giving effect to the dissolution.

7. Explain Garner vs. Murray rule.
8. Write a short note on accounting treatment of goodwill.
9. A, B and C sharing profits and losses in the proportion of 3:2:1. Their Balance Sheet was as follows:

Liabilities	Amount	Assets	Amount
Creditors	50,000	Land and Buildings	70,000
A's Loan A/c	10,000	Plant and Machinery	40,000
A's Capital A/c	50,000	Stock	25,000
B's Capital A/c	10,000	Debtors	20,000
C's Capital A/c	40,000	Cash	5,000
	<b>1,60,000</b>		<b>1,60,000</b>

The partnership is dissolved and the Assets are realized as follows:

1 <sup>st</sup> Realization	40000
2 <sup>nd</sup> Realization	30000
3 <sup>rd</sup> Realization	54000
4 <sup>th</sup> Realization	7000

Prepare a statement showing how the distribution should be made by using proportionate capital method.

10. M, N and O were partners in a firm sharing profits and losses in the ratio of 2:1:1 respectively on the date of dissolution their balance sheet was as follows:

Liabilities	Amount	Assets	Amount
Creditors	28,000	Sundry Assets	80,000
L's Capital A/c	20,000		
M's Capital A/c	20,000		
O's Capital A/c	12,000		
	<b>80,000</b>		<b>80,000</b>

The assets realized ₹ 68,000 and it was received in installments of ₹ 28,000, ₹ 20,000 and ₹ 20,000. Prepare a statement showing distribution of cash by using proportionate capital method.

**Check Your Progress: Model Answer**

1. Firm
2. Revaluation
3. Piecemeal distribution
4. Capital accounts
5. Insolvent
6. Compulsory dissolution

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**13.10 SUGGESTED READINGS**

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M. P. Pandikumar, *Accounting & Finance for Managers*, Excel Books, New Delhi.

R. L. Gupta and Radhaswamy, *Advanced Accountancy*.

V. K. Goyal, *Financial Accounting*. Excel Books, New Delhi.

Nitin Balwani, *Accounting & Finance for Managers*, Excel Books, New Delhi.