**Syllabus**

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| --- | --- |
| UNIT – I  | Definition nature and objectives financial accounting basic concepts and principles of accounting double entry system- maintenance of journal and ledger, subsidiary books and preparation of trial balance. |
| UNIT – II  | Errors and their rectification, preparation of final accounts.Manufacturing, trading profit and loss account and balance sheet with adjustment methods of depreciation (As per accounting standard-6) |
| UNIT – III  | Hire purchase and installment purchase system bank, Reconciliation statement, consigned accounts. |
| UNIT – IV  | Branch Accounts, Departmental Account, Bill of Exchange Discounting of Bills, Royalty Accounts. |
| UNIT – V  | Partnership Accounts: meaning partnership, partnership deed, Accounting for admission, Retirement death of partners. Dissolution of partnership firm. |

**Unit-I**

**FUNDAMENTAL PRINCIPLES OF FINANCIAL ACCOUNTING**

According to American Institution of Certified Public Accountant Committee:-

“Accounting as 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”.

From the above definition, it can be said that “Accounting is science of recording and classifying trading transaction of financial nature and is an art in which financial results are summarized and interpreted.”

**Characteristics of Accounting**

1. Accounting is science as well as an art.
2. The transaction and events relating to financial nature are recorded in it.
3. All transaction and events are recorded in monetary terms.
4. It maintain complete, accurate, permanent and legible records of all transaction in a systematic manner.
5. It analyses the results of all the transaction in detail.

**Objectives of Accounting**

**1. To Maintain a Systematic Record**

Accounting is done to maintain a systematic record of the monetary transactions of the firm which is the initial step leading to the creation of the financial statements. Once the recording is complete, the records are classified and summarized to depict the financial performance of the enterprise.

**2. To Ascertain the Performance of the Business**

The income statement also known as the profit and loss account is prepared to reflect the profits earned or losses incurred. All the expenses incurred in the course of conducting the business are aggregated and deducted from the total revenues to arrive at the profit earned or loss suffered during the relevant period.

**3. To Protect the properties of the Business**

The information about the assets and liabilities with the help of accountancy, provides control over the resources of the firm, because accounting gives information about how much the business has to pay to others ? And how much the business has to recover from others?

**4. To Facilitate Financial Reporting**

Accounting is the precursor to finance reporting. The vital liquidity/solvency position is comprehended through the Cash and Funds Flow Statement elucidating the capital transactions.

**5. To Facilitate Decision making**

Accounting facilitates in decision making. The American Accounting Association has explained this while defining the term accounting, it says accounting is, the process of identifying measuring and communicating economic information to permit informed judgments and decisions by users of the information.

**Accounting As Science and Art**

Accounting is both a science and an art. Science as well we know is the systematical body of knowledge establishing relationship between causes and their effects. In other words, science has its own concepts, assumptions and principles which are universal and verifiable. Accounting as discipline has also its own assumptions, concepts and principles, which have got universal application. Accounts have systematically and scientifically developed accounting equation and rules of debit and credit. It makes accounting, Science.

Art is the practical application of the knowledge. Accounting as discipline is used in the maintenance of books of accounts practically in the real life situations and day-today affairs of the business, so it is an art also. It can now be safely concluded that Accounting is both science and an art.

**BOOK-KEEPING**

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

Book-Keeping involves the following process:

1. Identifying accounting transactions
2. Initial record of accounting transactions
3. Preparation of ledger accounts
4. Balance Ledger accounts
5. Preparation of trial balance

**DIFFERENCE BETWEEN BOOK-KEEPING AND ACCOUNTING**

|  |  |  |  |
| --- | --- | --- | --- |
| **S.No** | **Basis of Difference** | **Book-Keeping** | **Accounting** |
| 1234567 | TransactionPosting Total and BalanceObjectsAdjustments and Rectification of errorsScope Final Accounts  | Trading transactions are recorded in primary books.Entries are posted in ledger from journal and subsidiary booksIt includes totaling of journal and finding of balances of ledger.The object of Book-keeping is to write all trading transactions in a reasonable manner.In Book-keeping entries of adjustments and rectification of errors are not included.Scope of Book keeping is narrow.Final Account is not prepared in Book-Keeping. | Entries written in primary books are checked and verified.Posting are checked whether correctly posted or not.On the basis of balances of ledger final accounts are preparedThe object of accounting is to analyses the transactions written in the books.Accounting includes entries of adjustments and rectification of errors.Scope of Accounting is wide.Final account preparation is must. |

**Accounting Concepts**

**Meaning and Significance: -** Accounting concepts are those basic assumptions or conditions upon which the accounting system is based. Some of the important accounting concepts are as follows :

**1) Business Entity Concept** : As per this concept, business is treated as a separate entity or unit distinct from that of the proprietor. The significance of this concept is that without such a distinction the affairs of the business will be mixed up with the private affairs of the proprietor and the true picture of the business will not be available. The transactions between the proprietor and the business will be recorded in the business books separately and shown separately under the heading capital account. For example, if when the proprietor invests Rs. 50000 in this business, it will be assumed that the owner has given that much money to the business and will be shown as a liability for the business. When he withdraws, say Rs. 10000 from the business it will be charged to his capital account and the net amount due to him will be only Rs. 40000.

**2) Going Concern Concept** : As per this concept it is assumed that a business unit has a perpetual succession or continued existence and transactions are recorded from this point of view. Hence, while valuing the business assets, the accountant does not take into account the realizable or market values of the assets. Assets are valued at cost at which they were originally purchased less depreciations till date, which is calculated on the basis of the original cost only.

The concept presumes that the business will continue in operation long enough to charge the cost of fixed assets over their useful life against the business income. It is only on the basis of this concept that a distinction is made between capital expenditure and revenue expenditure. If it is expected that the business will exist only for a limited period, the accounting records will be kept accordingly.

**3) Dual Aspect Concept** : Each business transaction has two aspects, i.e., the receiving of a benefit [debit] and giving of a benefit [credit]. For example, if a business purchases furniture, it must have given up cash or have incurred an obligation to pay for it in future. Technically speaking, for every debit, there is a credit this concept is the core of accountancy and upon this the whole superstructure of Double entry system of book keeping has been raised. As each transaction has giving account and receiving account equally, the total assets of a business firm will always be equal to its total equities [i.e. liabilities]. That is

 External liabilities + Capital = Total Assets

 Total Liabilities = Total Assets

This is called the Accounting or Balance Sheet equation.

**4) Historical Cost Concept** : This concept is based on the going concern concept According to this concept, assets purchased are normally entered in the accounting books at the cost at which they are purchased and this cost is the basis for all subsequent accounting for asset. The market value is immaterial for accounting purpose since the business is not going to be liquidated but is to be continued for a long time to come. This concept also prevents arbitrary values being used for recording purposes, mainly those resulting in the acquisition of assets.

 **5) Money Measurement Concept** : According to this concept, accounting records only those transactions, which can be expressed in terms of money. Events or transactions, which cannot be expressed in terms of money cannot find place in the books, however important they may be. Qualitative or non monetary transactions are either omitted or recorded separately. For example a strained relationship between production manager and sales manager, which may affect directly the operating results of the business, does not find place in accounting records.

**6)** **Realization Concept**: According to this concept, the revenue is recognized only when the sale is made. But the sale is a gradual process, which starts with the purchase of raw materials for production and ends with the sale. If no sale is effected, no revenue is recognized. This is important to stop business firms from inflating their profits. However, there are certain exceptions to this concept like hire purchase sale, or contract etc.

**7)** **Accrual Concept** : This concept is based on the economic that all transactions are settled in cash but even if cash settlement has not yet taken place, it is proper to bring the transaction or event concerned into the books. Expenditure incurred during the year but not paid and Income earned but not received is called as accrued items. According to this concept these items will be taken into consideration while arriving at profit or loss. This concept enables to define income and expense.

**8)** **Matching Concept** : The matching concept provides the guidelines as to how the expense be matched with revenues. In other words, costs are reported as expenses in the period in which the associated revenue is reported. Note that costs are matched with, revenues, not the other way round. The expense shown in an income statement must refer to the same accounting period, production units, division or department of business unit to which revenue refers.

**9) Accounting Period concept: -** It is also known as periodicity concepts or time period assumption. According to this assumption, the economic life of an enterprise is artificially split into periodic intervals which are known as accounting periods, at the end of which financial position. The use of this assumption further requires the allocation of expenses between capital and revenue. That portion of capital expenditure which is consumed during the current period is charged as an expense to income statement and t he unconsumed during the current period is charged as an expense to income statement and the unconsumed portion is shown in the balance sheet as an asset for future consumption. Truly speaking, measuring since, actual income can be determined only on the liquidation of the enterprise. It may be noted that the custom of using twelve month period applied only for external reporting. For internal reporting, accounts can be prepared even for shorter periods, say monthly, quarterly or half yearly.

**10) Verifiable Objective Concept:-** according to this principle, the accounting data should be definite, verifiable and free from personal bias of the accountant. In other words, this principle requires that each recorded transaction/event in the books of accounts should have an adequate evidence to support it. In historical cost accounting, the accounting data are verifiable since, the transactions are recorded on the basis of source documents such as vouchers, receipts, cash memos, invoices, and the like. The supporting documents form the basis for their verification by auditors afterwards.

**Accounting Conventions**

**Meaning and Significance**:- Accounting conventions, are those customs, usage and traditions that are being followed by the accountant for a long time while preparing the accounting statements.

**1) Convention of Conservatisms**: According to this convention, financial statements are usually drawn up on a conservative basis. While preparing accounts and statements, the accountants are expected not to take into account anticipated profits but to provide for all possible anticipated losses. It is only on the basis of this convention, the inventory is valued at cost or market price whichever is lower. Similarly provision for bad and doubtful debts is made in the books before ascertaining profits.

**2)** **Convention of Consistency** : According to this convention, accounting practices should remain unchanged for a fairly long time. And they should not be changed unless it becomes absolutely essential to change them. For example, if a particular method of charging depreciation on a particular asset is followed, it should be followed consistently. However, consistency does not prevent the introduction of new improved accounting methods or techniques. If any change is required, such change and its effects should be stated clearly. The aim of this convention is to provide for continuity in accounting practices and methods and enable meaningful comparison of accounting statements over a period or between different firms.

**3) Convention of Material Disclosure** : Apart from the legal requirements, good accounting practice demands that all vital information should be disclosed. For example, in addition to asset values, the mode of valuation should also be disclosed. The practice of giving footnotes, references, and parentheses in the statements is in accordance with this convention only. Accountants should report only material information and ignore insignificant details while preparing the accounting statements. What is material depends upon the circumstances and the discretion of the accountant.

**ACCOUNTING SYSTEMS**

The main systems of Financial Accounting are as under:

**(1) Cash system –** In this system, only cash entries are recorded in the accounts. All credit entries are written in a handbook and are entered in Cash Book only when they are paid or received. This system is kept by small trades, professional persons or non-trading institutions where most of the transactions are in cash.

**(2) Mahajani system –** It is oldest method of keeping accounts in India. Long Bahis are used for recording transactions and entries can be made in Mudia, Urdu, Sarafi, Hindi and any regional language. This system is completely scientific system as it is based on certain principles.

**(3) Single entry system –** Under it, some transactions are recorded at one place, some other transactions at two places and some transactions are recorded at all. Cash book and personal accounts are kept in it. It is an incomplete and unscientific system. Hence it is rarely used.

**(4) Double entry system –** Under it, every entry is recorded at two sides of the account so that the effect on each side of the account may remain equal. There are debit and credit side in it. This system was originated in Italy. Being a complete and scientific method, it is widely used and is more popular.

**CONCEPT OF DOUBLE ENTRY SYSTEM**

There are many systems of presenting business transactions in accounting books e.g., Mahajani system, Cash system, Double entry system etc. The use of these systems depends upon the size and type of business and nature of transactions. But in modern business world, double entry system of book-keeping is more popular and widely used.

The focus of the double entry system is that every business transaction has two aspects, i.e., when we receive something, we give something else in return. This approach of writing both the aspects of the transactions is known double entry system of accounting. Of the two accounts one account is given debit while the other is given credit with an equal amount. Thus, on any date the debits must be equal to the credits.

**Evolution of Double Entry system:**

The double entry system was originated in Italy in 15th century. First of all in 1494 Lucas Pacioli, the famous mathematician of Venus of Venus city of Italy wrote his first book “De Composite Scriptures’ and mentioned method of accounting in one of its part. Emphasis was given on division and utility of waste book. Journal, Ledger etc. In 1543 Huge Old Castle translated it in English and after that many learned persons showed their views and gave it a new shape.

The following are the three distinct stages of a complete system of double entry:

1. Recording the transactions in the journal.
2. Classifying the transactions in the journal by posting them to the appropriate ledger accounts and then preparing a trial balance.
3. Closing the books and preparing the final accounts

**Merits of Double Entry System**

1. Full description: Every financial transaction is recorded in two related accounts separately in which full particulars are given for each transaction.
2. Knowledge of some important information regarding business: In Double entry system, real and nominal accounts are also maintained together with personal accounts. The information about capital employed, assets and liabilities can be obtained easily.
3. Testing of Mathematical Accuracy: Under this system, each debit entry has a credit entry due to which arithmetical accuracy can be checked with the help of trial balance.
4. Less chances of fraud: Under this system, double entry of each transaction reduces the possibility of forgery and fraud. Fraud can be avoided and traced easily.
5. Information of Profit and Loss: under this system, profit and loss account is prepared at the end of the certain period to find profit and loss.
6. Knowledge of Economic Status: With the help of balance sheet, the economic and financial status of the business can be obtained easily.
7. Comparatively Study and useful results: Trading, profit and loss account and balance sheet of current year can be compared with trading, profit & loss account and balance sheet of previous year to obtain useful analysis and conclusions.

**Demerits and Limitations of Double Entry system**

1. It is difficult to follow the rules of debit and credit in this system.
2. Though this system is fully scientific even then there are chances of errors and mistakes.
3. It is necessary to follow the principles and even a small mistake may give erroneous results.
4. It is an expensive system for small traders.
5. In order to get full efficiency in the system, it is necessary to have education, training and practical knowledge of accounts.

**CLASSIFICATION OF ACCOUNTS**

**1) Personal Accounts**

a) Natural Personal Account: The term Natural persons means persons who are created by the almighty. For example: Shyam’s Account, Gopals’s Account etc.

b) Artificial Personal Account: These accounts include accounts of institutions or companies which are recognized as persons in business dealings. For example, the account of a Club, the account of an Insurance Company, Banking Company.

c) Representative Personal Account: These are accounts which represent a certain person or group of persons. For example, if the rent is due to the landlord, an account for the outstanding amount will be opened. Likewise for salaries due to the employees (not paid) an outstanding salaries account will be opened. The outstanding rent account represents the account of the landlord to whom the rent is to be paid while the outstanding salaries account represents the account of the person to whom the salaries have to be paid therefore such accounts are called as representative personal accountant.

**2)** **Real Accounts**

1. Intangible Assets: These accounts represent things which cannot be touched. However, they can be measured in terms of money, for example goodwill account, patents accounts.

Tangible Accounts: Tangible accounts are those which relate to things which can be touched, felt, measured etc. Examples of such accounts are furniture account, stock account, building account etc.

**3) Nominal Accounts: -**

Accounts related to income and gain or expenditure and loss are known as Nominal Accounts, e.g. Rent A/c, Interest A/c, Salary A/c, discount A/c, etc.

Nominal Accounts are divided into two parts as:

* + 1. Revenue Account: - Such as rent received, interest received, commission paid, salary paid, discount allowed, etc.
		2. Expenditure Account: - Such as rent paid, interest paid, commission paid, salary paid, discount received, etc.

At the end of each financial year, the balances of nominal accounts are transferred to Trading A/c or Profit & Loss A/c

**RULES OF DOUBLE ENTRY SYSTEM**

The rules related to debit and credit of any account in double entry system are as under:

**Personal accounts :- Debit the receiver, and credit the giver**.

**Real accounts :- Debit what comes in, and credit what goes out**

**Nominal accounts :- Debit all expenses and losses and credit all incomes and gains**.

**Capital and revenue**

**Classification of capital and revenue**

The Going Concern Assumption allows the accountant to classify the expenditure and receipts as Capital expenditure, Revenue expenditure, Deferred Revenue expenditure, Capital Receipts, Revenue Receipts. The expenditure and receipts may be classified as follows:

**Capital Expenditure:** Capital Expenditure is that expenditure which is incurred (a) for acquiring or bringing into existence an asset or advantage of an enduring benefit or (b) for extending or improving a fixed asset an asset or advantage of an enduring benefit or (b) for extending or improving a fixed asset or (c) for substantial replacement of an existing fixed asset. An asset of advantage of an enduring nature does not mean that it should last forever, it should not at the same time be so transitory and ephemeral that it can be terminated at any time. Basically, the capital expenditure is incurred with a view to brining in improvement in productivity or earring capacity. The examples of capital expenditure include cost of land and building, plant and machinery, furniture and fixtures etc. Such expenditure normally yields benefits which extended beyond the current accounting period.

**Revenue Expenditure:** Revenue Expenditure is that expenditure which is incurred for maintaining productivity or earning capacity of a business. Such expenditure yields benefits in the current accounting period. The examples of revenues expenditure include Office and Administrative expenses such as Salaries, Rent, Insurance, Telephone Exp., Electricity Charges, etc. Selling and Distribution Expenses such as Advertising, Travelling expenses, Commission to Salesman, Sales Promotion Expenses etc. Non-operating expenses and losses such as interest on loan taken, loss by theft etc.

**Deferred Revenue Expenditure:** Deferred Revenue Expenditure is that expenditure which yields benefits which extend beyond a current accounting period, but to relatively a short period as compared to the period for which a capital expenditure is expected to yield benefits. Such expenditure should normally be written-off over a period of 3 to 5 years. The examples of such, expenditure include heavy Advertising Campaign, Research and Development Expenditure.

**Capital Receipts Vs Revenue Receipts** There is no specific test to draw a clear cut demarcation between a capital receipt and a revenue receipt. In order to determine whether a receipt is capital or revenue in nature, one has to look into its true nature and substance over the form in the hands of its receipts. For example, sale proceeds of a land in the hands of a dealer in real estate is revenue receipt whereas the same in the hands of a dealer in cars is a capital receipt.

The examples of capital receipts include sale of fixed assets, capital contribution, loaned receipts, and the examples of revenue receipts include sale of stock-in-trade, revenue from services rendered in the normal course of business, revenue from permitting other to use the assets of the enterprise, such as interest, rent royalty.

**JOURNAL**

It is the fundamental book of account which is necessarily used by each organization whether it is a small or large institution. It can be known as foundation stone of accounting palace.

A journal may be defined as the book of original entry containing a chronological record of the transactions. The process of recording the transactions in a journal is called Journalizing.

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| **Date** | **Particulars** | **L/F** | **Debit amount** | **Credit Amount** |
| 2009 July,25 | ………………………….A/c Dr To …………………….A/c (……………………………………) |  |  |  |

**COMPOUND JOURNAL ENTRY**

 If two or more transactions of the same nature occur on the same day and either debit account and/or credit account are common in them, instead of passing a separate entry for each such transaction, one combined entry may be passed. Such type of entry is known as compound journal entry.

Example: Postage a/c Dr.

 Stationary a/c Dr.

 Cartage a/c Dr.

 To Cash a/c

**DISCOUNT**

**Types of Discount:-**

1. **Trade discount**: is allowed at the time of purchase or sale of goods by one trader another in order to promote sales. For example, a manufacturer may allow discount on sale goods to wholesaler or wholesaler may allow discount to a retailer. It is always allowed a certain percentage on sale price i.e., invoice price. The trade discount is not normally record in the books of account. In other words, only the net amount of purchase or sale i.e., invoice price minus trade discount is recorded in the journal.

**Cash discount**: is a discount allowed at the time of making payments or receipts of cash. It is allowed as certain percentage the amounts due. It is allowed to a debtor by a creditor in order to induce hirt pay on time. As the cash discount is calculated on the amounts already recorded in the books, it is shown in the book. Cash discount allowed to a debtor is a loss and it should be debited to discount a/c. Cash discount received from a creditor is a gain and it should be credited to discount a/c.

**DISTINCTIONS BETWEEN TRADE DISCOUNT AND CASH DISCOUNT**

|  |  |  |
| --- | --- | --- |
| **S.No.** | **Trade Discount** | **Cash Discount** |
| 1. | It is allowed at the time of making purchases or sales. | It is allowed at the time of making payments or receipts of cash.  |
| 2 | It is calculated as certain percentage on the invoice price of goods purchased or sold. | It is calculated as certain percentage on the amounts due to creditors or amounts due from debtors.  |
| 3 | It is not shown in the books of accounts. Only the net amount of purchase or sale is recorded in the books. | It is shown in the books: discount allowed as debit entry and discount received as a credit entry.  |
| 4 | It is allowed in order to promote more sales of purchases | It is allowed in order to encourage parties to make payments on time.  |

**Cash Book**

**Meaning of Cash Book**

Cash book may be defined as the record of transactions concerning cash receipts and cash receipts and cash payments. In other words in Cash Book, all transactions (i.e., receipts and payments of cash) are recorded as soon as they take place.

Cash Book is in the form of an account and actually it serves the purpose of Cash Account also. It has two sides-debit and credit side. On the debit side, all receipts of cash are recorded while on the credit side, all the payments of cash are recorded. Items on the debit side of the cash book are posted on the credit side of the ledger accounts and items on the credit side are posted on the debit side of the ledger accounts.

**Features of cash book:**

1. Only cash transactions are recorded in the cash book.
2. It performs the functions of both journal and ledger at the same time.
3. All cash receipts are recorded in the debit side and all cash payments are recorded in the credit side.
4. It records only one aspect of transactions i.e. cash.
5. All cash transactions are recorded chronologically in the cash book.

**Types of Cash Book**

The various types of cash book from the point of view of uses may be as follows:

**Types of Cash Books**

**Cash Book with Bank & Discount Column**

**Petty Cash Book**

**Single Column**

 **Book**

**Cash Book with discount**

**Column**

**1 Single Cash Book**

Single Column Book has one amount column on each side. All cash receipts are recorded on the side and all cash payments on the credit side. In fact, this book is nothing but a Cash Account. Hence, there is no needed to open this account in the ledger.

Format of Single Column Cash Book:

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

|  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- |
| Date | Particulars | L.F. | Amount Rs | Date | Particulars | L.F. | Amount Rs |
|  |  |  |  |  |  |  |  |

**2 Cash Book with Discount Column**

Cash book with discount Column has two amount columns (one for cash and another for discount) as each side. All cash receipts and cash discount allowed are recorded on the debit side and all cash payments and cash discount received are recorded on the credit side.

**Format of Cash Book with Discount Column:**

**Dr. Cash Book with Discount Column Cr.**

|  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
| Date | Particulars | L.F. | Dis. | Cash | Date | Particulars | L.F. | Dis. | Cash |
|  |  |  |  |  |  |  |  |  |  |

**3. Three Column Cash Book**

Three Column Book has three amount columns (one for cash, one for Bank, and one for Discount) on each side. All cash receipts, deposits into bank and discount allowed are recorded on debit side and all cash payments, withdrawals from bank and discount received are recorded on the credit side. In fact, a three-column cash book serves the purposes of Cash Account and Bank Account. Hence, there is no open these two accounts in the ledger.

**Contra Entries**

**Format of Cash Book with Discount Column**

**Dr. Three Column Cash Book Cr.**

|  |  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
| Date | Particulars | L.F. | Dis. | CashRs | BankRs | Date | Particulars | L.F. | Dis. | CashRs | BankRs |
|  |  |  |  |  |  |   |  |  |  |  |  |

**4. Petty Cash Book (Imprest system)**

Petty Cash Book is the book which is used for the purposes of recording the payment of petty cash expenses.

**Meaning of Petty Cashier**

Petty Cashier is the person who is authorized to make payments of petty cash expenses and to record them in petty cash book.

**Features of Petty Cash Book**

The amount of cash received from the main cashier is recorded on the left hand side column.

1. The payments of petty cash expenses are recorded on the right hand side in the respective columns.
2. It can never show a credit balance the cash payments can never exceed the cash receipts.
3. Its balance represents unspent petty cash in hand.
4. Recording is done on the basis of internal as well as external vouchers.
5. All the column of expenses are totaled periodically and such periodic totals are individually posted.
6. Petty Cash Book is both a book of original entry as well as a book of final entry.



**Advantages of Petty Cash Book**

1. Economy of time: The time of chief cashier is saved when petty expenses are recorded in petty cash book.
2. Saving of labour in posting : There is saving in labour in posting because :
	1. Limited number of accounts are opened for heads of petty expenses only,
	2. Periodical totals (say monthly) of each column of expenses are posted to the debit of the respective ledger accounts.
		1. Lesser chance of mistakes: The chances of mistakes are reduced since the chief cashier regularly examines the petty cash book.
		2. Control over petty expenses: Petty expenses are kept within the limits of imprest since the petty cashier can never spend more than the available petty cash.
		3. Control over fraud: Misappropriation if any, is always kept within the limits of imprest.
		4. Benefits of specialization: The benefits of specialization are available since recording of cash transactions is divided between main cash book and petty cash book.

**Posting of Petty Cash Book in ledger**

 1. Petty Cash Book as a part of Journal or Double Entry system

 2. Petty Cash Book as a Memorandum book.

**Imprest vs. Non-Imprest System of Petty Cash Book**

The amount which the main cashier hands over to the petty cashier in order to meet the petty cash expenses of a given period is known as ‘Imprest’ or ‘Float’.

Petty cash book may be maintained on imprest system on non-imprest system.

**Features of imprest system of petty cash**

1. Estimation by chief cashier: The Chief Cashier estimates the total petty cash expenses for a particular fixed period.
2. Advances by chief cashier: The Chief Cashier advance the estimated amount to the petty cashier in the beginning of the period.

Submission of petty cash book by petty cashier: The Petty Cashier submits the petty cash book along with supporting vouchers to the chief cashier at the end of the period.

1. Submission of petty cash book by petty cashier: The Petty Cashier submits the petty cash book along with supporting vouchers to the chief cashier at the end of the period.
2. Examination of petty cash bank by chief cashier: The Chief Cashier examines the petty cash book.
3. Reimbursement of amount spent: The Chief Cashier makes the reimbursement of the amount spent by the Petty Cashier.
4. Availability of same amount of petty cash: The Petty Cashier again has the same amount of petty cash in the beginning of new period.

**Ledger**

Ledger is the principal book or final book under double entry system of accounting in which the transactions recorded in subsidiary books are classified in various accounts chronologically with a view to knowing the position of business account-wise in a particular period.

**Characteristics of Ledger**

1. Major or principal book of accounts.
2. Index- The initial pages of ledger are left for indexing. These pages are not numbered. With the help of index one can find on which page of ledger a particular account is opened.
3. Pages booked- For every account one separate page or pages called folio is engaged in ledger.
4. One debit one credit- For every transaction one account is debited and other account is credited.
5. Books of final entry- Ledger is the last stage of daily accounting or book keeping.
6. Classification of transactions- While journal a bunch of various accounts, ledger is the classification of these accounts.

**Utility or importance or Advantages of Ledger**

1. Knowledge of account
2. Details of income and expenditure
3. Assessment of financial position
4. Text of accuracy
5. Knowledge of profit and loss
6. Economy of time
7. Knowledge of assets
8. Knowledge of liabilities
9. Assessment of overall position of business
10. Evidence in business disputes-

**Difference between journal and Ledger**

|  |  |  |  |
| --- | --- | --- | --- |
| **S. No.** | **Basic of differences** | **Journal** | **Ledger** |
| 1 | Nature of book | It is the book of first or original entry | It is the book of final entry |
| 2 | Record  | It is the book for chronological record | It is the book of analytical record |
| 3 | Weight in legal evidence  | It is the book of source entry and has a greater weight as legal evidence  | It has a lesser weight us legal evidence as it is based on journal  |
| 4 | Unit of classification of data | The unit of classification of data within the journal is transaction | The unit of classification of data within the ledger is account |
| 5 | Process of recording  | The process of recording in the journal is called ‘journaling’ | The process of recording in the ledger is called ’posting’ |
| 6 | Place | More than one transactions regarding one account are written at different places date-wise | More than one transaction regarding one account are written at one place |

**Posting**

When the transactions entered in journal are recorded in the ledger, it is called posting. It other words, posting is the process transferring the debits and credits of journal entries to the ledger account. The subject of such posting to have a fixed classified record of various transactions pertaining to each account.

**Balancing of ledger Accounts**

Assets, liabilities and capital accounts have certain closing balance of the end of accounting period, so their values are to be carried forward to the next accounting period. This is why they are closed as “By Balance b/d” or “To Balance c/d. The balance of those accounts carried forward to the next accounting period, because the firm has to carry on tits business with these assets, liabilities and capital in hand. While closing these accounts we write the ‘Balance c/d’ to show the closing balance of the account.

While closing nominal accounts or those accounts which are either an expense or revenue. we do not use the word balance c/d because the balance of these accounts need be carried forward to the next period. Whatever has been paid on account of expenses has been paid once and forever. This is the expense of the business. so it should be directly posted to the debit side of the profit and loss account or trading account. It the same way, account relating to income or gain or revenues are also closed by transfer to profit and loss account. Receipts i.e. rent, interest and discount are revenue of the business, so while closing these accounts their balance will be transferred to profit and loss account.

**Subsidiary Book**

**Preparation of Purchase Day Book**

This book is maintained mainly to record credit purchases of goods. The term goods refers to all such commodities and services in which we deal.

|  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- |
| Date | Particulars(Names of suppliers) | Invoice No. | L.F. | AmountRs. | Net AmountRs. |
|  |  |  |  |  |  |

**Posting:** Each suppliers personal account is credited in the ledger with its respective amount with the words “ By purchases a/c”. The monthly total of this book is debited to purchases a/c in the ledger with the words “To sundries as per Purchases Book”

**Preparation of Sales Book**

This book is maintained mainly to record credit sales of goods. Hence the cash sales of goods and assets sold are not entered in this book. Entries in this book are made from the outward invoice of credit sales.

|  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- |
| Date | Particulars(Names of Customer /Party) | Invoice No. | L.F. | AmountRs. | Net AmountRs |
|  |  |  |  |  |  |

Postings : Each Customer’s personal account is debited in the ledger with its respective amount with the words “to Sales a/c” . The periodical total of this book is credited to sales a/c with the words “ By sundries as per sales book”.

**Preparation of Returns Outward of Purchase Return Book**

This book is maintained to record the return of goods purchased earlier from the suppliers on credit. When goods are returned a debit note is made out and sent to the supplier to whom goods are returned.

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| Date | Particulars | Debit Note No. | I.F. | AmountRs. |
|  |  |  |  |  |

Postings : Each suppliers account mentioned in the purchased earlier from the suppliers on credit. When goods are returned a debit note is made our and sent to the supplier to whom goods are returned

**Preparation of Return inward or Sales Return Book**

 This Book is maintained manly the returns of goods sold to customers on credit. On receipt of the goods the firm prepares a Credit Note in the name of the customer and sends its original copy to the customer. Entries are made from credit note book into the sales returns books.

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| Date | Particulars | Credit Note No. | I.F. | AmountRs. |

**Posting:** Each customer’s personal account {as given in the sales returns book} is credited with the amount of goods returned by him with the words” By Sales a/c’’. The sales return A/c in the ledger gets the debit with the periodical total of Sales Returns Book with the words “To sundries as per Sales returns Book”

**Preparation of Bills Receivables Book**

 This books is maintained to keep a detailed record of the bills receivable received by the firm. This book provides a medium for posting bills receivable transactions. The ruling of this book is given below:

|  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
| Date When received  | Drawer | Acceptor | Where Payable | Date of bill | Term | Due date | I.F. | Amount Rs. | Remark |
|  |  |  |  |  |  |  |  |  |  |

Posting: - The personal account of the person from whom the bill is received is credit with the amount of that bill and the periodical total of the Bills Receivable Book is debit to Bills Receivable a/c in the ledger.

**Preparation of Bills Payable Book**

This book is maintained to keep a detailed record of all bills payable accepted by firm.

|  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
| Date of Acceptance  | To whom given | Payee | Where payable  | Date of bill | Term | Due date | L/F | Amount Rs. | Remark |
|  |  |  |  |  |  |  |  |  |  |

Posting: The person account of the person whose bill as accepted is debited with the amount of that bill and the periodical total of the Bills Payables Book is credited to Bills Payables in the ledger.

**TRIAL BALANCE**

**Meaning**

When all the accounts of a concern are balanced off they are put in a list, debit balances on one side and credit balances on the other side. The list so prepared is called trial balance. The total of the debit side of the trial balance must be equal to that of its credit side. This is based on the principle that in double entry system. For every debit there must be a corresponding credit. The preparation of a trial balance is an essential part of the process because if totals of both the sides are the same then it is proved that book are at least arithmetically correct.

**Main Characteristics and uses of a Trial Balance**

Following are the main characteristics of a trial balance :

1. It is a statement prepared in a tabular form. It has two columns- one for debit balance and another for credit balances.
2. Closing balance, i.e., balance at the end of the period as shown by ledger accounts, are shown in the statement.
3. Trial balance is not an account. It is only a statement of balance.
4. It can be prepared on any date provided accounts are balanced.
5. It is a consolidated list of all ledger balances at the end of a period at one place.
6. It is a method of verifying the arithmetical accuracy of entries made in the ledger. The agreement of the trial balance means that the total of the debit column agrees with the total of the credit column of the trial balance.

It is a big help in preparation of Trading A/c, Profit and Loss A/c and Balance Sheet at the end of the period which exhibit the financial position of the firm.

**Objects of preparing a Trial Balance**

The following are the important objects or purposes of preparing a trial balance:

1. If the two sides of the trial balance are equal, it is proved that the book are at least arithmetically correct.
2. Error in casting the books of subsidiary records in immediately known.
3. Error in posting from the books of subsidiary records to ledger is found out.
4. Error in balancing the ledger accounts is found out.
5. Schedules of debtors and creditors are verified to be correct.

**Limitations of a Trial Balance**

A trial balance is not a conclusive proof of the absolute accuracy of the accounts books. If the trial balance agrees, it does not mean that now there are absolutely no errors in books. Even if trial balance agrees, some errors may remain undetected and will not be disclosed by the trial balance. This is the limitation of a trial balance. The errors which are not disclosed by a trial balance are as under:

**Errors of Omission: -** If an entry has not been recorded in the original or subsidiary book at all, then both the aspects of the transaction will be omitted and the trial balance will not be affected.

1. **Errors of Commission: -** Posting an item on the correct side but to the wrong account.
2. **Error it subsidiary books-** Wrong amount entered in the subsidiary book.
3. **Compensating errors-** These are errors arising from the excess-debits on under debits of accounts being neutralized by excess credit or under credit to the same extent of some other accounts.
4. **Error of principle-** Whenever any amount is not properly allocated between capital and revenue or some double entry principles are violated the error so made is known as error of principle.

**Compensatory Errors-** Under it, the errors on one side of the ledger account are compensated by errors of the same amounts on the other side or on the same side.

**Methods of Preparation of Trial Balance –**

1. **Total Method –** Under this method debit and credit total of each account of ledger are recorded in trial balance.

**Trial Balance**

(As on …………….)

|  |  |  |  |
| --- | --- | --- | --- |
| **Title of Accounts** | **L.F.** | **Debit Total Rs.** | **Credit Total Rs.** |
|  |  |  |  |
| **Total** |  |  |  |

1. **Balance Method-** Under this method only balance of each account of ledger is recorded in trial balance.

**Trial Balance**

( As on ……………. )

|  |  |  |  |
| --- | --- | --- | --- |
| **Title of Accounts** | **L.F.** | **Debit Balance Rs.** | **Credit Balance Rs.** |
|  |  |  |  |
| **Total** |  |  |  |

1. **Total Cum Balance Method-** This method is a combination of Total method and Balances method.

**Trial Balance**

(As on …………….)

|  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- |
| Title of Accounts | L.F. | Debit Total Rs. | Credit Total Rs. | Debit Balance Rs. | Credit Balance Rs. |
|  |  |  |  |  |  |
| **Total** |  |  |  |  |  |

**Final Accounts**

The final object of every businessman is to earn profit. He is interested to know how much profit he has earned or how much loss he has incurred during the year. For the purpose income tax payment, financial position, distribution of dividend and for the future planning it becomes necessary to ascertain the profit or loss for the year. At the end of the year a trial balance is extracted from the ledger balances and then on the basis of the trial balance, closing entries are passed and final Accounts are prepared. The process of preparing Final Accounts from the original records is as under.

Recording of transaction in Journal or Subsidiary books

🡫

Postings into ledger from Journal or subsidiary books.

🡫

Preparation of Trial balance from ledger accounts

🡫

Preparation of Final Accounts on the basis of Trial balance and other information

To know the trading results (Profit or loss) for the accounting period and the financial position as it the end of accounting period the final accounts are prepared. The final accounts consists of:

1. Manufacturing Account
2. Trading and Profit & Loss Account
3. Balance sheet
4. Debit items of Trial Balance:- The items of expenses or assets appear on debit side of Trial balance. The expenses (the benefit of which is derived within the accounting year in which they are incurred are called revenue expenses. These are debited either to trading account or profit & Loss Account.) Direct expenses such wages. Carriage inwards, freight etc. are debited to trading and indirect exp. such as salaries, rent repairs etc. are debited to profit & Loss account.

The expenses the benefit of which is derived in many years are called capital expenditure. These expenditure are called assets and they appear in the assets side of Balance sheet e.g. Building, Machinery, Furniture, Vehicle etc.

1. Credit items of Trial Balance: The items of incomes, gains or liabilities appear in the credit side of trial balance. The receipts are divided into two parts capital receipts and revenue receipts. Capital receipts are liabilities items they are mentioned in the liabilities side or deducted from the assets side of Balance sheet. Revenue receipts are called incomes. It is again divided into direct and indirect incomes. Direct incomes means sale proceeds of the goods which is credited to Trading Account. Indirect incomes are other incomes not directly related to the main business activities such as rent commission, interest, dividend etc received. These are credited to profit and loss account.

**Unit II**

**Rectification of Errors**

Financial Accounts are prepared at the final stage to give the financial position of the business on the basis of information supplied by the trail balance. Thus, the accuracy of the trail balance determines to a great extent. Trial balance provides only proof of the arithmetical accuracy of the books of accounts. But it is not a conclusive proof.

It can be concluded, therefore, that if the trial balance does not agree, there are errors, and if

trial balance does agree there may be errors in the account books.

**TYPES OF ERRORS**

The types of errors can be illustrated in the following chart:



**Rectification of Errors –**

The errors must be rectified at the earliest from the point of view of rectification; the errors may be classified into the following two categories:

(a) Error which do not affect the Trail balance

(b) Errors which affect the Trail balance

This distinction is relevant because the errors which do not affect the trial balance usually take place in two accounts in such a manner that is can be easily rectified through a journal entry whereas the errors which affect the trial balance usually affect one account and a journal entry is not possible for rectification unless a suspense account has been appended.

(1) Rectification of Errors which do not affect the trail Balance –

These errors are committed in two or more accounts. Such errors are also known as two sided errors. They can be rectified by recording a journal entry giving the correct debit and credit to the concerned accounts.

These errors are explained below:

1. Errors of Omission- An error of omission is one where a transaction has not been recorded in the books of account.

For example omission to record goods sold to Rajesh, the rectify entry is

 Rajesh A/c Dr.

 To Sales

 (Being goods sold was not passed through books)

1. Error of Recording – Errors of recording means a wrong amount is recorded in the subsidiary books.

For e.g. a purchase of Rs. 8,000 to Mahesh is recorded as Rs. 800.

The rectifying entry will be –

 Purchases A/c Dr. 7,200

 To Mahesh 7200

1. Errors of Posting to wrong Account- Following are the errors of posting to

 Wrong account.

* 1. Correct Amount on the correct side to wrong account
	2. Wrong Amount on the correct side to wrong account
	3. Wrong Amount on the wrong side to wrong account
	4. Correct Amount on the wrong side to wrong account

 For e.g. Sales to Ravina Rs. 10,000 is posted to Ravi’s A/c Rectify entry is

 Ravina Dr. 10,000

 To Ravi 10,000

4. Error of Principle- Sometimes errors of recording are made due to ignorance of principles, i.e., correct distinction is not made between capital receipt and revenue receipt, between capital expenditure and revenue expenditure, between capital losses and gains and revenue losses and gains etc.

For e.g. Furniture purchased on credit wrongly recorded in purchases book

Rectify entry is –

 Furniture A/c Dr.

 To Purchases A/c

(2) Rectification of Errors which affect the trial balance:-.

There are some errors due to which the trail balance does not agree. These are the errors which are disclosed by the trial balance. These errors are also called one-sided errors.

Such errors should first be located and then rectified by giving an explanatory note or by giving a journal entry with the help of a suspense account

Following are some errors responsible for disagreement of trial balance

1. **Errors of Casting** – Casting is the process of totaling the transactions at the end of a period. An error of casting may be due to over casting or under casting. This type of errors may arise in any subsidiary book.

For e.g. If the sales book has been under cast by Rs. 100 The rectification of the error will be done by crediting sales account.

1. **Errors of Posting –** Errors of posting means a posting of wrong amount or posting in the wrong side.

For e.g. Raj’s account is debited with Rs. 750 instead of Rs. Rs. 705 the mistake lies only in this account. This will rectified by crediting Raj’s A/C with 45. If there is a suspense A/c, the entry will be

 Suspense A/c Dr. 45

 To Raj 45

1. **Errors of Carry forward -** The errors occurs when total of one page is wrongly copied on the next page. In order to rectify such errors, an explanatory note is given and if the suspense A/c is opened, then the correction is through a journal entry with the help of a suspense Account.

**SUSPENSE ACCOUNT**

When the Trial Balance does not tally, efforts are made to make the trail balance tally, but if these efforts fail, then temporarily the difference of Trail Balance is transferred to an account which is called “Suspense Account”. Suspense Account. Will be shown in the Balance Sheet on asset aside if debit balance or on the liabilities side if credit balance.

During the course of preparation of final accounts errors are located, they are corrected through the suspense A/c

**Effect on Profit and Losses Account**

All such rectifying entries which are related to normal account, affect profit or loss, hence after making rectifications, all nominal account which are affected should be taken into consideration and their amounts be considered for assessing the exact amount of loss or profit.

Effect on Balance Sheet

All such rectifying entries which are related with personal and real accounts affect the Balance Sheet. Rectifying entries related with nominal account affect profit or loss and this profit or loss is taken to Balance Sheet. Hence, these entries also affect Balance Sheet.

**Trading Account**

Trading Account is prepare to calculate gross profit. It can be prepared separately or combined with profit and loss account. Normally it is prepared jointly with profit and loss account. It is the first part of profit and loss account.

**Trading Account**

For the Year ending…………………..

|  |  |  |  |
| --- | --- | --- | --- |
|  | **Rs.** |  | **Rs.** |
| To Opening StockTo Purchase -Less: Ret. Outward ------- To WagesTo CarriageTo FuelTo Motive PowerTo OctroiTo Import DutyTo Clearing Charges To Dock Charges To Stores Consumed To Royalty based on Production -To Manufacturing Exp. To Gross Profit c/d (Balancing figure) - | ------------- | By Sales -Less: Returns Inward ---------By Goods Sent on Consignment By Closing StockBy Gross Loss c/d (Balancing figure ) | --- |
| **Rs.** | **-** | **Rs.** | - |

**Profit and Loss Account**

Profit and loss accounts are prepared to ascertain net profit or loss. This is the second stage of ascertaining trading results. Gross Profit calculated as per trading account is credited to Profit and loss account then all the indirect expenses are debited and all the indirect incomes are credited. The excess of credits side over debit side is called net Profit and vice versa. The format of P & L account is as under:

**Profit and Loss A/c**

**(For the year ending)**

|  |  |  |  |
| --- | --- | --- | --- |
| To Gross LossTo Office Salaries & WagesTo Office Rent, Rates and Taxes To Office Printing and Stationery To Office Lighting To Insurance PremiumTo Repairs & Maintenance To Postage & Telegram To Legal expenses To Trade expenses To Audit fees To Telephone expenses To General expenses To Bank Charges To Discount allowed To Interest on Capital To Interest on loanTo Discount of Rebate on bills of exchange To Carriage outward To Freight outward To Bad debts To Entertainment expenses To Travelling Expenses To Cost of Samples To Catalogue expenses To Salesmen’s salariesTo Expenses and commission To Advertising expenses To Depreciation on fixed Assets To Loss on sale of fixed assets To Net Profit (Transferred to capital account)  | ------------------------------- | By Gross ProfitBy Discount received By Bad debts recovered By Income from Investment By Commission received By Interest on Deposits By Profit on sale of fixed assets By Apprenticeship Premium By Interest on Drawings By Net Loss (Transferred to  Capital Account)  | ---------- |

**Balance Sheet**

**As on 31 March ………………**

|  |  |  |  |
| --- | --- | --- | --- |
| **Liabilities** | **Rs.** | **Assets** | **Rs.** |
| CapitalLong term liabilities Debentures Bank LoanCurrent Liabilities: Advance IncomeOutstanding expenses Bank overdraft Bills Payable Creditors Unearned Income  | ----------- | Fixed Assets:Patent GoodwillLand and Building Plant & Machinery Furniture and fixtures Current Assets:Short terms Investment Prepaid expenses)Accrued Income Debtors Closing StockBank Balance Cash Balance  | --------------- |

**Closing Entries**

At the end of the year after preparing trial balance a list of unrecorded items is prepared which is called list of adjustment for which adjustment entries are passed. Now closing entries will be passed. The purpose of closing entries is to closed all those accounts which comes in trading and profit & Loss and these accounts are mainly related to goods and expenses and incomes.

Procedure for closing entries- The accounts which are shown on the debit side of trading and profit & Loss account are transferred to these account by writing “By Trading account/Profit and loss account” in all those accounts. Similar in the accounts (appearing on the credit side of trading and profit and loss account) To trading or profit & Loss account is written The major closing entries are as under:

* 1. For opening stock, purchase, sales return and all direct expenses

 Trading A/c Dr.

 To Opening Stock A/c

 To Purchases A/c

 To Sales return A/c

 To Wages a/c

 To Carriage Inward A/c

* 1. For sales and purchase return

 Sales A/c Dr.

 Purchase return Dr.

 To Trading A/c

* 1. For gross profit or loss:

 (a) Profit Trading A/c Dr.

 To Profit and Loss A/c

 (b) loss Profit and loss A/c Dr.

 To Trading Account

* 1. For indirect expenses

 Profit & Loss A/c Dr.

 To Salaries A/c

 To Commission a/c

 To Discount allowed a/c

 To Advertisement A/c

* 1. For indirect in comes and gains

 Interest eared a/c Dr.

 Discount a/c Dr.

 Commission a/c Dr.

 Dividend a/c Dr.

 To Profit & Loss A/c

* 1. For Net profit or net loss
		1. For Net Profit

 P & L A/c Dr.

 To Capital A/c

* + 1. For Net loss A/c

 Capital A/c Dr.

 To P & L Account

**Adjustments at a glance**

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| **S.No.** | **Adjustments** | **Entry** | **Effects on Trading and Profit & Loss Account** | **Effects on Balance Sheet** |
| 1 | Closing Stock | Closing Stock A/c Dr. To Trading A/c | Credited to trading A/c | Shown on assets side. |
| 2 | If closing Stock is given in trial balance  | - | - | Shown on assets side. |
| (i)(ii) | Outstanding expenses(Expenses still un paid) | Expenses A/c Dr. To O/s Exp. A/c | Add to the concerned exp. on debit side. | Shown on liabilities side.  |
| O/S Exp. in trial Balance If they are of opening date i.e. of last year | O/S Exp. A/c To Expenses A/c | Deducted form the concerned expenses on debit side.  | - |
| If they are of closing date i.e. of current year. | - | - | Shown on liabilities side. |

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| 3(i) (i) | Prepaid Expenses:(Expenses of next year paid in advance this year) | P.P. Expenses A/c Dr. To Expenses A/c  | Deducted from the concerned expenses on debit side. | Shown on Assets side  |
| P.P. Exp. in trial balance.If they are of opening date i.e. of last year | Expenses A/c Dr. To P.P. Exp. A/c | Added to the concerned expenses on debit side | - |
| If they are of closing date i.e. of last year | - | - | Shown on assets side. |
| 4.  | Accrued, Earned or Receivable Income | Acc. Income A/c Dr. To Income A/c | Added to the concerned income on credit side of P & L A/c  | Shown on assets side. |
| (i) | If it is of op. date i.e. of last year | Income A/c Dr. To Acc. Income a/c | Deducted from concerned income on credit side of P & L a/c. | - |
| (ii) | If it is of closing date i.e. of current year | - | - | Shown on assets side. |
| 5. | Uncured, unearned or advanced income (Income of next year received in advance this year.) | Income A/c Dr. To Unacc. Income a/c | Deducted from the concerned income on the credit side of P & L a/c | Shown on liabilities side. |
| (i)  | Unacc. Income in trial balance-If it is of op. date i.e. of last year | Unacc. Income A/c Dr.To Income a/c | Added to concerned income on credit side of P & L A/c | - |
| (ii) | If it is of closing date i.e. of current year | - | - | Shown on liabilities side. |

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| 6. | Depreciation  | Depreciation A/c Dr.To Assets a/c | Shown on the debit side of P & L A/c | Deducted from the concerned assets side.  |
|  | Dep. in trial balance | - | Debited to P & L A/c | - |
| 7. | Interest on Capital/Loan | Int. on Cap./loan A/c Dr.To Cap./loan A/c | Shown on the debit side of P & L A/c | Added to capital/ Loan on liabilities side. |
|  | Interest on capital/Loan in trial balance | - | Shown on the debits side of P & L a/c  | - |
| 8. | Interest on Drawings. | Drawings. A/c Dr. To Int. on Drawings  | Shown on the credit side of P & L A/c | Deducted from capital on liabilities side. |
| 9 | Credit purchases not recorded | Purchase A/c Dr. To Creditor’s A/c | Added to purchases on the debit side of Trading A/c | Added to creditors on liabilities side. |
| 10. | Credit purchases return not recorded. | Creditor’s A/c Dr. To P/R a/c | Deducted from purchases on the debit side  | Deducted from creditors on liabilities side. |
| 11 | Credit sales not recorded  | Debtor’s A/c Dr.To Sales A/c  | Added to sales on the credit side of Trading A/c. | Added to debtors on assets side. |
| 12. | Credit sales returns not recorded. | S/R A/c Dr. To Debtor’s A/c | Deducted from sales on the credit side of Trading A/c. | Deducted form debtors on assets side. |
| 13. | Goods given as charity or free samples | Charity/Adv. A/c Dr. To Purchases Trading A/c | i. Deducted from purchases/credited to trading A/c  | - |
|  |  |  | ii. Shown on the debit side of P & L A/c  |  |
| 14. | Drawings of goods by owner | Drawings A/c Dr. To Purchases/Trad. A/c | Deducted from purchases credited to trading A/c  | Deducted from capital on liabilities side.  |
| 15. | Goods stolen/damaged by fire:Example : Goods of Rs. 10,000 stolen, claim accepted 6,000 | Ins. Co. A/c Dr. 6000 P & L A/c Dr. 4000To Purchases/Trad. A/c 10,000 | i. Rs. 10,000 deducted from purchases/credited to Trading A/c ii. Rs. 4,000 debited to P & L A/c | Rs. 6,000 shown on assets side as Insurance Co. |
| 16. | Goods in transit:(Goods bought yet in transit) |  |  |  |
|  | i. If it is already included in purchases  | Goods in transit A/c Dr. To Trading A/c  | Credited to Trading A/c  | Shown on assets side. |
|  | ii. If it is not already included in Purchases.(Note: If nothing is cleared in the sum, a note must be given. | i. Purchases A/c Dr. To Creditor’s A/cii. Goods in trans. A/c Dr. To Trading A/c  | ii. Credited to Trad. A/c | ii. Shown on asse. Side. |
| 17. | Goods sold on approval basis: Example- Goods costing Rs. 500 sold on approval for Rs. 600 which is recorded as actual sales. | i. Sales A/c Dr. 600 To Customer 600Note- This entry is passed by sale price. | i. Rs. 600 deducted from sales on credit side of Trading A/c | i. Rs. 600 deducted from debtors on assets side. |
|  |  | ii. Stock on approval a/c Dr. 600To Trading A/c 600Note- This entry is passed by lower of the cost or market price of the goods sold. | ii. Rs. 500 (Being lower of cost or market price) are shown on credit side of Trading A/c  | ii. Rs. 500 (Being lower of cost or market price) are shown on assets side. |
| 18.a. | Purchase of assets:Not rerecorded at all | Assets A/c Dr. To vendor  | - | i. Shown on assets side.ii. Shown on lib. Side  |
| b. | Wrongly included in purchases A/c  | Asset A/c Dr.To Purchases A/c | Deducted from purchases on debit side of Trad. A/c  | Shown on assets side. |
| c. | Installation charges included in wages A/c | Asset A/c Dr.To Wages A/c | Deducted from wages on debit side of Trad. A/c  | Added to the concerned asset on assets side. |
| d. | Depreciation on the above asset. | Depreciation A/c Dr. To Asset A/c  | Debited to P & L A/c | Deducted from the asset on assets side. |
| 19a. | Over/under valuation of stock:Over valuation of Opening Stock. | Capital A/c Dr. To Op. Stock/Trad. A/c | The Difference is either deducted from op. stock or credited to Trading A/c | The Difference is deducted from capital on liabilities side. |
| b. | Under valuation of opening stock. | Op. stock/Trad. A/c Dr.To Capital A/c | The Difference is either added to op. stock or debited to Trading A/c  | The difference is added to capital on liabilities side  |
| c. | Over valuation of closing stock. | Trading A/c Dr.To Cost stock A/c | The Difference is either deducted from clo. Stock or debited to Trading A/c | The difference is added to closing stock. |
| 20. | Personal use of business assets:Example- 25% of the use of business car is for personal purposes. Car exp. Rs. 2000 and deprecation Rs. 800 | Drawings A/c Dr. 700To Car Exp. A/c 500To Car Dep. A/c 200  | P & L A/c –To Car Exp. (2000×75%) 1500To Car Dep. (800×75%)600 | i. Liab. Rs. 700 deducted from Cap.ii. Assets: Rs. 800 deducted from car.  |
| 21. | Cheque/B/R/ received from debtors: | Bank/B/R/ A/c Dr.To Debtor’s A/c |  | Assets Side:i. Deducted from deb. ii. Added to Bank/B/R. |
| 22. | Dishonour of Cheque/ B/R received from debtors  | Debtor’s A/c Dr. To Bank/B/R A/c  | - | Assets Side:Add to debtor deducted from Bank. |
| 23. | Dishonour of discounted/endorsed B/R | Debtor’s A/c Dr. To Bank/Creditors’ | - | i. Assets side : added to debtors ii. Deducted from bank on assets side/added to creditors on liabilities side. |
| 24. | Discounting of a B/R due next year. | - | - | Liabilities side: shown below total in inner column as contingent liabilities.  |

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| 25. | Deposit from debtor wrongly deducted from debtor’s A/c | Debtor’s A/c Dr. To Deposit from debtors A/c  | - | i. Assets side : Added to debtors.ii. Liabilities side :Added to creditors  |
| 26. | Settlement with creditors: Example: A creditor for Rs. 400 is settled at Rs. 320. | - | - | - |
| a. | If it is assumed that payment of Rs. 320 is recorded but discount is not recorded. | Creditors A/c Dr. 80 To Discount 80 | P & L A/c:By Discount A/c 80 | Liabilities side:Rs. 400 deducted from creditors. |
| b. | If it assumed that whole the transaction is omitted. | Creditors A/c Dr. 400To Bank A/c 320To Discount 80 | P & L A/c:By Discount A/c 80 | Liabilities side:Rs. 400 deducted from creditors.Asset side : Rs. 320 deducted from bank |

**‘Depreciation Accounting’**

On the basis of accounting concept of going concern, assets are classified as fixed assets and current assets. Fixed assets are used in the business to derive benefits for more than one accounting period. Periodic profit is measured by charging cost against periodic revenue. Since fixed assets are used to generate periodic revenue, an appropriate proportion of the cost of fixed assets which is believed to be used or expired for generation of periodic revenue needs to be charged as cost. Such an appropriate proportion of the cost of fixed assets is termed as ‘Depreciation’.

**Meaning**

Depreciation means a fall in the value of an asset because of usage or efflux of time due to obsolescence or accident. It is the permanent and continuing diminution in the quality, quantity of value of an asset.

**Definition**

1. **According to Spicer & Pegler, “**Depreciation is the measure of the exhaustion of the effective life of an asset from any cause during a given period.”

Thus, depreciation may be defined as continuing and gradual shrinkage in the value of fixed asses. It has a significant impact in presenting the financial position and result of operations of a business enterprise. It is charged in every accounting period as an expense/ loss to the extent of shrinkage in the value of fixed assets so that cost of production can be determined properly.

**Features or Characteristics of Depreciation**

1. Depreciation is charged on fixed assets except land.
2. Depreciation is calculated on the book value (as shown in the books after charging of depreciation) and not on market value of assets.
3. Depreciation is charged on permanent basis. Once the depreciation is charged, it reduces the value of the asset permanently.
4. Depreciation is charged on a continuous basis. Once the depreciation is charged, it must be charged on regular basis in the succeeding period also.
5. The charge of depreciation will decrease the value of asset gradually. In other words, it must reduce the value of assets slowly and steadily.
6. The process of computation of depreciation implies allocation of cost of an asset over the effective and useful life of the assets.

**Causes of Depreciation**

The principal causes of depreciation are as follows:

1. **By Constant use:** Wear and tear of an asset due to its constant use is a cause of decline in the value of an asset. A fixed asset begins to lose its value when it is used in the business e.g. plant & machinery, building, furniture etc.
2. **By expiry of time**: Certain assets get decreased in their value with the expiry of time whether they are used in the business or no. this is true in case of assets like leasehold properties, patents or copyrights etc. For example, if a lease is obtained for 25 years for Ts. 1,00,000, it will lose 1/25th i.e. Rs. 4,000 of its value every year whether it is used in the business or not. So at the end of 25th year, its value will be reduced to zero.
3. **By Obsolescence:** Some assets are discarded before they are worn out because of changed conditions. For example, an old machine which is still workable may have to be replaced by a new machine because of the later being more efficient and economical. Such a loss on account of new inventions or charged fashions is termed as loss on account of obsolescence.
4. **By Depletion:** Some assets like mineral mines, oil wells etc. get exhausted or depleted through working. On account of continuous extraction of minerals or oil, a stage comes when the mine or oil gets completely exhausted and nothing is left.
5. **By Accidents:** An asset may meet an accident and therefore, it may get depreciated in its value.
6. **By Permanent fall in market price:** Though the fall in the market value of fixed assets is not recorded because such assets are not resale for use in the business. Sometimes, the fall in the value of certain fixed assets is treated as depreciation e.g. permanent fall in the value of investment.
7. **Changes in economic environment:** There may be instances when slackening of demand for the services of an asset may bring about a fall in its value. Such a change in conditions arises due to a number of factors e.g. technological changes within an industry, changes in tastes and habits of consumers, changes in availability of natural resources and so on.

Thus, depreciation applies to fixed assets, depletion to wasting assets, amortization to intangible assets and damage due to dilapidations of building or other property during tenancy.

Need or Objects or Significance of Providing Depreciation

**The following are the objectives of providing depreciation:**

1. **Ascertainment of true profit or loss:** Depreciation being a loss, will certainly affect the business profits. Therefore, to arrive at the true profit or loss, depreciation must be provided for and records in the books of accounts.
2. **Presentation of true financial position**: In a balance sheet, assets must be shown at their true values. This is not possible unless depreciation is provided and deducted from the values of these assets.
3. **Replacement of assets:** Some assets used in the business need replacement after the expiry of their service life. By providing depreciation, a part of the profit of the business is kept in the business which can be used for purchase of new asserts when the old fixed asserts become useless.
4. **Calculation of correct cost of production**: Correct cost of production cannot be calculated unless depreciation is properly provided and accounted for an item of cost of production.
5. **Prevention to withdrawal of capital:** Capital of a business remains invested in different assets. If no depreciation is charged, assets and capital are shown at enhanced figures due to such misrepresentation; capital itself may be withdrawn in the guise of imaginary profit.
6. **Excess payment of income tax**: Depreciation accounting is required for correct computation of profit for tax purposes and for computation of tax liability, otherwise more income tax will be paid on account of excess profit.
7. **To prevent distribution of profit out of capital:** If no depreciation is charged, it will result in showing more profit. Such excess profit may either be withdrawn by the owner or may be distributed among shareholders of the company as dividend. This will mean payment out of capital to the shareholders.
8. **Other objectives:** The workers may demand an increase in the wages or salary or in the payment of bonus as more profit will be shown if depreciation is not provided.

**Factors Affecting Depreciation**

Calculation of depreciation is a difficult work. Following three basic factors are of utmost importance in the calculation of depreciation:

1. **Total cost of the assets:** The cost of the asset includes the invoice price of the asset, less any trade discount plus all costs essential to bring the asset to a useable condition. In other words, cost includes all expenses upto the installation of the assets e.g. freight, carriage, installation charges etc.
2. **Estimated useful life of an asset:** This is represented by the number of years of the estimated serviceable life span of an asset. Thus, if an asset is expected to last for 15 years before completely losing its usefulness for business operations, its life is taken to be 15 years. If a machine can work for 15 years but it is likely to become obsolete in 10 years due to availability of better type of machine, its useful life will be considered as 10 years.
3. **Estimates scrap value of an asset:** The term scrap value means the residual or break up or salvage value which is estimated to be realized on account of the sale of the asset at the end of its useful life. An important part in this connection is that an asset may not necessarily have a scrap value e.g., leasehold property.

Example: if a machine is bought for Rs. 50,000; Rs. 3,000 are spent on its freight, Rs. 2,000 for its installation, it is estimated by the expert that its working life will be 10 years and at that time residual value will be Rs. 2,500. In such case, depreciation will be calculated as follows:

Cost of the asset = Rs. 50,000 + Rs. 3,000 + Rs. 2,000 = Rs. 55,000

Working life of the asset = 10 years

Scrap value of asset Rs. 2,500

It means Rs. 52,500 (Rs. 55,000 – Rs. 2,500) will be written off in the time span of 10 year i.e. Rs. 5,250 every year as depreciation.

**Depreciation and other Related Concepts**

1. **Depreciation and Depletion:** Depreciation refers to a reduction in the value of all kinds of fixed assets arising from then wear and tear. Depletion is used in respect of the extraction of natural resources like quarries, mines, etc. that reduces the availability of the quantity of material or asset.
2. **Depreciation and Obsolescence:** Obsolescence refers to decrease in usefulness caused on account of the asset becoming out of date, old fashioned, etc, and it is one of the causes of depreciation. Depreciation is the loss in the value of an asset on account of wear and tear.
3. **Depreciation and Amortization:** Amortization refers to writing off of the proportionate value of the intangibles such as goodwill patents, copyrights while depreciation refers to writing off of the expired cost of the tangible assets like machinery, building, etc.
4. **Depreciation and Fluctuation :** The points of difference are as follows :

|  |  |
| --- | --- |
| **Depreciation** | **Fluctuation** |
| 1. Charged on fixed assets. | 1. It appears in respect of current assets |
| 2. It is consistent in nature  | 2. It is inconsistent in nature. |
| 3. It has a virtue of continuity. | 3. It has no continuity  |
| 4. It always reduces the value of the asset. | 4. It may cause increase in the value of asset.  |

Use of word per annum for calculation of amount of depreciation

In case the word “per annum” is given with the rate of deprecation than the amount of deprecation is calculated for the number of months the asset is used in business. When sale or purchase of asset takes place in between the year the deprecation is calculated for the period for which the asset was used.

In case per annum word is not given than the concept of number of months for which asset is used is over looked and depreciation is charged for whole year irrespective of asset being purchased in between the year and in case of sale of asset in between the year no deprecation is charged in selling year.

**Methods of Charging Depreciation:**

1. **Fixed Installment Method/ Original Cost Method:**

In fixed installment method, a fixed part of the original cost of the asset is transferred to P & L A/c every year as depreciation. The amount transferred as depreciation is fixed or the same. In this method when the asset becomes useless, its value becomes zero.

1. When the asset has no residual value:

 Original cost of asset

 Each year’s Dep. = Number of years of estimated life of the asset

1. When the asset has residual value:

 Original cost of the asset – Its estimated resident value

 Each years Dep. = Number of years of estimated life of the asset

1. **Diminishing Balance Method/ Reducing balance method/ Written down value method**:

In this method, depreciation is charged on the residual balance of the asset by a fixed rate of percentage. Thus, as the value of asset keeps going down year by year, depreciation also goes down in proportion. In this method the amount of depreciation is decreased every year.

Rate of depreciation is fixed in this method, but depreciation at this rate is calculated on the balance of the asset standing in the books on the first day of each year.

This method is suitable in case of those assets whose repair charges increase as they become old, e.g., Machinery. Also known as Reducing Balance method and written down

value method.

**Difference between Fixed Installment and Reducing Balance Method**

|  |  |  |
| --- | --- | --- |
| **Basis of different** | **Fixed Installment Method** | **Reducing Balance Method** |
| 1. Calculation of Depreciation
 | Depreciation is calculated on the original cost. | Depreciation is calculated on the remaining balance or opening book value of the asset. |
| 1. Variation in dep. amount
 | Amount of annual depreciation remains same. | Amount of annual depreciation keeps decreasing. |
| 1. Balance at the end of life
 | Under this method, balance of asset account is either equal to zero or is equal to scrap value at the end of life of an asset. | According to this method balance of the asset can never be equal to zero. |
| 1. Rate of Depreciation
 | Rate of depreciation is not kept high. | Rate of depreciation is normally kept high. |
| 1. Burden on Profit & Loss
 | Burden of repairs and depreciation is not equitable under this method. | Burden to total cost of running the asset is almost equitable. |
| 1. Applicability
 | This method is adopted on the assets which are of less value and shorter life. | This method is more suitable for those assets which lose their utility gradually and heavy repair cost is incurred on them. |
| 1. Validity
 | This method is not approved by income tax laws. | This method is approved by tax laws and tax rebate is given on depreciation calculated by this method.  |
| 1. Practicability
 | Same depreciation is charged even when the asset is of less value. | As the utility of the asset reduces, the amount of depreciation keeps on decreasing. |

**Journal entries in case of Depreciation**

1. **On asset purchase**

 Asset A/c Dr

 To cash/ Bank

1. **On depreciation charged**

 Depreciation on asset A/c Dr

 To asset A/c

1. **On Transfer of depreciation to P&L A/c**

 P&L A/c Dr

 To depreciation

1. **On sale of asset at profit**

 Cash/ Bank A/c Dr

 To P&L A/c

 To asset A/c

1. **On sale of asset at loss**

 Cash/ Bank a/c Dr

 P&L A/c Dr

 To asset A/c

**Journal entries for Depreciation when provision of Depreciation is made**

1. **For providing depreciation**

 Depreciation a/c Dr

 To provision For Depreciation A/c

1. **For transfer of depreciation to P&L A/c**

 P&L A/c Dr

 To Depreciation A/c

1. **On sale of asset**
	1. Provision for Depreciation A/c Dr

 To Assets A/c

In case of profit or loss on sale of asset

**If Profit:** Asset A/c Dr

 To P&L A/c

**If Loss:** P&L A/c Dr

 To asset A/c

Alternately, on sale asset, an asset disposal account may be opened.

**Change of Method:**

1. In case of change of method of charging depreciation from straight line method to diminishing balance method, the depreciation is charged on the reduced balance of asset on the date when change is applicable.
2. In case of change of method of charging depreciation from diminishing balance to straight line method, the depreciation is charged on the original cost of asset when change is applicable.

**Change of method from previous date (Retrospective effect)**

The change of method from straight line to diminishing balance and from diminishing to straight line can be made effective from the original/ previous date. In such a case there might be extra depreciation already charged or to be charged as change is to be made effective from previous date. The treatment of this extra of less depreciation is to be made. Such change of method is known as change of method from previous date i.e. retrospective effect. As per AS-6 when any change of method of depreciation is recommended, then the change is to be made effective from retrospective effect and not immediate effects.

1. **Annuity Method:** In annuity method the amount invested in an asset is considered as an investment and interest is calculated on such amount. Every year the amount of interest is calculated and same is transferred to debit side of the asset A/c and depreciation A/c is credited. Thus the effect of depreciation and interest keeps increasing on the P & L A/c because every year the P & L A/c is debited with the amount of depreciation and credited with the interest.

Under this method amount of depreciation is found out from annuity table. When as asset is purchased, the purchaser not only loses the amount spent in purchasing the asset but he also loses the expected amount of interest which he would have earned had he invested this amount elsewhere instead of purchasing this asset. Under this method amount of depreciation includes some portion of the asset and some portion of this expected amount of interest also.

1. **Depreciation Fund Method:** In this method, Govt. Investments are purchased every year by the amount of depreciation. More securities are purchased by the return on previous securities. Thus the depreciation is invested in securities. Compound interest is received on such securities. Investments are not made in the last year; instead all securities are sold out and the return is used for renewal. Amount of depreciation is not deducted from the value of the asset; instead it is transferred to the credit side of Depreciation Fund A/c. Asset is shown on the original cost every year.
2. **Depreciation Repairs & Renewals Fund Method**: In this method, the life of the asset, depreciation thereon, scrap value at the end of its life and repairing expenses of the asset are estimated in advance. Such estimated amount is transferred to the P & L A/c in equal parts. In this method a Depreciation Repairs and Renewals Fund a/c is opened. In this account, the estimated installment calculated in the above mentioned manner is transferred to the P & L A/c every year. When the life of the asset is over, it is disposed of. The balance of Fund A/c is transferred to the asset A/c and both accounts are closed. If some balance remains in the Asset A/c it is transferred to the P & L A/c.
3. **Insurance Policy Method:** In Insurance Policy Method the amount of depreciation is not invested in external securities. Instead, an insurance policy is taken for renewal of the asset. Every year a fixed amount is paid as premium of the policy and after a certain period the insurance company pays back in lump sum, which is used for renewal.
4. **Revaluation Method:** In this method at the end of each year the asset is revalued by an expert before the preparation of final accounts and any reduction in the value of the asset is assumed as depreciation and is duly charged. If there is an appreciation in the value of such asset, it is overlooked. When the asset is revalued at a lower price, the amount by which it is reduced is assumed as depreciation. The Depreciation A/c is debited with this amount and asset A/c is credited with the same.
5. **Sum of the year digits method**: First of all the estimated cost of assets is calculated by deducting scrap value from original cost. The total of digits of the assets is made in an order. If the life of a company is five years – 5 + 4 + 3 + 2 + 1 = 15 will be sum of the digits. For calculation of depreciation assets of first year will be assumed to be equal in use of the asset throughout its life. In the following years the period will gradually be reduced. The following formula is used to calculate depreciation:

Estimated value of the asset x Total life of asset

First year = Total of all years

In second and following years one year respectively will be reduced from the total number of years.

1. **Machine hour rate method:** In this method the life of machinery is estimated in hours and the whole loss on the machinery (Cost - Scrap Value) is divided by such hours. Thus the depreciation is calculated on per hour use of the machinery.
2. **Depletion Method :** In this method, an estimate of the profits which the assets is supposed to yield in the future is made and the amount invested in the asset is divided in such profit and depreciation per unit is calculated.

**Difference between Reserves & Provisions**

|  |  |  |  |
| --- | --- | --- | --- |
| **S. No** | **Basis of Difference** | **Reserve** | **Provision** |
| 1 | Meaning  | A reserve is meant for meeting an unanticipated situation. | A provision is created for some specific object |
| 2 | Mode of creation | A reserve is created only out of profit. If there is no sufficient profit, a reserve cannot be created. | A provision is a charge against profit. It is created even though there is no profit. |
| 3 | Time of creation | A reserve is created after ascertaining the profit  | A provision is created before ascertaining the profit or loss of a business. |
| 4 | Object  | The object of creating such reserves is to strengthen the financial position of the business and to increase the working capital. | The object of making provisions is arrangement made to provide funds for known liability. |
| 5 | Utilization  | Reserve can be used in the payment of any liability or loss. | Provision can be utilized only for the purpose for which it is meant. |
| 6 | Distribution  | General reserve are always available for distribution of profits e.g. as dividend. | A provision cannot be utilized for the distribution of profit e.g. as dividend. |
| 7 | Place in accounting | Reserves show excess of assets over liabilities. | A provision is not shown as excess of asset over liabilities but it is helpful for determining the real valuation of assets. |
| 8 | Presenting in balance sheet | Reserves are always on the liabilities side in the balance sheet. | A provision is shown as an item of deduction from its related asset or shown on liability side. |

**UNIT - III**

**Accounting For Hire Purchase**

Accounting for Hire Purchase

Hire purchase system is a special system of purchase and sale. When goods are purchased on hire purchase system, purchasers pay the price in installments, these installments may be monthly, quarterly, six monthly or yearly or of any other period as mentioned in hire-purchase agreement.

Definition of Hire Purchase System

“Under the hire purchase system, goods are delivered to a person who agrees to pay the owner by equal periodical installments, such installments are to be treated as hire of these goods until a certain fixed amount has been paid, when these goods become the property of hirer”

----- J.R. Baltiboi

**Content of hire purchase agreement**

Every hire-purchase agreement shall state – (a) the hire purchase price of the goods to which the agreement relates; (b) the cash price of the goods, that is to say, the price at which the good may purchased by the hirer for cash; (c) the date on which agreement shall be deemed to have commenced ; (d) the number of installments by which the hire purchase price is to be paid, the amount of each of those installments, and the date, or the mode of determining the date, upon which it is payable, and the person to whom and the place where it is payable; and (e) the goods to which the agreement relates, in a manner sufficient to identify them.

Hire Purchase Price: Hire Purchase price means the total sum payable by the hirer under a hire-purchase agreement in order to complete the purchase of, or the acquisition of property in the goods to which the agreement relates; and include any sum, so payable by the hirer under the hire purchase agreement by way of a deposit or other initial payment or credited or to be credited to him under such agreement on account of any such deposit or payment, but does not include any sum payable as penalty or as compensation or damages for a breach of the agreement.

Hirer: Hirer means the person who obtains or as obtained possession of goods from the owner under a Hire-Purchase Agreement and include a person to whom the hirer’s right of liabilities under the Agreement have passed the assignment or by operation of law.

Contract of Guarantee in relation to any Hire: Purchase agreement means contract whereby a person guarantees the performance of all or any of the hirer’s obligations under the Hire-Purchase Agreement.

Owner: Owner means the person who lets or has let, delivers or as delivered possession of goods, to a hirer.

Characteristics of Hire Purchase System:

* Purchase is credit purchase.
* Purchase price is paid in installments.
* Goods are delivered to the buyer.
* Buyer has a right to use these goods.
* Hirer has a right to terminate agreement at any time.

**Characteristics of Hire-purchase System**

(i) Purchase is credit purchase.

(ii) Purchase price is paid in installments.

(iii) Goods are delivered to the buyer.

(iv) Buyer has a right to use these goods.

(v) Seller remains the owner of the goods up to the time of payment of the last installment.

(vi) Hire-purchaser becomes the owner of these goods on a payment of the last instalment.

(vii) It is the duty of these hirer to keep the goods condition upto the date of payment of last instalment.

(viii) It is the responsibility of the owner to make normal repairs free of cost in these goods up to the date of payment of last instalment.

(ix) Hirer has a right to terminate agreement at any time.

(x) If default is made in payment of instalment to the owner, the owner can take possession of the goods subject to legal requirements.

**ACCOUNTING RECORDS FOR GOODS OF SUBSTANTIAL SALE VALUES**

There are two methods of making accounting of making accounting record in the books of Hire-Purchaser:

Asset Accrued Method: This method is adopted by those Hire-Purchasers who think that they have become owner of the portion of goods only for which payment has been made by them.

1. Payment in Cash at the time of Hire-Purchase Agreement:

Assets A/c … …..Dr.

 To Cash A/c

(Being payment of amount at the time of signing of the agreement)

1. For instalment due :

Assets A/c … …..Dr. (Cash price of the asset)

 (Amount of Interest)

Interest A/c … …..Dr. (Total Instalment)

 To Hire Vendor’s A/c

(Being the instalment falling due)

1. For payment of instalment:

Hire Vendor’s A/c … …..Dr.

 To Cash or Bank A/c

(Being payment of instalment)

1. For depreciation :

Depreciation A/c … ….Dr. (On total cash price)

 To Assets A/c

(Being depreciation made at…..% on Rs…..)

1. For transferring of interest and depreciation to Profit and Loss A/c
2. Profit and Loss A/c … ….Dr.

To Interest A/c

To Depreciation A/c

(Being the balance of Int. A/c and Dep. A/c transferred to P. and L. A/c)

Credit Purchase Method: This method is adopted by those hire-purchasers who treat hire-purchasers who treat hire-purchase as real purchase.

1. On the date of Hire-Purchase Agreement:

Assets A/c … …Dr.

To Hire Vendor’s A/c

 (Being the purchase of Assets on Hire-purchase System)

1. For payment at the time of Hire-Purchase Agreement:

Hire Vendor’s A/c … …Dr.

(Being payment of instalment made)

1. For interest due:

Interest A/c … …Dr.

 To Hire Vendor’s A/c

(Being interest becoming due)

1. For payment of instalement:

Hire Vendor’s A/c … …Dr. (with interest & cash price

 To Cash o Bank A/c of instalment)

(Being payment of instalment)

1. For depreciation :

Depreciation A/c … …Dr.(To be calculate on cash price)

1. For transferring interest and depreciation:

Profit and Loss A/c … …Dr.

 To Interest A/c

 To Depreciation A/c

(Being interest & dep. Transferred to Profit and Loss A/c)

**BOOKS OF BUYER**

**Asset Account**

**(Real A/c Dr. and Cr.)**

|  |  |  |  |
| --- | --- | --- | --- |
| To VendorTo Balance b/d |  **Rs.**Full Value | By Depreciation A/cBy Balance c/d |  **Rs.** |
|  |  |
|  |  |

**Vendor Account**

**(Cr. And Dr.)**

|  |  |  |  |
| --- | --- | --- | --- |
| To Cash A/cTo Balance c/d |  **Rs.** | By Asset A/cBy Interest A/cBy Balance b/d |  **Rs.**Full Value  |
|  |  |
|  |  |

**(B) IN THE BOOKS OF HIRE VENDOR**

There is only one method of making record in the books of Hire vendor. Whether record in the books of Hire-Purchaser has been made by the first method or by the second method described above, Journal entries in the books of Hire Vendor are made as under:

1. On the date of Hire-Purchase Agreement:

Hire purchaser A/c …. …Dr.

 To Hire Sales A/c

(Being cash price of the goods sold on Hire-

purchase System)

1. On receipt of Cash at Hire-Purchase Agreement:

Cash or Bank A/c …. ….Dr.

 To Hire-purchase A/c1

(Being the amount received on signing of the agreement)

1. For interest due:Hire-purchaser A/c

Hire-purchaser A/c …. …Dr.

 To Interest A/c

1. For receipt of instalment:

Cash or Bank A/c …. …Dr.

 To Hire-purchaser A/c

(Being the amount of instalment received)

1. For transfer of interest:

Interest A/c ..... …Dr.

 To Profit and Loss A/c

(Being transfer of balance of Interest A/c to Profit

and Loss A/c)

1. For transferring Hire Sales A/c:

Hire Sales A/c …. …Dr.

 To Trading A/c

Depreciation: No entry for depreciation is made in the books of Hire Vendor because the machinery etc. sold has been transferred to Hire-Purchaser and it will depreciate there and not at Hire Vendor’s place.

**DEFAULT IN PAYMENT OF INSTALMENT**

If default is made by the hire-purchaser in payment of any instalment, Hire-Vendor has a right to take possession of the goods and file a suit for recovery of the amount. But provisions of Section 20 of the Hire-Purchase Act are important in this connection.

Where goods have been let under Hire-Purchase Agreement and the statutory proportion of the hire-purchase price has been paid, whether in pursuance of the judgment of a Court or otherwise, or tendered by or on behalf of hirer or any surety, the owner shall not enforce any right to recover possession of the goods from the hirer otherwise than in accordance with sub-section (3) or by suit, Sub-section (3) is as under:

:Where by virtue of the above possession, the owner is precluded from enforcing a right to recover possession of the goods, he may make an application for recovery of possession of goods to any Court having jurisdiction to entertain a suit for the same relief.”

Statutory Proportion here means: (1) One-half where the hire-purchase price is less than fifteen thousand rupees, and (2) three –fourths where the hire-purchase price is less than fifteen thousand rupees:

Provided that in the case of motor-vehicles statutory proportion shall mean:

(i) One-half, where hire-purchase price is less than five thousand rupees; (ii) three-fourth, where the hire-purchase price is not less than five thousand rupees but less than fifteen thousand rupees; (iii) three-fourth or such higher proportion not exceeding nine-tenths as the Central Government may, notification in the official gazette, specify, where the hire-purchases price is not less than fifteen thousand rupees.

If the owner recovers possession of goods in contravention of the above provision, the Hire-Purchase Agreement, if not previously terminated, shall stand terminated and the hirer shall be released from all liability under the agreement and shall be entitled to recover all sums paid by the hirer under the agreement or under any security given by him in respect thereof; and the surety shall be entitled to recover from the owner all sums paid by him in respect thereof.

AS the above Act has not come in force so far, taking possession of goods by the vendor depends on the provisions of agreement entered into between the Hire-Vendor and Hire-Purchaser, but the general rule is that on default of payment of instalment, hire-vendor reserves the right of taking back the goods from Hire-Purchaser. This act of recovery of assets is termed as Repossession.

As regard repossession the hire-vendor has the right to take back the entire asset or any part of it depending on the agreement. When the entire assets are taken over then it is referred as “Complete Repossession” and when only some part of assets are taken back then it is termed as “Partial Repossession”.

Complete Repossession–Accounting Records: The following entries are recorded in the books of:

(A) Hire-Vendor

 (i) On taking back the assets:

 Repossessed Assets A/c … …Dr.

 To Hire-Purchaser’s A/c

 (ii) If some repairing & reconditioning expenses are paid or repossessed asset:

 Repossessed Asset A/c … …Dr.

 To Bank/Cash A/c

 (iii) On Sale of Repossessed Asset:

 Bank A/c … …Dr.

 To Repossessed Asset A/c

 (iv) In case of debit balance in Repossessed asset account after sale (loss):

 Profit & Loss A/c … …Dr.

 To Repossessed Asset A/c

 (v) In case of credit balance in Repossessed asset account after sale (Profit):

 Repossessed Asset A/c … …Dr.

 To Profit & Loss A/c

(B) In the Books of Hire-Purchaser

 (a) When the asset is taken back and to close the Vendor’s Account

 Hire-Vendor’s A/c … …Dr.

 To Assets A/c

(b) To close the asset account:

 Profit & Loss A/c … …Dr.

 To Asset A/c

**INSTALMENT PAYMENT SYSTEM**

Instalment Payment System is one of the methods of credit sale and purchase. Under this system, purchase price is paid by the buyer in instalments and become the owner on the date of entering into agreement.

**DEFINITON OF INSTALMENT PAYMENT SYSTEM**

“Under an agreement to purchase and pay by instalments, the goods become the property of the purchaser immediately when he receives the delivery of the same.”

“Under instalment system property in goods or ownership is transferred to the buyer immediately, though he has to make payment in goods or ownership is transferred to the buyer immediately, though he has to make payment in many years. If buyer is unable to make payment of any instalment, vendor cannot take back the goods, he can only file suit for recovery of amount.”

“Though hire-purchase and instalment system appear similar from outside because under both the systems, payment is made to the seller in instalments, but there is vast difference between the two. First system is a hire transaction which takes the form of a sale at the end, second method (Instalment Payment System) is a transaction of immediate sale; under this system instead of making payment in a lump sum, payment is made during a prescribed period by instalments and provision is made for payment of interest also.”

Ideal Definiton: Instalment Payment Susyem is such a system of sale in which property in goods or ownership is immediately transferred to the buyer at the time of sale and sale price is paid in instalments along with the amount of interest on unpaid balance. On default of payment of any instalment, seller is not entitled to take back the goods, but he may file a suit for the amount due.

**Characteristics of the Instalment Payment System**

1. Under this system goods are sold and delivery is also made to the buyer, but its full price is not paid at the time of sale, therefore, this sale is like credit sale.
2. Payment of purchase price is made in agreed instalments.
3. Ownership is transferred to the buyer immediately at the time of sale.
4. On making default in payment of instalment, seller cannot take back the goods, he third only file a suit for the amount due.
5. If buyer sells these goods before payment of the last instalment to the third party, third party gets better title.

**Difference between Hire-purchase and Instalment Payment System**

|  |  |  |
| --- | --- | --- |
| **Basic of Difference**  | **Hire-Purchase System** | **Instalment System** |
| 1. Nature of contract  | It is like contract of hire, though later on it becomes sale. | It is sale from the very beginning  |
| 2. Transfer of ownership | Here ownership is transferred after the payment of the last instalment. | Here ownership is transferred in the beginning at the time of sale. |
| 3. Return of Goods | On default of payment of instalment, seller has a right to take back the goods. | On default of payment of instalment, sellers have no right to take back the goods from the buyer. |
| 4. Better Title | If buyer sells goods to the third party before payment of the last instalment, this third party does not get better title on these goods. | If the buyer sells goods to the third party before the payment of the last instalment, this third party gets better title on these goods. |
| 5. Responsibilities of Normal Repair | Upto the time of payment of the last instalment responsibility of normal repair is on the seller because he continues to be the owner thereof. | Here seller is not at all responsible for the repair. |
| 6. Bailee  | Here buyer is like a bailee. | Here buyer is not like a bailee. |
| 7. Risk | Upto the payment of last instalment risk is on the seller. | Risk is not on the seller |

**ACCOUNTING RECORD UNDER INSTALMENT SYSTEM**

**Entries in the Purchaser’s Books**

1. For Purchase

Assets A/c … …Dr. (Cash Price)

Interest Suspense A/c … …Dr. (Total Interest)

To Vendor’s A/c (Total Price)

(Being the purchase under the Instalment Purchase System, interest calculated……..)

Buyer has to pay the cash price plus the amount of interest to the Vendor. On the first day of the transaction, the whole of this interest should not be treated as interest because it becomes due year after year, according to the nature of instalments. Hence, it is temporarily transferred to Interest Suspense Account. As interest becomes due Interest Suspense Account is written off with this amount of interest and thus in the year of payment of last instalment, Interest Suspense Account is completely written off.

1. On Payment of Cash at the time of Purchase

Vendor’s A/c … …Dr.

 To Cash A/c or Bank A/c

(Being payment of cash to the seller at the time of transaction)

1. For Interest becoming Due

Interest A/c … …Dr.

 To Interest Suspense A/c

(Being transfer of interest falling due)

1. For Payment of Instalment

Vendor’s A/c … …Dr.

 To cash A/c or Bank A/c

(Being the amount of instalment paid)

1. For Depreciation

Depreciation A/c … …Dr.

 To Asset A/c

(Being charging of depreciation @......)

1. For transfer of Interest and Depreciation

Profit & Loss A/c … …Dr.

 To Interest A/c

 To Depreciation A/c

(Being transfer of balance of interest and depreciation accounts to P. & L. A/c)

**Entries in the Book of Vendor**

1. For Sale

Buyer A/c … …Dr. (Full Cash Price

 + Total Interest) To Sales A/c (Cash Price)

 To Interest Suspense A/c (Total Interest)

(Being sale of goods on instalment system and record of Interest Suspense A/c)

1. For receipt of Cash at the time of Sale

Cash/Bank A/c … …Dr.

 To Buyer A/c

(Being receipt of cash on delivery of the goods)

1. For Interest becoming due

Interest Suspense A/c … …Dr.

 To Interest A/c

(Being interest due)

1. For receipt of Instalment

Cash/Bank A/c … …Dr.

 To Buyer A/c

(Being receipt of instalment)

1. Transfer of Interest Account to Profit & Loss Account

Interest A/c … …Dr.

 To P. & L. A/c

(Being transfer of interest)

1. Transfer of Sale to Trading A/c

Sale A/c … …Dr.

 To Trading A/c

(Being transfer of sales to Trading Account)

**Bank Reconciliation Statement**

**Meaning of Bank Reconciliation Statement**

In modern time, every businessman has an account in the bank. The money is regularly deposited and withdrawn. These are known as Baking transactions. They are recorded in cash book and Pass Book.

 There should be no difference between the balance shown by the pass book and the cash book. This will be so if all the entries are recorded in the cash books but not in the pass book and vice-versa. This why that there may be different balance between the both the cash book and pass book on a particular date. This disagreement between the both books will be because of some of the reasons.

 At the end of each month, two balances should be compared and if there is disagreement, exact reasons for it should be found out. In other words, the two balances must be fully reconciled. For the purpose a statement reconciling two balances is prepared. This statement is called **Bank Reconciliation Statement.**

A Bank Reconciliation statement, can be defined as a statement prepared with a view to indicate the items which cause disagreement between the balance as per the bank columns of cash book and pass book on any given date.

**Characteristics**

It is now clear that Bank Reconciliation statement is prepared with a specific purpose. The purpose is to reconcile the two balances. Following are the main characteristics of Bank Reconciliation Statement-

1. **Preparation in case of Difference-** Bank Reconciliation Statement is prepared when there is difference between the balances shown by Pass Book and Cash Book.
2. **Preparation on Fixed Date-** Bank, after making entries in the pass book, sends it to the customer. After this the Bank Reconciliation is prepared on a particular date which may be end of week, end of forth night or end of month.
3. **Preparation by the Trader-** This statement is prepared by the customer or trader n the basis of balance of pass book and cash book.
4. **To know reasons-** Bank Reconciliation Statement is prepared only for knowing exact reasons of disagreement of two balances shown by cash book and pass book.

**Causes of difference between Cash book and Pass Book**

|  |
| --- |
| **Causes of difference** |
| 1. Cheque deposited into the bank but not yet collected and credited.
2. Cheques issued but not yet presented for payment.
3. Amount collected or credited by bank.
4. Amounts paid or debited by bank.
5. Bank charges.
6. Interest credited by the bank.
7. Interest credited by bank on overdraft.
8. Direct payment by customers into the bank account.
9. Dishonour of cheques or bill.
 |

 Following are the cause of difference in the balance as shown by the cash book and the bank pass book on any particular date.

1. **Cheques deposited into the bank but not yet collected-** When cheques are deposited, in the books of firms, the bank account is immediately debited but in the books of bank, the firm’s account is not credited until they are actually collected by the bank.
2. **Cheques issued but not presented for payment-** Similarly, the entry for the issue of cheque is made in the books of the concern immediately and the bank account is credited. But in the books of bank, entry for payment can be made only when cheque is presented for payment. At the time of comparison it is quite possible to find out some case where cheques were issued and recorded in the cash book but not presented for payment.
3. **Amount collected or credited by bank-** Often, a concern issue standing instructions to the bank to collect on its behalf dividends, interest etc. on investments. When the bank collects such amounts, it immediately credits the customer account with it. The necessary intimation and advice is sent to the concerned party after this done. The party will debit the bank account in the cash book only when it receives such intimation. If, before this entry, the two balances are to be compared, the cash book balance will be lower than the bank balance.
4. **Amounts paid or debit by the bank-** The concern may also issue instruction to the bank for making some payments on its behalf and debit the concern’s account with it, e.g., life insurance premium, rent, payment of instalments, payment of bills payable etc. Whenever such payments are made by the bank, the Party’s account is immediately debited. Thus, the pass book balance is reduced. The Party will credit the bank account in the cash book only when it gets intimation of such payment from the bank. Till then, the two books will show difference.
5. **Bank charges-** Bank renders many services to its clients and for that it levies charges. Entry charges is made by the bank but corresponding entry for its does not appear in the cash book of the concern because it is not known to the client until he receives a statement. This causes a difference.
6. **Interest credited by the bank-** Bank normally, do not allow any interest on current accounts. But if it is allowed, the concern’s account is credited by the bank, which will increase the firm’s balance with the bank. On the other hand, the firm will record it on the debit side of the bank account in the cash book only when the pass book is received.
7. **Interest debited by bank on overdraft-** If the firm withdraws more money from the bank than the available deposits with it, it is called an overdraft. Overdraft facility is permitted to the party by the bank only when it fulfils certain conditions. The bank charges interest on overdrawn balances. The firm will record the interest on the credit side of the cash book only when it gets the pass book duly completed. Till then, the two books will show different balance.
8. **Direct payment by customers into the bank account-** Sometimes, customers may deposit money direct into the firm’s account in the bank. The bank will immediately record the entry on the credit side of the firm’s account and thus in the pass book and increase the balance. But, the firm will debit the bank account in the cash book only when it gets the intimation or the pass boo. In the meantime, if two balances are to be compared, the cash book balance will be lower than the pass books balance.
9. **Dishonour of cheques or bills-** When cheques are depositedin the bank for collection, the firm debits the bank account in the cash book. It increases the balance immediately. But the bank will credit the proceeds of cheques only when they are collected. If due to some reason, some cheques are dishonoured, i.e., not collected, the bank will net credit the firm’s account. If the two balances are compared, the cash books balance will be more than the pass book. Balance.

**Preparation of Bank Reconciliation statement**

The Bank Reconciliation Statement is prepared to know the exact reasons of disagreement of balance shown by Cash Book and Pass Book at a particular date. For this all the entries of Pass Book should be tallied with the entries of Cash Book. Those entries which are done in both the books are ticked with the sign of right. There are certainly some entries which are recorded in Pass Book but not recorded in the Cash Book by the trader or recorded in Cash Book but not yet recorded in Pass Book by the bank. Only these entries are responsible for the difference in the balances shown by Pass Book and Cash Book. These entries must be chosen and a reconciliation statement is prepared.

 While preparing reconciliation statement following points should be taken into consideration-

1. The debit balance of Cash Book means the trader has deposit of money in the bank. The credit balance of Pass Book has the same meaning.
2. The credit balance of Cash Book or debit balance of Pass Book shown an overdraft position. In other words, the trader has taken excess money from bank than of his deposits in banks.
3. If the trader issues cheques to the parties for payment, it will be recorded in the credit side of Cash Book and debit side of Pass Book.
4. Cheques, Bills, Drafts, Cash etc. deposited in bank are recorded in the debit side of cash book and credit side of pass book.
5. Bank Reconciliation Statement is prepared by taking base of any one balance either of Cash Book or Pass Book.
6. If the statement is prepared taking the base of cash Book balance, Pass Book balance would be known. If the base of Pass Book balance is taken, Cash Book balance would be known.

**Methods of preparing Bank Reconciliation Statement**

 Bank Reconciliation Statement is prepared to remove the reasons (if any) of the disagreement of balances shown by Cash Book and Pass Book. This disagreement arises when some transaction are recorded in cash book but not in Pass book or recorded in pass book but not in cash book. There are two methods of preparing this statement. In other words, Reconciliation Statement may be prepared by following two methods-

1. On the basis of Bank Balance of Cash Book.
2. On the basis of Bank Balance of Pass Book.
3. **On the basis of Bank Balance of Cash Book-** If we start to reconcile two balance with the Cash Book Balance which may be either Debit or Credit. The methods is described in the both cases as below-
4. **Debit Balance as per Cash Book-** Debit balance of Cash Book means that the money is in the bank in the trader’s account. In this case, items would have to be added to or subtracted from such balance to arrive at the Pass Book Balance. Following rules are to be taken into consideration:

**Items to be added in Cash Book Debit Balance.**

1. Cheques issued but not presented for payments in the bank.
2. Interest credited or allowed by the bank but not entered in cash book.
3. Interest on investments, dividends, amount of Bill Receivable not entered in Cash Book.
4. Direct deposit by our customer into the bank in trader’s account.

**Items to be subtracted in Cash Book Debit balance.**

1. Cheques, Bank Drafts B/R etc. deposited into bank but not yet collected and credited in our account by the bank.
2. Bank expenses, Commission, Bank charges, Interest on overdraft etc.
3. Direct payment made by the bank but nit entered in Cash Book.
4. Discounted bill dishonoured and not entered in Cash Book.
5. **Credit Balance as Per Cash Book-** Credit Balance of Cash Book shows an overdraft position. Its meaning is that the credit side of bank column is bigger than the debit side. In this situation, balance should be written in minus Item side.
6. **On the basis of Bank Balance of Pass Book-** The Pass Book balance may also be debit or credit. While preparing a reconciliation statement, certain items are also to be added and subtracted from such balance and thus the Cash Book Balance is arrived. Following rules in both the cases to be followed:
7. **Debit Balance as per pass Book-** Debit balance of Pass Book shows as overdraft position. While preparing reconciliation statement, opposite rules of the above should be followed.
8. **Credit Balance as per Pass Book-** In this situation, there is debit balance of Cash Book. Rules described in A should be followed.

**How to Prepare**

**Bank Reconciliation Statement**

The aim of preparing Bank Reconciliation Statement is to tally the balance of cash Book with pass Book. For this purpose, either balance as per cash book or balance as per pass book is given in problem and we are required to calculate another balance.

**When Balance as per cash Book is given**

1. Add those items which have been added in Pass Book.
2. Less those items which have been deducted in Pass Book.
3. It any item is added in Cash Book but not in Pass Book, it should be added.
4. If any item is deducted in Cash book but not in pass book, it should be added.

**When Balance as Per Pass Book is given**

1. Add those items which have been added in Cash Book.
2. Less those items which have been deducted in cash Book.
3. If any item is added in Pass Book but not in Cash Book, it should be deducted.
4. If any item is deducted in Cash Book but not in Pass Book, it should be added.

**Proforma for Preparing**

**Bank Reconciliation Statement**

As on……

|  |  |  |
| --- | --- | --- |
| **Particulars** | **Rs.** | **Rs.** |
| **Balance as per Cash Book** |  |  |
| 1. Add
2. Less
3. Add
4. Less
5. Add
6. Less
7. Add
8. Less
9. Add
10. Less
11. Add
12. Less
13. Add
14. Less
 | Cheques issued but not yet presented for Payment.Cheques deposited or paid into bankBut not yet collected or credited.Interest allowed by the bank Bank chargesDirect payment by a customer into bankInsurance premium paid by the bank Interest on investment allowed by the bankInterest on overdraft charged by the bankDishonoured cheques or bills Rebate on bills retired under rebate through the bank but full amount entered in the cash book. Drawings made by partners not entered in cashAny wrong entry on Cr. Side of in cashAny wrong entry on Dr. side of the pass book  Balance as per Pass Book Rs. |  |  |

**Bank Reconciliation Statement**

As on……

|  |  |  |
| --- | --- | --- |
| **Particulars** | **Rs.** | **Rs.** |
| **Balance as per Cash Book** |  |  |
| 1. Less
2. Add
3. Less
4. Add
5. Less
6. Add
7. Less
8. Add
9. Less
10. Add
11. Less
12. Add
13. Less
14. Add
 | Cheques issued but not yet presented for payment.Cheques paid into bank but not yet collectedInterest allowed by the bank Bank chargesDirect payment made by a customer into bankInsurance premium paid by the bankInterest on investment received by the bank Interest overdraft charged by the bank Dividend on shares collected by the bankDishonoured cheqes or bills Bills retired under rebate through the bank Drawing made by partners not entered in cash bookAny wrong entry on Cr. side of the pass book Any wrong entry on Dr. side of the pass book Balance as per Pass Book Rs. |  |  |

**CONSIGNMENT**

Quite often, goods are dispatched a manufacture or wholesale merchant to someone else on the basis that the goods are to be treated as the property of the consignor (the person who dispatches them) and to be sold at his risk. The consignee (the person receiving the goods) does not buy these goods, but merely undertakes to sell them on behalf of the consignor. The sale proceeds belong to the consignor and the consignee merely gets the agreed commission for his services in addition to any expense he might have incurred. The relationship between the consignor and the consignee is that of principal agent. Whatever the consignee does in on behalf of the consignor and, therefore, the consignor must reimburse the consignee for his expenses (unless otherwise agreed upon); he is entitled to recover from the agent the monies received by him on behalf of the principal. However, everything depends on the agreement between the consignor and the consignee.

**Account Sales**

When goods are dispatched, the consignor makes out a “Pro Forma Invoice” that is, a statement which looks like a regular invoice but which does not make the consignee responsible to pay the amount named. The consignee may, of course, remit a sum of money in advance to assure the consignor of his goods faith. This may be done in the form of acceptance of a bill of exchange or a simple bank draft. The advance will be adjusted proportionately as goods are sold. Suppose a sum of Rs. 20,000 is sent as advance against a consignment of 100 cases and only 80 cases are sold when accounts are drawn up. Only Rs. 16,000 will be adjusted when these are disposed of. Periodically, the consignee will send statements of sales made and expenses incurred, commission earned and the consequent amount due to the consignor. Such statement is known as Account Sales. A specimen of the Account Sales is given on the next page.

 From the Account Sales, the consignor will know that 25 bales of the goods sent to the consignee have realized Rs. 53,000 gross. The consignee is to be reimbursed to the extent of Rs. 2,250 for expenses incurred by him and is to be allowed a commission of Rs. 3,180, i.e. 6% on Rs. 53,000. Deducting Rs. 10,000 for which a bill of exchange has already been accepted, the consignee encloses bank draft for the balance. “E.& O. E.” stand for “errors and omissions excepted”, meaning thereby that if any mistake has crept in, it will be corrected.

**Account Sales of 25 bales of cotton goods received form and sold on account of Smith and Sons, by Gokulbhai Lalbhai, 24, Cloth Market, Delhi**

|  |  |  |
| --- | --- | --- |
| 20 ales, cotton goods @ Rs. 2,100 per bale5 bales, cotton goods @ Rs. 2,200 per baleLess: Charges:– Rs. Octroi 750 Freight 1,000 Godown rent 500Less: Commission @ 6 per cent on Rs. 53,000Less: Amount of bill of exchange accepted earlierBalance due, bank draft enclosed herewith |  Rs. 42,000 11,000 |  Rs.  53,000 5,430 |
|  2,250 3,180 |
|  |  47,570 10,000 |
|  37,570 |

E. & O. E. For Gokulbhai Lalbhai

Delhi, the 16th August, 2000 Signed …………………………

**Del Credere Commission**

 For the ordinary commission that the consignee gets, the consignee does not guarantee that all those who buy on credit will pay up; the consignee is not responsible for bad debts. It is usual, however, to make the consignee responsible for bad debts by giving him an additional commission, on total sales. The additional commission for which the consignee guarantees debts is called Del Credere Commission. The agent is responsible for bad debts but not for loss due to dispute between the buyer and the seller.

 It should be noted that Del credere commission is payable on total sales and not merely on credit sales. This is presumably because the agent should be remunerated also for distinguishing those to whom credit may be allowed from others. Also, if the commission were to be allowed those to whom credit may be allowed from others. Also, if the commission were to be allowed only on credit sales, the agent would be tempted to record all sales as credit sales, by making out an invoice instead of a cash memo, and then recording a receipt from the customer concerned.

**Books of the Consignor**

It desirable to know the profit or loss made on a consignment separately. For the purpose, a Consignment Account is opened. If goods are consigned to a number of parties, as many consignment accounts as there are consignees will be opened so that profit or loss on consignment to be each consignee may be ascertained separately. At the outset, it should be noted that a consignment account is not a personal account but is in the nature of a special type of a trading and profit and loss account; it is designed to show profit or loss made on the particular consignment.

 To this account, goods sent to the consignee are debited at cost; expenses incurred by the consignor in dispatching the goods are also debited. On receipt of the account sales from the consignee, the gross sale proceeds will be credited, the consignee’s expenses and commission being debited to the consignment account. The double entry is completed in the consignee’s personal account. The difference in the two sides of the consignment account will show profit (if the credit side is bigger) or loss (if the debit side is bigger). This is assuming that all the goods have been sold; otherwise an adjustment for stock on hand has to be made. This is dealt with later.

1. On dispatch of goods:– …. Dr.] with the cost\* of goods

Consignment Account

 To Goods Sent on Consignment Account

\* The method to deal with goods invoiced at selling price is discussed later.

1. On the consignee reporting sale (as per Account Sales):

Consignee’s Personal Account ……Dr. ] with gross proceeds of sales.

 To Consignment Account

1. For commission payable to the consignee:– ……Dr.] with the account of the

To Consignee’s Personal. Account commission due to the consignee.

Assuming that all the goods sent have been sold, the Consignment Account will now reflect profit or loss. This should be transferred to the Profit and Loss Account. The entry in case of profit is:

 Consignment Account …… Dr.

 To Profit and Loss Account

 In case of loss, the entry is reverse.

**Note:–** The “Goods Sent on Consignment Account” is transferred to the Purchases Account is case the consignor carries on a trading business in which there are no carriage inwards etc. (to reduce the debit shown in the Trading Account so as to make it matching with the sale price of the goods sold normally and credited to the Trading Account ) and to Trading Account if the consignor carries on a manufacturing business.

**Books of the Consignee**

 No entry is passed by the consignee when he receives goods from the consignor. Also, he does not record the expenses incurred by the consignor in connection with dispatch of goods. The consignee make entries only when he accepts a bill drawn on him by the consignor, when he (the consignee) incurs some expenses on the consignment, when the goods are sold, for the commission earned and when he makes payment either on account or in full settlement of his account with the consignor. Hence, the entries made by the consignee are a follows:–

1. On dispatch of goods by the consignor no entry.
2. On payment of expenses by the consignor no entry.
3. On the consignee accepting a bill or exchange:

Consignor’s Personal Account ….. Dr.] with the amount of bill

1. On expenses incurred by the consignee on the consignment:

Consignor’s personal Account ….. Dr.

 To Cash Account

1. On sale being affected:

Cash (or Bank) Account ……Dr.

 To Consignor’s Personal Account

1. On commission being earned:

Consignor’s Personal Account ……Dr.

 To Commission Account.

1. On making payment to the consignor:

Consignor’s Personal Account

To Bank ……Dr.

**Valuation of Stock**

 When consignor closes his books of account for an accounting year, he may find that some of the goods sent on consignment have not yet been sold by the consignee and they are still lying with the consignee. These goods must be valued and brought into account just like the closing stock for preparation of the Trading Account. The stock is usually valued at cost, But “cost” should not mean merely the cost at which the consignor invoices the goods. If such expenses as normally increase the value of goods have been included, a proportion of such expenses should be included in the cost. Freight, customs duty, insurance in transit and loading and unloading charge are all added to the value of goods. If one orders goods from London worth Rs. 10,000 and has to pay Rs. 2,000 as freight and Rs. 2,500 as customs duty, the real value of the goods is Rs. 14,500. It is on this basis that the cost of the closing stock should be calculated. It does not matter who pays the expenses. If such expenses have been incurred (whether by the consignor or by the consignee), they from part of cost, since they bring the goods to the place and the condition in which they are to be sold.

But there are some other expenses which are incurred while the consignment is being disposed of, but which do not increase the value of goods. Examples of such expenses are godwon rent, insurance of godown, advertisement, salaries of salesmen, etc. Hence, at the time of valuation of stock, such expenses should be ignored. The main principle of valuing closing stock at cost or market price, whichever is less, is also applicable here. Hence, if the stock with the consignee can be disposed of at a price lower than the cost, the closing stock should not be valued at anything higher than the selling price.

**Entry in Books**

 Only the consignor makes an entry for the stock–the consignee makes no entry. The entry is:

 Stock on Consignment Account ….. Dr.

 To Consignment Account

 The Stock on Consignment Account is an asset and will appear in the balance sheet. Next year, it will be transferred to the debit of Consignment Account as opening stock.

 Alternatively, no entry may be passed. The value of the stock will be credited in the Consignment Account itself (and shown in the Balance Sheet).

**Loss of Goods–Abnormal:**

 Abnormal loss of goods occurs due to accident, mischief or carelessness. For example, goods may be destroyed by fire or there may be a theft of goods. Such a loss does not occur often. In order to ascertain the normal profitability of a Consignment, abnormal loss should be debited to Abnormal Loss Account and credited to Consignment Account. The amount of the loss is ascertained like the value of closing stock at cost except the expenses incurred on the remaining goods after the loss have to be ignored while calculating the amount of the loss because nor part of such expenses can be said to have been incurred on the goods lost. For example, suppose 200 packets of a commodity are consigned, cost being Rs. 400 per packet, the consignor spending Rs. 600 by way of cartage and railway freight. Suppose, five packets of the commodity are lost in transit and the consignee takes delivery of 195 packets only which he brings to his godown paying cartage amounting to Rs. 150. In this case, Abnormal Loss Account will be debit and Consignment Account credited with Rs. 2,015 calculated as follows:–

 Rs.

 Invoice price of 5 packets = Rs. 400 × 5 2,000

 Add: Proportionates cartage and railway \_\_\_\_\_\_

 freight paid by consignor Rs. 600 ×  15

 2,015

 Cartage amounting to Rs. 150 paid by the consignee has been ignored because no part of this cartage has been spent of goods lost.

 Even when abnormal loss is fully or partly covered by insurance, Abnormal Loss Account may be debited and Consignment Account credited with the full cost of the goods involved in the loss; the amount recovered from the insurance company will be credited to Abnormal Loss Account and the balance, if any, left in Abnormal Loss Account will be transferred to Profit & Loss Account.

 Alternatively, Abnormal Loss Account may not opened; entries relating to goods lost in abnormal manner will all, then be passed in the Consignment Account itself, the final abnormal loss being debited of Profit & Loss Account and credited to Consignment Account.

If abnormal loss is ignored, the final net profit is not affected. But it is desirable to record the abnormal loss so that normal profitability of the Consignment may be revealed.

**Normal Loss:**

In certain cases, some loss is inherent and unavoidable. For instance, if a certain quantity of coal is consigned, some of it is bound to be lost because of loading and unloading and because of some of it turning into dust. Such inherent unavoidable loss is known as normal loss and should be allowed while calculating the cost of the stock on hand. Suppose 200 tonnes of coal are consigned at Rs. 1,000 per tonne, freight being Rs. 10,000 By the end of the year, the consignee has sold 130 tonnes of coal and is left with 65 tonnes of coal, the remaining 5 tonnes of coal having been lost due to normal wastage. The closing stock of 65 tonnes will be valued at Rs. 70,000; calculation being made as follows:–

 Total Cost:

 Invoice price of 200 tonnes = Rs. 1,000 × 200 Rs. 2,00,000

 Add: Freight Rs. 10,000

 Rs. 2,10,000

 Total quantity–Normal wastage = 200 tonnes – 5 tonnes = 195 tonnes

 Considering Rs. 2,10,000 to be the value of 195 tonnes, value of 65 tonnes – Rs 2,10,000 × 65/195 = Rs. 70,000

 (It will be a mistake to value closing stock as Rs. 2,10,000 × 65/200 or Rs. 68,250.)

**Invoicing Goods Higher than Cost**

Sometimes, the consignee is sent the proforma invoice at selling (or near selling) price. The main purpose is to keep the real profit a secret from the consignee. It must be understood at the very outset that this cannot make any difference to the real profit (or loss), since that is always the difference between selling price and cost. However, the entries made in this case are a little different from those if goods are invoiced at cost. The difference in entries is in respect of goods sent on consignment and stock. When goods are invoiced at a figure higher than cost, the following entries are made:–

1. On sending the goods:

Consignment Account …… Dr.] with invoice value of goods sent.

 To Goods Sent on Consignment Account

1. On expenses being incurred by the consignor:

Consignment Account ……. Dr.] with expenses incurred.

 To Cash (or Bank)

1. On the consignee sending account sales:

(a) For sales:

 Consignee’s Personal Account ……. Dr.] with sale proceeds.

 To Consignment Account

(b) For expenses incurred by the consignee:

 Consignment Account …… Dr.] with expenses incurred

To Consignee’s Personal Account

 (c) For commission:

 Consignment Account …… Dr.] with commission payable to

To Consignee’s Personal Account consignee

1. For the stock lying unsold:

Stock on Consignment Account …… Dr.] with the proportionate invoice

 To Consignment Account ] value and those expenses which

 ] add to the value of goods.

1. To bring the value of goods sent down to

Good Sent on Consignment Account …… Dr.] with the difference between the

 To Consignment Account ] invoice value and cost.

1. To adjust the value of stock lying with the

consignee:

Consignment Account …… Dr.] with the difference between the

 To Consignment Stock Reserve Account ] value of stock computed as in (4)

 ] and the cost plus proportionate

 ] expenses of the stock.

 The whole idea of entries (5) and (6) is to really construct the account on cost basis. Entry (1) was made at selling price. Entry (5) is made to bring it down to cost. Similarly, entry (4) for stock is also on the basis of in invoice price, whereas it should have been on the basis of cost: entry (6) ensures that.

 The balance of the Goods Sent on Consignment Account will be transferred to the Trading Account (in case of manufacturing concerns) or Purchases Account (in case of trading concerns having no carriage inwards etc.) The balance in the Stock on Consignment Account will be carried forward. The balance in the Consignment Stock Reserve Account will be carried forward. In the balance sheet, the Consignment Stock will appear on the assets side as reduced by the balance in the Consignment Stock Reserve Account. Thus:

**Balance Sheet**

 **Rs.**

 Stock on Consignment ……

 Less: Consignment Stock Reserve Account ……

 Next year, the Stock on Consignment Account will be transferred to the debit side of the Consignment Account and the Consignment Stock Reserve Account will to transferred to the credit side of the Consignment Account.

**UNIT-IV**

**BRANCH ACCOUNTS**

Many business concerns open branches at various places for selling their goods. These branches may be opened in the town, in the state and in the country at various places and also in foreign countries.

Meaning of Branch Accounts : Account which are opened in the books of head office and branches, related to branches are called Branch Accounts.

Objects of maintaining Branch Accounts : (i) Profit or loss of each branch can be found out; (ii) They help in controlling branches; (iii) Actual financial position of the business can be found out on the basis of Head Office and Branch accounting records; (iv) Branch requirements of goods and cash can be estimated; (v) Suggestions for increasing the efficiency of the Branch can be made on the basis of Branch Accounts;(iv) They help in complying the requirements of law because according to the Companies Act, 1956, maintenance of accounting record of branches by companies is essential.

**Specimen of Branch Account in Head Office Books**

|  |  |
| --- | --- |
| **Rs.** | **Rs.** |
| To Balance b/d | By Balance b/d (op. Liabilities |
| Opening stock | By Cash A/c |
| Opening Petty Cash | By goods Supplied to Branch |
| Opening Assets | (Return) |
| To Goods Supplied to Br. | By Assets (Closing Balance) |
| To Cash (Exp.) a/c | Stock at Branch a/c |
| To Liabilities (Closing) | Petty Cash at Branch a/c (Closing) |
| To General P & L A/c | By General P & L A/c (Closing) |
| (if profit) | (if Loss) |

**INCORPORATION OF BRANCH TRIAL BALANCE IN HEAD OFFICE BOOKS**

Each branch sends its Trial Balance to Head Office. With the help of this Trial Balance Head Office makes record in its books regarding Branch. It is known as Incorporation of Branch Trial Balance. In order to incorporate Branch Trial Balance in Head office books, it should be divided in two parts:

**STOCK AND DEBTORS METHOD**

Under this method following accounts are opened in the books of Head Office for Branch :

1. Branch Stock Account.
2. Goods sent to Branch Account
3. Branch Debtors’ Account
4. Branch Expenses Account
5. Branch Adjustment Account
6. Stock Reserve Account
7. Branch P & L Account.

**INDEPENDENT BRANCH**

These branches receive goods from Head Office but they are allowed to manufacture and purchase goods also. They are completely independent for all the activities but their owner is Head Office and they have to follow the instructions of Head Office.

1. Items related with Trading and Profit and Loss Account ‘
	1. Opening Stocks, Purchases and Direct Expenses :

Branch Trading A/c … …Dr. To Branch A/c

(Being incorporation of the following items from Branch Trial Balance:

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
|  | Opening Stock | … | Rs. |  |
|  | Purchases |  | … |  |
|  | Goods from Head Office | …) | … |  |
| (i) | Carriage, etc. |  |  |
| Sales and Closing Stock : | … | …Dr. |  |
|  | Branch A/c |  |
|  | To Branch Trading A/c |  |  |  |

(Being incorporation of the following items from Branch Trial Balance:

|  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- |
|  | Sales less Returns |  | … | Rs. |  |
| (ii) | Closing Stock |  | …) |  |  |
| Gross Profit and Loss : | … |  | …Dr. |  |
|  | Branch Trading A/c |  |  |
|  | To Branch P & L A/c |  |  |  |  |
|  | (Being transfer of gross profit) |  |  |  |  |
|  | Branch P & L A/c |  |  |  |  |
|  | To Branch Trading A/c |  |  |  |  |
|  | (Being transfer of gross loss) |  |  |  |  |

1. Indirect expenses like Salaries and Rent, etc. :

Branch P & L A/c … …Dr.

To Branch a/c

(Being incorporation of the following items from Branch Trial Balance:

|  |  |  |
| --- | --- | --- |
| Salaries | Rs. |  |
| … |  |
| Rent | … |  |
| Bad Debts | …) |  |

1. Items of Revenue Income :

Branch A/c … …Dr. To Branch P & L A/c

(Being incorporation of the following items of revenue income from Branch Trial Balance)

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| (iv) | Net Profit and Loss : | … | …Dr. |  |
|  | Branch P & L A/c |  |
|  | To General P & L A/c |  |  |  |

 (Being transfer of net profit)

General P & L A/c …

…Dr.

To Branch P & L A/c

(Being transfer of branch loss)

1. Amount related with Branch Assets and Liabilities
	1. For Assets :

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| Branch Cash A/c |  | … | ….Dr. |  |
| Branch B/R A/c | … | … | …Dr. |  |
| Branch Debtors A/c |  | …Dr. |  |
| Branch Furniture A/c | … |  | …Dr. |  |
| Branch Stock in Trade A/c | … |  | …Dr. |  |
| To Branch A/c |  |  |  |  |

(Being incorporation of the following above mentioned assets From Branch Trial Balance)

1. For Liabilities :

Branch A/c … ….Dr. To branch Liabilities A/c

(Being the incorporation of Branch Liabilities from the Branch Trial Balance).

When Branch Account is closed after transferring all assets and Liabilities in the beginning of new year in the Head Office books following entry is made. This entry is called opening entry

|  |  |  |
| --- | --- | --- |
| Branch A/c | … |  …Dr. |
| To Branch Assets A/c | … | ….Dr. |
| Branch Liabilities A/c |
| To Branch A/c | … | …Dr. |

**DEPARTMENTAL ACCOUNTS**

When activities of a big organization are divided into different processes or divisions or unit or functions than there process or functions are performed in different departments all though all these departments are part of a business it is necessary to that which department is earning profit and which one is suffering loss. So separate accounts are made for each department and at the end of the year their separate P&l a/c are prepared.

**Method of keeping departmental accounts**:

For preparing departmental trading and profit & loss account the books of original records are also ruled out accordingly. There are two methods of departmental accounting .

1. **Unit wise method**: in this method each department is treated as an independentunit and separate books of accounts are maintained for each of them and final accounts are prepared at the end of the year.
2. **Columnar method** : under this method entries of each department are made jointlyand separate column of each department is given and one column is made for the

total of all the department

**Departmental final accounts:** departmental trading and Profit & Loss account is prepared onthe basis of same rules of which are followed for preparation of general trading and profit & loss a/c. under departmental trading and profit & loss account a separate column is drawn for each department on debit and credit side and a total column is also drawn on both the side. Each item of related department is shown in that column and total of those columns will be shown in total column this profit or loss of each department and total profit or loss of business can be found out.

**Balance sheet**: - this is not prepared departmental wise but only one B.S. is made for whole thebusiness as usual.

**Allocation of departmental expenses: -**

In Practice the following general rules are usually applied for allocation and apportionment of expenses. Expenses directly related is a particular department should be changed to that department, but is any exp is not particularly belongs to a particular department can be apportionment on the following basis table. Some of the expenses such as interest on debentures loan, capital, director’s fees, salary of general manager office exp etc. can not be apportioned to different department on any equitable basis. Thus such expenses are debited in general profit & loss account only. These may be some income e.g. interest as dividend received on investment transfer fees, etc are not related to any department these incomes are credited in general profit & loss a/c

|  |  |  |
| --- | --- | --- |
| **S.No.** | **Expenses** | **Basis** |
| 1. | (a) Travelling salesman’s salary and commission (b) Selling expenses (c) After-sales service(d) Discount allowed (e) Freight outwards(f) Provision for discounts on debtors(g) Sales manager’s salary and other benefits | Sales of each department |
| 2. | (a) Rent, rates and takes(b) Air conditioning expenses (c) Heating | Area |
| 3. | Lighting  | Light points Area |
| 4. | Insurance of Stock  | Average stock carried |
| 5. | Insurance of Building | Area |
| 6. | Insurance of Plant & Machinery | Value of Plant & Machinery |
| 7. | Group insurance premium | Direct wages |
| 8. | Power  | H.P. or H.P. x Hours worked  |
| 9. | (a) Depreciation (b) Repairs and renewals | Value of assets in each department  |
| 10. | (a) Canteen expenses (b) Labour welfare expenses | Number of employees  |
| 11. | Works manager’s salary | Time spent in each department  |
| 12. | Carriage inwards. | Purchases of each department. |

**Inter departmental transfers:**

Generally a department may transfer its products or services to other department such transfers are treated like normal sales and purchases of the departments while preparing departmental trading account. Transfer will be shown as sales of Transferor department and purchases of transferee department. Reverse treatment will be made in the case of return.

If inter-departmental transfers are made at cost price then no adjustment will be required for unrealized profit included in the stock of transferee department taken from transferor department.

If the goods are transferred at selling price, then such adjustment will be required. Reserve for unrealized profit will be shown in general profit & loss account. This will be equal to the profit added by the transferor department. It will be adjusted in the next year as opening balance in general profit & loss account.

**Journal entries** for unrealized profit –

General profit & loss a/c Dr.

To Reserve /Provision for unrealized profit

Or

To Stock Reserve

The reverse entry will be made at the beginning of the next

year. Amount of stock reserve will be computed as under-

(a) If the Profit percentage is given on selling/transfer/invoice price-Stock

reserve = Percentage × amount of stock on which reserve is required

100

(b) if the profit percentage is given on cost price-

Stock Reserve = Percentage × Amount of stock on which reserve is

required 100 + Rate of Profit

**Bills of Exchange**

**1. General**

 A good deal of trade and commerce these days is carried on, on the basis of written promises to pay a definite sum of money: the promises can be passed on from one person to another. Such written promises are known as negotiable instruments (or even as bills of exchange). The following are the chief types of negotiable instruments.

1. **Bill of Exchange:**

The legal definition is: “A bill of exchange is an instrument in writing containing an unconditional order signed by the maker, directing a certain person to pay a certain sum of money only o, or to the order of, a certain person or to the bearer of the instrument.” It means that if an order is made in writing by one person on another directing him to pay a certain sum of money unconditionally to a certain person or according to his instructions or to the bearer, and if that order is accepted by the person on whom the order was made, the document is a bill of exchange.

The following is a specimen of bill of exchange:

|  |
| --- |
|   126, Chandni Chowk, Delhi-110 006 5th May, 2001.Rs. 10,000.00 P Three months after date, pay to us or our order a sum of Rupes Ten  Stamp Thousand Only, for value received. Accepted For M/s Aggarwal Stores To (Signed) Nakul Gupta For M.s Lakhmi Chand & Sons.  M/s Aggarwal Stores, 5.5.2001 (Signed) Lakhmi Chand216, Malka Ganj, Partner (Lakhmi Chand)Delhi-11007 Partner |

1. **Cheques** are also included among negotiable instruments.

In the specimen bill of exchange shown above, M/s Lakhmi Chand & Sons are the drawers as well as the payees of the bill of exchange. M/s Aggarwal Stores are the acceptors of the negotiable instrument. The drawees become liabile to pay for the bill of exchange only after they have accepted it. Before acceptance, a bill of exchange is known as a draft.

**Advantages of Bills**

The following are the advantages of bills:

1. Presumption of consideration: In a bill, consideration is presumed. In other words the Court presumes that the acceptor of the bills of exchange or marker of the promissory note is indebted to the drawer of the bill or payee of promissory note. It is a big advantage. In the absence of the bill, the seller of goods and services or the lender of the money has to prove the indebtedness of the purchaser or borrower in case of a default.
2. No locking of money: A bill provides the payee an option either to wait for money till the date of maturity of the bill or to get cash at any time by getting the bill discounted with the bank at a reasonable rate of interest. The bill can also be used to discharge the liability to a creditor by endorsing the bill in the creditor’s favour. Thus, the seller need not keep the money locked up for period of credit allowed by him to the customer.
3. Source of finance: Accommodation bills enable the businessmen to obtain funds at a low rate of interest to meet their temporary financial requirements.
4. Safe and convenient means of transmitting money: Bill is a safe and convenient means of transmitting money by one person to the other; one can avoid the risk of carrying he is required to make payment and can make arrangements accordingly.
5. Planning by creditors: A bill fixes the exact date of payment. The creditor knows when he is required to make payment and can make arrangements accordingly.

**Dishonour of bill**

A bill may be dishonoured either by non-acceptance or by non-payment, When an instrument is dishonoured, the holder must give notice of dishonor to the drawer or his previous holders if the wants to make them liable. In certain cases, notice is not required to be given.

 **Dishonour by non-acceptance:** A bill is said to be dishonoured by non-acceptance:

1. When the drawee does not accept it within 48 hours from the time of presentation for acceptance.
2. When presentation for acceptance is excused and the bill remains unaccepted.
3. When the drawee is incompetent to contract.
4. When the drawee is a fictitious person or after reasonable search, cannot be foud.
5. Where the acceptance is a qualified one or where one or some of several drawees not being partners make default in acceptance, on being duly required to accept. In this case, the holder may at his own risk treat the bill as accepted.

**Dishonour by non-payment:** A promissory note, a bill of exchange or cheque is said to be dishnoured by non-payment when the maker of the note, acceptor of the bill or drawee of the cheque makes default in payment upon being duly required to pay the same. Also a negotiable instrument is dishonoured by non-payment when presentation fro payment is excused and the instrument when overdue remains unpaid.

**RECORD OF BILLS OF EXCHANGE OR PROMISSORY NOTES**

A person who receives a promise to pay has got something valuable, The name given to it is Bills Receivable, Similarly, a person who has promised to pay has created a liability for himself. The name given to it is Bills Payable.

**Entries on Receipt of a Bill:**

1. On receipt of the promissory note or bill of exchange duly accepted: Debit Bills receivable Account and credit the Party from whom or on whose behalf the bills or note has been received.

Examples: (1) A draws a bills of exchange on B who returns it after acceptance.

 A will record:

 Bill Receivable Account … Dr.

 To B

 (2) A receives a bill of exchange from D; the bill is accepted by C.

 A’s entry is

 Bills Receivable Account …. Dr.

 To D

(3) A draws a bill of exchange on C payable to D.C. accepts the bill.

 The entry in D’s books will be:

 Bills Receivable Account …. Dr.

 To D

Note: In A’s books the entry will be:

 D …. Dr.

 To C

1. (a) If the bill is held till maturity, no entry is naturally required for holding it.

(b) If the is enclosed over to a creditor, the creditor will be debited and Bills

 Receivable Account credited.

(c) If the bills is discounted with the bank, the entry will be:

 Bank Account …..Dr. with cash given by the bank.

 Discount Account …..Dr. with the charges made by the bank.

 To Bills Receivable Account with the full amount of the bill.

 Note: The discount charged by the bank is always at the current rate of interest and

is calculated for the period the bill has still to run. At 12%, a bill for Rs. 5,000, which will mature for payment after two months, will be discounted for Rs. 100; the bank will pay Rs. 4,900.

1. On maturity. If the bill is met (honoured), cash will be received only in case the bill has been held till maturity. In this case, the entry will be:
2. Cash Account/Bank Account ….Dr.

To Bills receivable Account

**Endorsement of Bill**

The payee of a bill may use the bill to discharge his debt to his creditor. For this purpose, he will have to transfer the ownership of the bill in favour of the creditor by means of a legal procedure. The process of transferring the ownership of bill is termed as the endorsement of bill. The person endorsing the bill is called the endorser and the person in whose favour the bill is endorsed is called the endorsee. Suppose P is the payees of a bill and he wants to endorse the bill in favour of Q. He will have to make the endorsement on the back of the bill as follows:

 Pay to Q or order.

 (Signed) Q

 The endorsement is an order to the acceptor of the bill or maker of the promissory note to make payment of the bill on the due date to Q or to any other person instructed by Q.

 Q can further endorse the bill in favour of his creditor, say R by making the following endorsement:

 Pay to R or order.

 (Signed) Q

Now R becomes entitled to receive payment of the bill.

Sometimes after some endorsements and endorser may once again become the payee of the bill. In this case the liability of the intervening endorser comes to an end.

Where the bill has either been endorsed to a creditor or discounted with a bank, on the date of maturity cash will be received by the creditor or by the bank and hence no entry is needed in the books of the original receiver of the bill.

**Dishonour of Bill**

If, on maturity, the bill is dishonoured, the bill becomes useless at once; the liability of the acceptor comes into being. In case the bill is held till maturity, the entry will be to debit the person from whom the bill was received and credit the Bills receivable Account. In other words, the entry made on the receipt of the bill will be as follows in the books of A:

 Example (1)

 B …Dr.

 To Bills Receivable

 Example (2)

 D ….Dr.

 To Bills Receivable

 Example (3)

 C …Dr.

 To D

 If the bill has not been held till maturity, but has been endorsed to a creditor of discounted with a bank, the entry is to debit the person from whom the bill was received and credit the creditor or the bank, as the case may be. The Bills Receivable Account must not be credited in these two cases.

**Noting:**

In order to remove any doubt that the bill was properly presented for payment and to establish beyond doubt that the bill was, in fact, dishonoured, it is preferable to get it “noted.” Present a bill for payment and, if payment is not forthcoming, to note the fact on the face of the bill. The “Noting” must be recorded within a reasonable time after the dishonor and must contain the fact of dishonor, the date of dishonor, the reason, if any, given for such dishonor and the noting charges. Noting is compulsory in case of foreign bills only if the law of the place where the bill was drawn requires it. Noting charges have to be borne by the person responsible for dishonor. Hence, when a bill is dishonoured, the amount due is the amount of the bill plus the noting charges.

**Renewal of a bill**

 Sometimes, the acceptor of a bill or maker of a promissory note realises in time that he cannot meet it at the time of maturity. He may, therefore, approach the holder with a request to let him withdraw the old bill and replace it by a new one. In accounts, the effect is that of dishonor of the old bill and the acceptance of a new one. The amount of the new bill includes the interest for the period for which the new bill is accepted. Before passing the entries for the new bill, the entries for the interest will also have to be passed. The entries fro the new bills are exactly the same as already explained.

**ENTRIES TO BE MADE ON ACCEPTANCE OF A BILL**

 Acceptance of a bill and forwarding the bill to the party concerned is treated like settling the personal account of the party and creating another liability. On acceptance of a bill, the party at whose instance the bill is accepted should be debited and Bills Payable Account credited. This party to whom the bill is actually sent may not come into the picture at all. If a draw a bill on B, payable to C, B will debit A (and not C) on his accepting the bill.

 During the currency of the receiver of the bill, the acceptor is not concerned at all and, hence, he makes no record of the doings of the receiver of the bill. The acceptor will be concerned only on the date of maturity when he will be called upon to make payment; the entry on payment will be:

 Bill Payable Account ….. …. Dr.

 To Cash (or Bank) Account

 If he does not make payment for any reason, the entry is to debit the Bills Payable Account and credit the party which was debited when the bill was issued. This is to say that in case of dishonor of a bill payable, the entry made at the time of the issue of the bill should be reversed.

 If the holder of the bills has incurred some noting charges, these also should be taken into account. Noting Charges Account should be debited and the party concerned should be credited. When a bill is renewed, firstly an entry is passed for dishonor. The, the entry for interest payable for the extended period is passed. Finally, the usual entry for acceptance of a fresh bill is passed.

**ACCOMMODATION BILLS**

 Normally, bills of exchange or promissory notes are meant to finance only actual transaction in goods; for example, if Q buys goods from B, he may postpone the payment by sending to B his promissory note for the amount of the goods purchased. B can, if he wants, get the money immediately by getting the promissory note discounted at his bank. But apart from financing transactions in goods, bills may also be used for raising funds temporarily. For example, if A is in need of money to the extent of Rs. 10,000 for 3 months, he may induce his friend, B, to accept a bill of exchange drawn in him for Rs. 10,000 for 3 months. A can then funds for there months and, just before maturity, he will remit the amount to B to whom the bill will be presented by the bank for payment. A may use the whole of the amount himself or he may share proceeds with B in which case B will have to share the discount also. Just before would be for A to accept B’s bill, and for B accept A’s draft. Each gets a bill and each accepts a bill. Both A and B get the bills discounted, use the proceeds and on the due date honour their own acceptance. These are instances of accommodation bills Accommodation Bills are those which are drawn to enable one on both the parties to temporarily raise funds by getting the bills discounted at a bank.

**ROYALTY**

Royalty mean the sum payable by one person to another person for using right i.e. it is the periodic payment to the owner of some form of privilege or monopoly for being allowed to use such right or privilege.

**DEFINITION OF ROYALTY**

‘‘Royalty refers to the amount paid by one person to another for granting the some special rights by the former to the latter”.

**DIFFERENCE BETWEEN ROYALTY AND RENT**

1. Use- Consideration received from using some tangible assets like building, factory etc. is known as rent. While consideration which is received from using both tangible and intangible assets like patent, copyright etc. is known as royalty.
2. Basis of payment- Payment of rent is based on period like yearly, half-yearly, monthly , weekly etc. while payment of royalty is based upon the limit of using it like per item, per ton production or sale basis.

**KINDS OF ROYALTY**

1. Mining royalty
2. Bricks making royalties
3. Royalties in connection with ail-wells
4. Patent royalty
5. Copy right royalty
6. Royalties in connection with machine, secret instruments and technical knowledge etc.

**TERMS IN RESPECT OF ROYALTY**

1. Landlord or lessor- This person is owner of the property and gives his property to other for use and has the right in return to receive a royalty.
2. Lessee- This person takes a property from other land has a right to use it and in return, he has to pay royalty to the owner of the property.
3. Minimum rent- Payment of amount of royalty is decided on the basis of production or on sale of such property. As production or sale fluctuate, owner of property calculate the minimum rent at the beginning of the year which has to paid to him in any condition i.e. if there is reduction in production or sale even the owner will receive a minimum rent. When royalty is equal to or more than minimum then payment should be made of royalty only, not of minimum rent.
4. Short working- The excess of minimum rent over royalty is called short-working .i.e. short working= Minimum rent-Royalty.
5. Recouping or writing off short -working- When actual royalty is lower than minimum rent, then it give rise to recouping or writing off short-working. For compensating the loss arising from short-working lessee can make the contract with landlord, according to which he will be allowed to recoup or recover the short working., from the future surplus (i.e. excess of actual royalty over minimum rent subject to certain conditions. It may be recouped without any time limit or within prescribed time limits.

**CALCULATION OR ANALYSIS TABLE**

|  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- |
| 1 | 2 | 3 | 4 | 5 | 6 | 7 | 8 | 9 |
| years | Output | Actual | Minimum | Short | Surplus | Recoup | Lapse | Payment |
|  | or sale | Royalty | Rent | Working |  |  |  | (3+5-7) |

**ACCOUNTING FOR ROYALTY**

**Journal Entries**

|  |  |
| --- | --- |
| In the books of Lessee | In the books of lessor |
| (1) For royalty and short workingRoyalty (Payable) A/c Drshort working (Recoupable)A/c Dr.To Lessor[Being amount payable] | (1) For royalty and short workingLessee A/c Dr.To Short working (Allowable)[Being amount receivable] |
| (2) For short working recoupedLessor Dr.To short working A/c[Being short working recouped] | (2) For short working recoupedShort working Dr.To Lessee[Being short working allowed to recouped] |
| (3) For PaymentLessor Dr.To Bank A/c[Being payment made] | (3) For PaymentBank A/c Dr.To Lessee[Being payment received] |
| (4) For transfer of royaltyManufacturing A/c P&L A/c Dr.To Royalty A/c[Being transfer of Royalty] | (4) For transfer of royaltyRoyalty A/c Dr.To P&L A/c[Being transfer of Royalty] |
| (5) For recoupable short workingP&L A/c Dr,To Short working A/c[Being recoupable S.W.) | (5) For recoupable short workingShort working A/c Dr.To P&L A/c[Being recoupable S.W.) |

**SUB-LEASE**

If the lessee again leases out to other person some part of assets taken by him on lease, it is called ‘sub -lease’. The other person is called sub-lease. Suppose A has given 500 acres of land to B on lease and B has given 100 acres of land (out of 500 acres) to C on lease, then A is called main lessor, B is called main lessee as well as sub -lessor and C is called sub-lessee. There will be two separate agreements, the first one is between A and B and second one is between B and C. A will receive the royalty on the total production

of A and B, while B will receive the royalty on the production by Coal. Two analysis Table will be

prepared accordingly.

**UNIT-V**

**DEFINITION OF PARTNERSHIP**

Meaning of Partnership [Section 4]

Partnership is the relation between two or more who have agreed to share the profits of a business carried on by all or any of them acting for all.

Persons who have entered into partnership with one another are called individually partners and collectively a firm and the name under which their business is carried on is called the firms name. Essential Elements of Partnership

1. Two or more Persons: There must be at least two partners in a partnership fir,. Maximum number of partners in banking business is 10 and in other 20.
2. Agreement: partnership is an agreement between partners. The agreement may be written or it may be verbal also.
3. Business: partnership is formed for doing business.
4. Sharing of Profits: profit and loss of the partnership firm will be divided in the partners in their profit sharing ratio.
5. Mutual Agency: the business of the partnership firm may be carried by all the partners or any of them acting for all.

**PARTNERSHIP DEED**

A partnership is formed by an agreement. This agreement may be express (i.e., oral or in writing) or implied. Though the law does not expressly require that the partnership agreement should be in writing, it is desirable to have it in writing in order to avoid any dispute with regard to the terms of the partnership. The document which contains the term of a partnership as agreed among the partners is called ‘partnership deed’. The deed is required to be duly stamped as per the Indian Stamp Act, 1889 and duly singed by all the partners. The partnership deed contains various provisions relating to various matters such as:

1. Name of the firm.
2. Names and addressed of all partners
3. Nature and place of business
4. Date of commencement of partnership
5. Duration of partnership
6. Amount of capital of each partner
7. Profit sharing ratio
8. Interest on capital
9. Interest on drawings
10. Interest on loan advanced by a partner to the firm
11. Salary or commission payable to any partner
12. Method of valuation of goodwill and other assets and liabilities in case of admission or retirement or death of a partner
13. Settlement of accounts in case of retirement/death of a partners dissolution of firm
14. Profit sharing ratio will be equal.
15. No partner is entitled for interest on capital.
16. No interest on drawings will be charged from the partners.

1. If any partners have advanced to the firm, he is entitled to receive interest at the rate of 6% per annum.
2. No partner is entitled for salary, bonus and commission etc.

**Partnership accounting:** just like any other business books of accounts are maintained in thefirm. In partnership firm capital account of each partner is maintained separately. Following methods are used for maintaining partner’s capital account.

1. Fixed capital method: in this method the capital of the partners will be fixed in the books of accounts. To maintain the fixed balance of capital a separate account that is partner’s current account is opened. Interest on capital, interest on drawings, salary, profit and loss etc are shown in current account.
2. Fluctuating capital account method: IN fluctuating capital account the balance will be changed every year. In this method Interest on capital, interest on drawings, salary, profit and loss etc are shown in capital account.

**Profit and loss appropriation account:** This account shows the distribution of profitsamongst the partners, any transaction which is not recorded in profit and loss account and appropriation of profit.

**Guarantee of profit to the partners:** sometimes a new partner is entered in a firm with aguarantee of profit. If his share of profit is less than the guaranteed amount. The new partner gets the guaranteed amount of profit. This difference of profit is borne by the guarantor. The guarantor may be the firm or any partner.

**ADMISSION OF A NEW PARTNER**

**Introduction**

In partnership firm the number of partners in **banking business** has been specified as minimum 2 and maximum 10 and in other partnership business minimum 2 and maximum 20. The new partner is admitted into the business with free consent of the other partners. While admitting the new partner he is paid a share in the total profit of the firm.

**Need for Admission of a New Partner**

A new partner may be admitted for any one or more of the following reasons:

1. For procuring more capital for expanding business.
2. For acquiring more ability for efficient management and administration of business.
3. For looking after the increased business of the firm.
4. For progress of the firm.
5. For reducing competition.
6. For various other reasons.

**ACCOUNTING PROBLEMS AT THE TIME OF ADMISSION OF A PARTNER**

1. Determination of new profit sharing ratio and sacrificing ratio at the time of admission of new partner.
2. Valuation and accounting of goodwill of the firm.
3. Revaluation of the assets and liabilities of the firm.
4. Transfer of reserves, undistributed profit and profit and loss of the firm.
5. Writing off of fictitious assets of the firm.
6. Adjustment of capital or calculation of old partners capitals on the basis of new partners capital account.
7. Calculation of new partner capital on the basis of old partners capital jointly.
8. Adjustment of joint life insurance policy.

In partnership business, at the time of admission of a new partner he is paid a certain share out of the total profit. Thereafter, the remaining profit is distributed to the old partners. The profit sharing ratio of the old partners is changed due to the admission of new partner.

Meaning of New profit Sharing Ratio: The ratio calculated to distribute the future profits of the partnership business among all the partners (old & new) is known as new profit sharing ratio. On the admission of a new partner, the old partners sacrifice a part of their profit in favour of new partner.

|  |
| --- |
| New Profit Sharing Ratio = Old Profit Sharing Ratio – Sacrificing Ratio |

Meaning of Sacrificing Ratio : The old partners either jointly or any of the partner individually may sacrifice a share of their profit in order to give a share of profit to the new partner.

|  |
| --- |
| Sacrificing Ratio = Old Profit Sharing Ratio – New Profit Sharing Ratio |

Use of Sacrificing Ratio : It is necessary to determine the sacrificing ratio of the old partners at the time of bringing goodwill in cash by the new partner because the cash brought in by the new partner in form of goodwill has to be distributed among the old partners sacrificing ratio. If only a single partner has sacrificed his share of profit in favour of new partner then the entire amount of goodwill brought in cash will be received by him.

**Difference between New Profit Sharing Ratio and Sacrificing Ratio:**

|  |  |  |
| --- | --- | --- |
|   | **New Profit Sharing Ratio** | **Sacrificing Ratio** |
| 1. Meaning  | The new profit sharing ratio is the ratio used to distribute the future profit of business among all the partners (old & new). | The share of profit sacrificed by the old partners in favour of new partner is sacrificing ratio. |
| 2. Scope | In new profit sharing ratio both old and new partners are included. | Only old partners are included in it. |
| 3. Object & Use | The new profit sharing ratio is used to distribute the future profit among all partners. | The share of goodwill brought in cash by the new partner is distributed among the old partners by sacrificing ratio. |
| 4. Calculation | New profit sharing ratio = Old profit sharing ratio = Sacrificing ratio. | Sacrificing ratio = Old profit sharing ratio – New profit sharing ratio. |

**Calculation of sacrificing ratio old profit sharing ratio & new profit sharing ratio**

Old partners can give share to the new partner in the following way :

1. In their old profit sharing ratio.
2. In equal ratio.
3. In unequal ratio.
4. By sacrifice of any partner.

**(1) IN THEIR OLD PROFIT SHARING RATIO**

**Example –** Ram, Shyam and Mohan are partners. Sharing in the ratio of 3:2:1. They admit Hari for 1/8 share. Calculate new ratio.

(2) By sacrifice of any partner

e.g. If Hari gets his entire share from Ram:

(3) In equal ratio

e.g. If Hari gets his share in equal ratio from all the partners :

(4) In Unequal ratio

e.g. When Hari gets 2/3 from Ram and 1/3 from Shayam:

**GOODWILL**

Goodwill is an intangible fixed asset by which business organization attains a position to earn excess earnings in future. Goodwill is created by various factors and its form and value may vary in difference trades and even in different business of the same trade. In short, ‘Capacity to earn additional profit is termed as Goodwill’.

**Characteristics**

Generally goodwill has following characteristics:

1. Goodwill is an intangible fixed asset.
2. Goodwill can’t be touched or seen but can be fell.
3. Value of goodwill depends upon the name and popularity of business.
4. Goodwill is created by various elements.
5. It can’t be separated from business.
6. It is created along with business and it comes to an end with closure of business.
7. Sound goodwill attracts customers, it increase their business contacts.
8. In fact, goodwill is not a fictitious asset as it can purchase or sold like any other asset.
9. Goodwill depends upon the position of business, owner reputation, and capabilities of employees, popularity of product and good name of business.
10. It is marketable asset.

**Types of Goodwill** :

1. Cat Goodwill
2. Dog Goodwill
3. Rat Goodwill
4. Goodwill of Strange Nature

**Factors affecting value of Goodwill**

1. Place of Business
2. Nature of Business
3. Risk and uncertainty of Business
4. Monopolistic Business
5. Management of Business
6. Personality of Businessmen
7. Volume of Capital
8. Popularity of Trade Mark
9. Volume of profit.
10. Other factors like: Government policy, License policy, National peace, conditions of market, Consumerism, Purchasing power of customers, etc.

|  |
| --- |
| Recommendations as per AS 10 And AS 26 Issued by ICAI |

Goodwill should be **recorded in the books only when some consideration in money or** **moneys worth has been paid for it**. Whenever a business is acquired for a price (payable incash or in shares or otherwise) which is in excess of the value of the net assets of the business takeover, the excess should be termed as goodwill.

1. Only purchased goodwill to be recorded in the books of accounts.
2. Non purchased goodwill (Self generated goodwill) will have to be adjusted through partner’s capital accounts. Hence, this goodwill now cannot be shown in balance sheet of partnership business.

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**METHODS OF VALUATION OF GOODWILL**

Partnership deed requires the disclosure of method used for valuation of goodwill. Goodwill can be valued by any one of the following methods:

(1) **Average Profit Method**

**Super Profit Method** Total Profit

Goodwill = Number of Years X Number of years of purchase

(2) Average profit of the firm is compared with the normal yield on the invested capital in the firm. Excess of average profit over normal yield or profit is known as super profit.

Capital invested x Rate of profit generally earned

Normal Profit = 100

Super Profit = Actual profit – Normal profit

Goodwill = Super profit x No. of years purchased

(3) Annuity Method

If a firm is making super profits, it is estimated as to how many years firm will continue to get this super profit. Present value of super profits of these years is found out by Annuity Method.

Goodwill = Super profit x Present Value of Re. 1 by Annuity Method

(4) Capitalization Method

Average profits are first capitalized on the basis of normal rate of return, and then excess of this capitalized amount over net assets of the firm is goodwill.

Total value of firm = Average profit/normal rate of return x 100

Net Assets = Total Assets (excluding Fictitious Assets) – Outside

Liabilities Goodwill = Value of Firm – Net Assets

**Journal Entries For Bringing Capital by new partner**

1. Capital brought in cash :

Cash/Bank A/c Dr.

|  |  |  |  |
| --- | --- | --- | --- |
|  | To New Partner’s Capital A/c |  |  |
| 2. | (Being cash brought in by new partner as capital) |  |  |
| Capital brought in kind (asset) : | Dr. |  |
|  | Assets A/c |  |
|  | Purchase (Goods) A/c | Dr. |  |

To New Partners Capital A/c

**Accounting Treatment of Goodwill on admission of Partner**

(Being assets and goods brought in by new partner as capital)

|  |  |
| --- | --- |
| **Transactions** | **Journal Entries** |
| 1. New partner giving share of goodwill to old partners privately | No journal entry (Due to payment of amount of goodwill outside the firm this amount doesn’t come in the business. Therefore, it will not be entered in firms books of accounts) |
| 2. (a) New partner bringing his share of goodwill in cash.(b) Distributing the amount of goodwill by old partners in their sacrificing ratio. | (a) Cash/Bank A/cTo Premium A/c ..Dr.(Being cash brought in by new partner as goodwill/premium for his share of profit)(b) Premium A/c ..Dr.To Old Partners Capital A/cs(in sacrificing ratio)(Being premium credited to old partners capital accounts in their sacrificing ratio) |
| 3. As per question, withdrawal of their share of goodwill by a old partners in full or part. | Old Partners Capital A/cs ..Dr.To Cash/Bank A/c(Being amount of premium fully/partially withdrawn by old partners) |
| 4. If new partner doesn’t bring his amount of goodwill in cash then calculating his share of goodwill on the basis of his profit sharing ratio out of valuation of total goodwill.4.1 No goodwill account is raised.4.2 When goodwill a/c is raised.When goodwill a/c is closed. | New Partners Capital A/c (with his share of goodwill) To Old Partners Capital A/Cs(in sacrificing ratio)(Being new partners share of goodwill debited to his capital account and credited to Old Partners Capital accounts in their sacrificing ratio)Goodwill a/c Dr.To Partner Capital A/c (old ratio) (being goodwill a/c raised on admission of new partner)All partners capital A/c Dr.To Goodwill A/c(being goodwill a/c written off in new profit sharing ratio) |
| 5. Writing off goodwill shown in balance sheet by old partners in their old profit loss ratio. | Old Partners Capital A/c ..Dr.(in old profit sharing ratio)To Goodwill A/c(in Balance Sheet)(Being existing goodwill in balance sheet written off by old partners in their profit sharing ratio)Cash/Bank A/c ..Dr. |
| 6. In place of 2(a) and 2(b), a combined entry can be passed as | To Old Partners Capital A/c (Being amount of premium brought in by new partner, directly credited to old partners capital accounts in their sacrificing ratio) |

**REVALUATION ACCOUNT**

When a new partner is admitted sometimes revaluation is made of all the assets and liabilities of the old firm. Excesses and deficits of assets and liabilities are transferred to an account known as Revaluation Account or Profit and Loss Adjustment account.

**Revaluation Account or Profit and Loss Adjustment account**

|  |  |  |  |
| --- | --- | --- | --- |
| **Particulars** | **Amount** | **Particulars** | **Amount** |
|  | Rs. |  | Rs. |
| To Decrease in the value of Assets (Individually) | √ | By Increase in the value of Assets (Individually) | √ |
| To Reserve for Bad and Doubtful debts (Individually)  | √ | By Decrease in the value of Liabilities (Individually) | √ |
| To Increase in the value of Liabilities (Individually) | √ | By Unrecorded Assets (viz. Unrecorded Investment prepaid expenses etc.) | √ |
| To Unrecorded Liabilities (viz. Outstanding expenses) | √ | By Cash/Bank A/c (Sale of unrecorded asset) | √ |
| To Cash/Bank A/c(Payment of unrecorded liability) | √ | To Reserve for Discount on Creditors A/c | √ |
| To Profit transferred to Old.Partners Capital A/cs (In old ratio) | (Balancing figure) | By Loss transferred to Old Partners capital A/cs (in old ratio) | (Balancing figure) |

Journal entries: On revaluation of assets and liabilities following journal entries are made:

|  |
| --- |
| Journal entries : On revaluation of assets and liabilities following journal entries are made : |
| (1) | For depreciation in assets | Profit and Loss adjustment A/c Revaluation A/c |
|  | reserve for doubtful on | To Various assets A/c (write individually) |
|  | debtors outstanding exp. | To Reserve for bad and doubtful debate A/c |
|  |  |  | To Outstanding expenses A/c |  |
|  |  | (Being depreciation in the value of assets provision for reserve |
| (2) |  | and bad and doubtful debts and outstanding expenses adjusted) |
| For appreciation in assets | Various Assets A/c (write individually) |
|  | prepaid expenses, reserve | Prepaid/Unexpired expenses A/c |
|  | for discount on creditors | Reserve for discount on creditors A/c |
|  | decrease in reserve for |  | To Profit and loss adjustment A/c Revaluation A/c |
|  | for doubtful debts | (Being appreciation in the value of assets, prepaid expenses |
|  |  | reserve for discount on creditors and reserve for doubtful |
| (3) |  | debts adjusted) |  | .Dr. |
| For reduction in value Particular Liabilities A/c |
|  | of liabilities | To Profit and loss adjustment A/c Revaluation A/c |
| (4) |  | (Being decrease in the value of liabilities adjusted) |
| For increase in value of | Profit and Loss Adjustment A/c Revaluation A/c |
|  | liabilities |  | To Particular Liabilities A/c |
| (5) | Entry for unrecorded | Particular Unrecorded Asset A/c |  | .Dr. |
|  | asset | To Profit and Loss Adjustment A/c Revaluation A/c |
| (6) | Sale of unrecorded asset | (Being unrecorded assets adjusted) | .Dr. |  |
| Cash/Bank A/c |  |
|  |  | To Profit and Loss Adjustment A/c Revaluation A/c |
| (7) |  | (Being unrecorded asset sold) |  | .Dr |
| Entry for unrecorded Profit and Loss Adjustment A/c / Revaluation A/c |
|  | liability | To Particular Unrecorded Liabilities A/c. |  |
| (8) |  | (Being unrecorded liabilities adjusted) | .Dr. |
| Payment of unrecorded Profit and Loss Adjustment A/c / Revaluation A/c |
|  | Liability | To Cash/Bank A/c |  |  |
|  |  | (Being payment made on unrecorded liability) |

Now Profit and Loss Adjustment account or Revaluation Account is opened and above entries are posted in the account. After posting, balance of this account is found out. If total of credit side is more than the total of debit side then such difference is termed as profit. If total of debit side is more than total of credit side then such difference is known as loss. The profit or loss is distributed among old partners in old profit-loss ratio for which following journal entries is made:

|  |  |  |
| --- | --- | --- |
| (7) Profit on revaluation Profit and Loss Adjustment A/c / Revolution A/c |  |  |
|  | To Old Partners' Capital A/c |  |  |
|  | (Being profit on revaluation transferred to Old Partners' |  |
| (8) Loss on revaluation | Capital A/c in their profit sharing ratio\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_ |  |
| Old Partners’ Capital A/c | .Dr. |  |  |
|  | To Profit and Loss Adjustment A/c /Revaluation A/c |  |

(Being loss on revaluation transferred to old Partners' Capital A/cs in their profit-sharing ratio)\_\_\_\_\_\_\_

Opening of necessary Ledger Accounts : At the time of admission of new partner following accounts are opened :

1. Profit and Loss Adjustment A/c or Revaluation A/c
2. Old Partners' Capital A/c
3. New Partner's Capital A/c
4. Goodwill A/c
5. Cash/Bank A/c

On the basis of above accounts and keeping the old balance sheet into consideration the new balance sheet is prepared after the admission of new partner.

**TRANSFER OF RESERVES, UNDISTRIBUTED**

**PROFIT & LOSS IN TO PARTNERS CAPITAL A/C**

This account is closed and not shown in balance sheet of the new firm.

|  |  |  |  |
| --- | --- | --- | --- |
| (1) | This account is closed and not shown in balance sheet of the new firm. | .Dr. |  |
| Profit & Loss A/c. Reserve, | Profit and Loss A/c |  |
|  | General Reserve, Reserve | Reserve A/c | .Dr. |  |
|  | Fund, Contingency Fund, etc. | General Reserve A/c | .Dr. |  |
|  | shown in liabilities side of | Reserve Fund A/c | .Dr. |  |
|  | balance sheet divided in old | Contingency Fund A/c .Dr. |  |  |
|  | partners in old profit loss ratio | To Old Partners Capital A/c |  |  |

(Being profit and loss A/c, Reserve, General Reserve,

|  |  |  |
| --- | --- | --- |
|  |  | Reserve Fund, Contingency Fund credited to old partners |
| (2) | Loss shown in assets side of | Capital accounts in the old profit sharing ratio) |
| Old Partners Capital A/c | .Dr. |
|  | balance sheet distributed | To Profit and Loss A/c |  |
|  | among old partners in profit | (Being old losses debited to old partners capital accounts |
|  | in loss ratio. | Old profit sharing ratio) |  |

**AMORTIZATION OF FICTITIOUS ASSETS**

Journal entry for Amortization of Fictitious Assets : (i.e. differed revenue exp. preliminary exp. etc.)

Fictitious Assets shown in assets side of

Balance sheet distributed among old Old Partners Capital A/c

partners In old profit loss ratio. To Fictitious Assets A/c

(Being writing off fictitious assets by debiting Old partners capital accounts in old profit Sharing ratio)

**RETIREMENT OF A PARTNER**

**Introduction** :

A legal partnership is a mutual contract between partners. Partnership can be established with by at least two persons any time, and it can be dissolved any time with the consent of all the partners. Any partner engaged in partnership business can retire from partnership business the anytime due to any reason. For this purpose he will have to give six months prior intimation to the firm about his retirement and can retire from the firm in accordance with the provisions of partnership Act. At the time of retirement, retiring partner receives his share of interest from the firm. The partner who retires from the firm is known as ‘Retiring Partner’ while other remaining partners in firm are known as ‘Continuing Partners’.

**MEANING AND REASON FOR RETIREMENT OF A PARTNER**

According to section 32 of Indian Partnership Act, 1932, a partner may retire from partnership

(a) with consent of all other partners (whether implied or expressed); or (b) in accordance with an express agreement by the partners; or (c) conveying his intention to retire (in case of partnership at will) by a written notice.

When a partner wants to leave the firm due to any of the following reasons then it is termed as retirement from partnership :

1. due to a disease or physical weakness.
2. Due to old age.
3. Due to dispute with any partner.
4. A desire to do some more profitable business or work.
5. Due to any other reason by which he doesn’t want to continue in partnership.

**CALCULATION OF TOTAL AMOUNT PAYABLE TO RETIREING PARTNER**

In order to determine the total amount due to retiring partner, his capital account is prepared on the date of his retirement. Retiring partner is entitled to get his share of interest out of the following items or following items are recorded in credit side at his capital account after writing the amount of his capital as per balance sheet:

1. His share in total goodwill of the firm at the date of retirement.
2. His share in undistributed profit, profit and loss account (credit balance), reserve, reserve fund, general reserve, etc. shown in liabilities side of balance sheet.
3. His share in profit in case of revaluation of assets and liabilities of the firm on the date of retirement as reflected by profit & loss Adjustment Account or Revaluation Account.
4. Any interest on his capital, salary, commission, remuneration, etc. either due or outstanding.
5. His share in estimated net profit from the last balance sheet date till the date of retirement.
6. His share in surrender value of Joint Life Insurance Policy.

Following items are recorded in the debit side of retiring partners capital account at

the time of retirement.

1. His share in profit and loss account as shown in assets side of balance sheet.
2. His share in loss in case of revaluation of firm’s assets and liabilities on the date of retirement as reflected by profit & loss Adjustment Account or Revaluation Account.
3. His drawings and interest on drawings.
4. His share in net estimated loss from last balance sheet date till the date of

retirement.

After writing all the above items in the capital account of the retiring partner on the date credit balance which is paid in full or in part in cash or in case of lack of cash the balance is transferred to his loan account.

|  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- |
| **Retiring Partners Capital Account** | **Cr.** |  |  |  | J.F Amount |  |
| Date Particulars | J.F. Amount | Date Particulars |  |  |  |
| To Profit and | Rs. | By Balance b/d |  | Rs. |  |
| Loss |  | Capital |  |
| a/c(Dr.) |  | By Profit and loss a/c |  |  |
| To Profit and loss |  | (Cr.) |  |  |  |  |
| Adjustment a/c or |  | By Undistributed profit |  |  |
| Revaluation a/c (Loss) | By Reserve |  |  |  |  |
| To Drawing a/c |  | By Reserve fund |  |  |  |
| To Interest on drawing | By General reserve | (if due) |  |
| a/c | (Balance | By | Profit | & | loss |  |
| To Retiring partners | - | adjustment a/c or | (Share in |  |
| Loan a/c | Ing | Revaluation a/c (Profit) | surrende |  |
| or | figure) | By | Interest | on | Capital | r value) |  |
| To Cash or Bank a/c |  | a/c |  |  |  |  |  |
|  |  | By Joint life policy a/c |  |  |

**ACCOUNTING TREATMENT/SETTLEMENT OF TOTAL AMOUNT PAYABLE TO RETIRING PARTNER**

The credit balance of retiring partner’s capital account is the total amount payable to retiring partner, whose liability for payment depends upon the firm. The total amount payable to the retiring partner can be paid by any of the following mode and its accounting will be done as under :

(A) Full payment to retiring partner :

1. Full payment in cash or from bank balance Retiring Partner’s Capital A/c Dr.

To Cash/Bank A/c

(Being full payment made to Retiring Partner)

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| 2. | Full payment by taking loan from bank |  |  |  |
|  | by the firm : | Bank A/c | Dr. |  |
|  | (a) | On taking loan from the bank |  |
|  |  |  | (Being loan taken from bank for payment |  |
|  |  |  | to Retiring partner) |  |  |
|  | (b) | Full payment to retiring partner | \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_ |  |
|  | Retiring Partner Capital A/c | Dr. |  |

To Cash/Bank A/c

(Being full payment made to Retiring Partner)

(B) Incase of inadequate cash balance or bank balance, full payment to retiring partner from available cash and bank balance and remaining amount brought by continuing partners in their

|  |  |  |  |
| --- | --- | --- | --- |
| profit sharing ratio or adjusted capital ratio : | Cash/Bank A/c | Dr. |  |
| 3 | (a) On bringing additional capital by |  |
|  | continuing partners | To Remaining Partners Capital A/cs |  |  |
|  | (Being additional amount brought in by remaining partners to make payment to retiring |  |
|  | partner) |  | Retiring Partners Capital A/c | Dr. |  |
|  | (b) On making full payment to retiring partner |  |
|  |  |  |  | To Cash/Bank A/c |  |  |
|  |  |  |  | (Being full payment made to |  |
|  | (c) |  |  | Retiring Partner) |  |  |
|  | Part payment to retiring partner : In case of inadequate cash and bank balance |  |
|  | retiring partner may be paid partially in cash and remaining amount is transferred to his |  |
| 4. | loan account. | Retiring Partner’s Capital A/c Dr. |  |  |
| On making part payment in cash and |  |  |
|  | transferred remaining amount to his |  | To Cash/Bank A/c |  |  |
|  | loan account |  | To Retiring Partner’s Loan A/c |  |  |
|  |  |  | (Being part payment made and balance |  |

 transferred to his loan account)

(D) Transferring the total amount payable to retiring partner to loan account : Sometimes, due to lack of cash, it may be possible that amount due to retiring partner may entirely be transferred to his loan account. The firm will provide interest on the amount of loan at a prescribed rate or @ 6% increase if no rate has been determined.

1. On transferring total amount payable Retiring Partner’s Capital A/c Dr.

|  |  |  |  |
| --- | --- | --- | --- |
|  | to his loan account | To Retiring Partner’s Loan A/c |  |
|  |  | (Being balance of capital account transferred to |  |
|  |  | his loan account) |  |  |
| 6. | Interest being due on loan | \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_ |  |
| Interest A/c | Dr. |  |
|  |  | To Retiring Partner’s Loan A/c |  |  |
|  |  | (Being interest due on retiring partners loan |  |
| 7. | Payment of above interest | account) | Dr. |  |
| Retiring Partner’s Loan A/c |  |
|  |  | To Cash/Bank A/c |  |  |
|  |  | (Being interest paid to retiring partner on dueamount) |  |

E) Payment in installments to retiring partner: After transferring the balance of retiring partner’s capital account to his loan account, if this balance is paid in installments with interest then interest is calculated on the opening balance and added to amount of installments; thereafter amount of installment is paid. Interest is calculated till the entire amount of loan is paid off. On payment of installments the due amount as well as amount of interest decreases. After payment of last installment retiring partner’s loan account is closed.

|  |  |  |  |
| --- | --- | --- | --- |
| 8.(a) | Interest being due on | Interest A/c | Dr. |
|  | outstanding amount payable | To Retiring Partner’s Capital A/c |  |
|  |  | (Being interest due on balance of |
| (b) | Payment of installment along with | Partner’s Loan a/c) | Dr. |
| Retiring Partner’s Capital A/c |
|  | Interest | To Cash/Bank A/c |
|  |  | (Being installment money including interest paid) |  |

**Note: The above two entries will be made up to the**

(F) Payment by annuity to retiring partner: In case of payment if due amount by annuity to

 retiring partner in limited number of years, then balance of retiring partners capital account is transferred to Annuity Suspense Account. Amount of interest is credited in this account from time to time and at the time of annual payment. Annuity account is debited while Cash/Bank

|  |  |  |  |
| --- | --- | --- | --- |
| account is credited. | Retiring Partner’s Capital A/c | Dr. |  |
| 9.(i) | Balance of capital account of retiring |  |
|  | partner transferred to Annuity Suspense | To Annuity Suspense A/c |  |  |
|  | Account | (Being balance of Retiring Partners |  |  |
|  |  | Capital A/c |  |  |
| (ii) | On interest being due | Transferred to Annuity Suspense A/c) | Dr. |  |
| Interest A/c |  |
|  |  | To Annuity Suspense A/c |  |  |
| (iii) | On payment | (Being interest due on balance amount) |  |
| Annuity Suspense A/c | Dr. |  |
|  |  | To Cash/Bank A/c |  |  |
|  |  | (Being payment made by Annuity) |  |  |

It is noteworthy that in case of death of retiring partner before full payment by annuity, the outstanding balance of annuity suspense account is considered as capital profit and it is distributed among the remaining partners in their profit loss sharing ratio. As against this, if retiring partner remains alive even after the entire payment of amount of Annuity Suspense Account even then he is paid the amount of annuity till he is alive (until he dies) and profit and loss account is debited by the amount of this payment.

**ACCOUNTING PROBLEMS AT THE TIME OF RETIREMENT OF A PARTNER**

At the time of retirement of a partner following accounting problems require adjustments:

1. Calculation of Goodwill.
2. Accounting of Goodwill.
3. Revaluation of assets and liabilities of the firm.
4. Transfer of reserve, undistributed profit and profit and loss account to capital a/c.
5. Writing off fictitious assets.
6. Adjustment of capital.
7. Adjustment of joint life insurance policy.
8. Payment in installments.

|  |  |  |
| --- | --- | --- |
| **Basis of ratio:****Difference** | **Sacrificing Ratio** | **Gaining Ratio** |
| 1. Meaning | Old partners sacrifice their share in favour of New partner. Ratio of such sacrifice is termed as‘Sacrificing Ratio’ | In case of death or retirement of a partner, there is an increase in share of profits of remaining partners. Such increase in profit sharing ratio is termed as Gaining Ratio.  |
| 2. Calculation | Sacrificing Ratio = Old Profit Loss ratio – New Profit loss ratio.  | Gaining Ratio = New profit loss ratio – Old profit loss ratio. |
| 3. Time of computation | Sacrificing ratio is computed at the time of admission of a partner. | Gaining ratio is computed at the time of death or retirement of any partner. |
| 4. Objective | Objective of calculating this ratio is to distribute the amount of goodwill brought in cash by the new partner among the old partners in their sacrificing ratio. | Objective of calculating this ratio is for make payment to the retiring partner his share of goodwill by the continuing partners. |
| 5. Adjustment of Goodwill | For adjustment of goodwill account of partners are credited | For adjustment of goodwill account of continuing partners is debited. |

**TREATMENT OF GOODWILL: APPLICATION OF ACCOUNTING STANDARD-10**

“According to Paragraph-16 of Accounting Standard-10, ‘In case of admission or retirement or death of a partner or in case of change in profit sharing ratio among partners, Goodwill Account cannot be raised in the books of firm because no consideration in money or moneys worth is paid for it. Goodwill can be recorded in the books only when some consideration in money or money worth has been paid for it. Therefore, only purchased Goodwill should be recorded in the books of account”.

Retiring partner gets his share in his profit and loss sharing ratio in internally generated inherent goodwill of the firm. According to Accounting Standard -10, goodwill will be shown in books of accounts only if cash is paid in consideration of goodwill. According to this Standard, goodwill will recorded in the books of accounts by the share of retiring partner through remaining partners capital accounts. In no case goodwill account can be raised.

**ADJUSTMENT OF JOINT LIFE**

**POLICY Meaning of Joint Life Policy**

Joint Life Policy means that life insurance policy which is taken by partnership firm on joint life of all the partners from Life Insurance Corporation. The sum insured on such policy is paid by the Life Insurance Corporation on the expiry of period of policy of term or on death of any partner, whichever is earlier. Accounting Treatment of Joint Life Policy At the time of retirement of partner, partnership firm inquires about the surrender value of Joint Life Policy from Life Insurance Corporation. Surrender value refers to that value which will be paid by Life Insurance Corporation on surrendering the policy to LIC before completion of term of policy or at the time of insured being alive. Thereafter, Partnership firm make entry for adjustment of surrender value at the time of retirement of any partner.

Before making any record of JLP in the books of accounts it is necessary to know whether the premium paid on JLP is revenue or trade expense or it is a capital expenditure.

**I Case I: When Premium paid is treated as Trading Expenses/Revenue Expenditure]**

What partnership firm treat premium paid on JLP as expenses like—Salaries, Rent, Electricity charges, etc. then it is recorded in debit side of profit & loss account, then there will be no Joint Life Policy appearing in Balance Sheet.

At the time of retirement of any partner, partnership firm inquires about the surrender value of Joint Life Policy from Life Insurance Corporation. Accounting of surrender value is done as follows at the time of retirement of a partner :

(a) When amount of surrender value is not received from Life Insurance Corporation and Joint Life Policy Account is open.

Opening Joint Life Policy Account with Joint Life Policy A/c (Surrender value) Dr. To All Partners' Capital A/c

(Profit sharing ratio)

(Being surrender value of Joint Life Policy credited to all partners' capital accounts in their profit sharing ratio on retirement of a partner)

Treatment in Balance Sheet: Now joint life policy account is prepared and its debit balance is

Shown in assets side of balance sheet. In such case, joint life policy account

When amount of surrender value is not received from Life Insurance Corporation remains opened.

and (b)

 (i) Opening Joint Life Policy Account with Joint Life Policy A/c (Surrender Value) Dr. surrender value

 To All Partners' Capital A/c

 (Profit Sharing Ratio)

 (Being surrender value of Joint Life

 Policy credited to all partners' capital

 accounts in their profit sharing ratio

 on retirement of a partner)

(ii) Closing of Joint Life Policy Account by Remaining partnership A/c Dr.

 To Joint Life Policy A/c

 (Surrender value)

 (Being surrender value of Joint Life Policy

written off by remaining partners in their new profit sharing ratio)

Treatment in Balance Sheet : In above condition Joint Life Policy Account is closed automatically. Therefore, it is not shown is Balance Sheet.

(c) When surrender value of Joint Life Policy is not to be shown and surrender value is to be entered through capital account of partners.

On entering surrender value of Joint Life Policy Gaining Partners' Capital A/c Dr. through Partners' Capital Accounts. (In gaining ratio)

To Retiring Partner's Capital A/c (With his share in Surrender Value) (Being retiring partner's share in surrender value \_payable gaining partners in their gaining ratio)

**Case II: When Premium paid is treated as Capital Expenditure (Asset)1**

In case of premium of Joint Life Policy being treated as a capital expenditure (asset) then Joint Life Policy appears in assets side of Balance Sheet at surrender value. In such condition, at the time of a partner it has to be decided that whether joint life policy appearing in Balance Sheet should be written off or continued as it is.

(a) When Joint Life Policy is kept in Balance Sheet : In such case, there is no entry made for adjustment of Joint Life Policy because the amount (surrenders value) of Joint Life Policy has already been credited to capital account of all the partners.

(b) When Joint Life Policy is not to be kept in Balance Sheet: Sometimes remaining partners may decide to close the JLP Account after retirement of a partner.

On closing Joint Life Policy Account by Remaining Partners' Capital A/cs Dr.

remaining partners (In new ratio)

 To Joint Life Policy A/c (Given in B/S) (Being

 existing Joint Life Policy in Balance Sheet written

 off by remaining partners in their new profit

 sharing ratio)

**DEATH OF A PARTNER**

**INTRODUCTION**

Man knows that death is inevitable but when he does not know. Any partner may die any time in partnership firm. After his death, partnership firm continues to operate business as per provisions laid down in partnership deed. In fact, death of a partner dissolves the partnership but it results in reconstitution of the partnership firm.

In case of death of partner, his executor is eligible to receive the amount due to deceased partner from partnership firm. It is already prescribed in partnership deed that how the amount due to deceased partner will be calculated and how it will be paid. In absence of partnership deed, section 37 of Indian Partnership Act, 1932 is applied.

Death of a partner from accounting point of view implies permanent retirement. Thus all entries, adjustment and accounting rules which are followed at the time of retirement are also applied in case of death of partner. It also included problems as to share of profit for the period between last balance sheet date and the date of death of partner along with share in joint life policy. These are discussed in detail in this chapter.

**CALCULATION OF TOTAL AMOUNT PAYABLE TO THE EXECUTORS OF THE DECEASED PARTNER**

 In case of death of a partner, amount due to executors is calculated and journal entries are made and books of account are maintained in the same manner as in case of retirement.

 In partnership firm, executors of deceased partner are authorized to receive payment of following items (these item are written in the credit side of the capital account of deceased partner):

1. Credit balance of capital and current accounts of deceased partner.
2. His share in total goodwill (calculated on the date of death).
3. His share in undistributed profit (retained earnings), profit & loss account, reserve, reserve found, general reserve etc. shown in liabilities side of balance sheet.
4. His share in profit on revaluation of assets and liabilities at the date of death.
5. If interest on capital, salary, commission, remuneration, etc. is outstanding or due to him.
6. His share in net estimated profit for the period between balance sheet date and date of death.
7. His share in joint life policy.
8. Loan given to partnership firm and interest due thereon.

**Following items are subtracted while calculating amount due to executors of deceased partners:**

1. Debit balance of capital or current account of deceased partner.
2. His share in undisturbed accumulated loss or profit-loss account shown in assets side of balance sheet.
3. His share in loss of revaluation of assets and liabilities at the date of death.
4. Drawings and interest on drawings on deceased partner.
5. His share in form’s net estimated loss for the period between last balance sheet date and date of death.
6. Loan given to deceased partner by firm and interest due thereon.
7. His share in goodwill to write off goodwill shown in assets side of balance sheet.

After recording all above items in debit/credit side of deceased partner’s capital account, balance is calculated. Generally this account has a credit balance. This credit balance is transferred to executor’s account. As per partnership deed either amount due is fully or partially paid to the executor or transferred to executor’s loan account.

**SETTLEMENT AND ACCOUNTING TREATMENT OF TOTAL AMOUNT PAYABLE**

**TO THE EXECUTORS OF DECEASED PARTNER**

 Credit balance of capital account of deceased partner is the amount due to executors of deceased partner. Partnership firm is responsible for the payment of this due amount. Partnership firm makes payment of this amount as per provisions of partnership deed.

 In absence of partnership deed, in case of incomplete payment to executor of deceased partner, according to section 37 of Indian Partnership Act, 1932, executor may opt for any of the two alternatives mentioned as follows:

1. Interest @ 6% p.a. since data of death upto date of last payment.
2. Share in profit earned by firm on the amount due.

Journal entries and mode of payment in case of death of a partners similar to the retirement of partner. (See chapter Partnership Accounts: Retirement of a Partner).

**SPECIAL ACCOUNTIGN PROBLEMS AFTER DEATH OF A PARTNER**

 Following accounting problems arise in case of death of a partner:

1. Accounting Treatment of Goodwill: The accounting treatment of Goodwill is done as per Accounting Standard-10. Goodwill appearing in balance sheet is written of by all the partners as per this standard. Therefore, goodwill is valued as per partnership deed o0r as mentioned in question. Share of deceased partner out of total goodwill of the firm is calculated as per his old profit-loss ratio. Remaining partners make payment of this amount in their gaining ratio. Old as well as new goodwill in not written in new balance sheet.
2. Calculation of Deceased Partner will take Profit: A agreement is generally made by the partner that retirement of the partner will take place on the last day of the financial year. This provision leads to convenience in calculation amount due to retiring partner and payment as well. But due to uncertainty of death, a partner may die anytime during the financial year. In such case net estimated profit is calculated for the net estimated profit is calculated. This net estimated profit of deceased partner is shown net assets side of balance sheet.
3. Share in Joint Life Policy: Partnership firm may take separate Life Insurance Policy for all partners or a joint life insurance policy on combined life of all the partners. Partnership firm make payment of premium on these policies. In case of death, sum insured in separate joint life insurance joint life insurance policy or in case of joint life insurance policy is made by Life Insurance Corporation. In both cases, deceased partner is given share as per rules out of the amount of the insurance policies.

**TREATMENT OF GOODWILL: APPLICATION OF ACCOUNTING STANDARD-10**

 Executor of deceased partner has right to receive a share out of total goodwill of the firm in the profit sharing ratio of deceased partner. In such case, goodwill of the firm is valued as per partnership agreement. Then a share of deceased partner is calculated in his profit-loss ratio out of total goodwill.

 Accounting of goodwill of deceased partner is done according to accounting standard-10: According to this standard, adjustment of deceased partner’s goodwill is done by continuing partners in their gaining ratio. For this following journal entry is passed:

 Continuing Partners Capital A/Cs …Dr.

 To Deceased Partners’ Capital A/c

 (Being deceased share of goodwill debited to continuing partners’ capital accounts in their gaining ratio)

 If goodwill already appears in Balance Sheet: If goodwill appears in the assets side of Balance Sheet then goodwill is to be written of against partner’s capital account in their profit & loss ratio.

Writing of Goodwill shown in Balance All Partners’ Capital A/cs …Dr.

Sheet by all the partners To Goodwill A/c

(Being existing goodwill in Balance Sheet written off by all partners in their profit sharing ratio)

 Presentation ion Balance Sheet:

1. Continuing partner pay share of goodwill to deceased partner without opening goodwill account. Therefore, there is no record of goodwill in new balance sheet.
2. As old goodwill appearing in balance sheet has also been written off, therefore, this goodwill is also not shown in new balance sheet.

**CALCULATION OF DECEASED PARTNER’S SHARE OF PROFIT**

 In case of death of partner in partnership business, executors have the right to receive share of profit for the period for which he was alive during the year. As per accounting principle, net profit should be determined by preparing trial balance at the date of death of partner and balance sheet should also be prepared. But from practical view of accounting it is not feasible and easier to prepare trial balance and balance sheet and it also does not have any legal significance as well. Therefore, there is specific disclosure of method of calculation of deceased partner’s share of profit in partnership agreement. Profit calculated by this specific method is estimated net profit. Following journal entry is passed for this:

 Profit and Loss Suspense Account ….Dr.

 To Deceased Partner’s Capital A/c

 Or

 To Deceased Partner’s Executor’s A/c

 (Being deceased partner’s share of profit to date of death credited to his capital/executor’s account)

 Presentation in Balance Sheet: Deceased partner’s share of profit (Profit & Loss Suspense A/c is shown in assets side of balance sheet. If Profit and Loss Account appears in liabilities side of balance sheet then it may be reduced by the amount of deceased partner’s share of profit.

Method of Calculating: Partnership deed generally contains one of the following three for calculating deceased partner’s share profit:

1. First Method: On the basis of average profit of last year’s: This method includes following steps for calculating deceased partner’s share:
2. Determine average profit of last few years as given.
3. Determine one month profit by diving average profit by 12.
4. Multiply this monthly profit with number of months for which deceased partner was alive. The product so obtained is net estimated profit of the said period.
5. Multiply this net estimated profit by share of deceased partner, the product so obtained is net estimated profit of deceased partner for the period when he was alive.
6. Second Method: On the basis of last-year’s profit: Under this method, calculation of deceased partner’s share of profit is done under:
7. Calculate monthly profit by dividing last year’s profit by 12.
8. Multiply this monthly profit by the period for which deceased partner was alive. The product obtained is net estimated profit of above period.
9. Multiply net estimated profit by share of deceased partner. Product obtained is net estimated profit of deceased partner for the period he was alive.
10. Third Method: On the basis of Sales: Following process is followed for calculation of deceased partner’s share of profit:
11. Calculated percentage of profit on total sales on the basis of net profit and total of previous year.

Percentage of Profit on Total Sales = 

1. Sales upto the date of death of partner in current year is generally given. Net profit on this total sales is calculated on the basis of percentage of profit on total sales. This is net estimated profit of partnership business till the death of partner.
2. Now share of deceased partner is multiplied to total net estimated profit and deceased partner’s share of profit is calculated.

**JOINT LIFE POLICY**

**Meaning of Joint Life Policy**

 A Life Policy means an insurance policy taken out by a partnership firm on the joint lives of all the partners. The sum insured on such a policy is payable by Life Insurance Corporation either on the death of any partner or on maturity of the policy, whichever is earlier.

**Need/Objectives for taking a Joint Life Policy**

 In case of sudden death of a partner, executor of deceased partner is eligible to receive capital of deceased partner, goodwill, profit till the date of death, reserve, undistributed profit, interest on capital and profit on revaluation of assets and liabilities etc. If partnership firm pays the amount in lump sum then its working capital will be adversely affected. It may even affect the functioning of partnership firm. A partnership firm obtains a joint life policy with the objective of receiving a sufficient amount in cash, if there is a sudden death of a partner. This money help in making payment of amount due to deceased partner and working capital is also not affected.

**Kinds of Joint Life Policy**

 Joint Life Policy may be of two kinds:

 (1) Individual Life Policy: When partnership firm obtains separate life insurance policy for each partner, it is termed as individual life policy. In this condition, separate insurance policy is taken on life of each partner and amount of premium is paid off.

 Calculation of deceased partner’s share: In case of individual life policy, if any partner dies then sum insured is paid by Life Insurance Corporation. Surrender value of continuing partners life policies are also determined. Now full amount of deceased partner’s policy and surrender value of other continuing partner are added and out of deceased partner’s policy and surrender partner as per profit-loss ratio is calculated.

 Journal Entries in case of Individual Life Policy: In case of obtaining individual life insurance policy for all the partners then at the time of death of partner following journal entries are made:

|  |  |
| --- | --- |
| 1. Sum insured for deceased

 Partner being due | Life Insurance Corporation A/c Dr. To Deceased Partner’s Life Policy A/c(Being amount due on death) |
| 1. Receiving sum insured from L.I.C
 | Bank A/c To Life Insurance Corporation A/c(Being amount of deceased partner’s life policy received) |
| 1. On distributing sum insured of deceased partner amongst all partners in profit & loss ratio
 | Deceased Partner’s Life Policy A/c Dr. To All Partners’ Capital A/cs (Being amount of deceased partner’s life policy transferred to all partner’s capital account in their profit sharing  |
| 1. Deceased partner’s share in surrender value of other life policies adjusted in remaining partner’s capital account in gaining ratio
 | Remaining Partner’s Capital A/cs Dr. To Deceased Partner’s Capital A/c(Being deceased share in the surrender value of other life policies adjusted in remaining partner’s capital account in gaining ratio)  |

 (2) Single/Joint Life Policy: When partnership firm obtains a single/joint life policy on the combined life of all the partners, it is known as single/joint life policy. Partnership firm makes payment of premium of joint life policy. In case of death of any partner during the period of policy, sum insured is paid out by Life Insurance Corporation.

 As payment of premium on joint life policy is paid by partnership firm. In such case partnership firm can adopt three different point of views as to payment of premium of joint life policy:

1. When premium on joint life policy is treated as trading expenses and profit and loss account is opened.
2. When Joint Life Premium is considered as an investment.
3. When premium on joint life policy is treated is as an asset and Joint Life Policy Reserve Account is opened.

Journal entries also vary accordingly in respect to these views:

**(A) When Life Insurance Premium is treated as Business Expenses**

 According to this method, premium on joint life policy is treated as trading/revenue business expenses. In this condition, partnership firm obtains a single/joint life policy then premium of policy is paid annually by the firm till the period of policy. Life Insurance Corporation makes payment of sum insured in case of maturity of policy or death of a partner and loss ratio.

Then amount of joint life policy is distributed among all partners in profit and loss ratio.

 Following journal entries are passed when life insurance premium is treated as trading expenses:

|  |  |
| --- | --- |
| 1. Payment of insurance premium annually

  | Joint Life Insurance Premium A/c Dr. To Bank A/c(Being life insurance premium paid on joint life policy) |
| 1. Transfer of life insurance premium to P & L A/c at year end
 | Profit and Loss A/c Dr. To Joint Life Insurance Premium A/c(Being amount of life insurance premium charged/transferred to Profit and Loss A/c) |

Above two entries are made for the payment of sum insured every year. At the time of payment of amount of joint life police following entries are made:

|  |  |
| --- | --- |
| 1. Sum insured on joint life policy being due (completion of term of policy or death of partner, whichever is earlier)
 | Life Insurance Corporation A/c Dr. To Joint Life Policy A/c (Being amount of joint life policy due)  |
| 1. Receipt of sum insured from L.I.C
 | Joint Life Policy A/c Dr.  To All Partners’ Capital A/cs(Being amount of joint life policy credit to all partners’ capital account in their profit sharing ratio) |

**Preparation of Accounts**

On the basis of above journal entries following accounts are prepared:

1. Joint Life Insurance Premium A/c is prepared and closed every year.
2. Life Insurance Corporation A/c and Joint Life Policy A/c are also closed.
3. Joint Life Insurance Premium Account is not shown in balance sheet because it is a revenue expenditure.

**(B) When Life Insurance Premium is treated as an Investment**

There is an element of investment in payment of premium on joint life policy premium for receiving economic protection and the amount of premium, term and sum insured are mentioned in the policy. Partnership firm receives the amount, on joint life policy in case of maturity of policy or death of partner, whichever is earlier and after it firm stops making payment of premium. Thus from this point of view premium paid on joint life policy can be treated as capital expenditure or investment for partnership firm. On treating premium on joint life policy as capital expenditure or investment following journal entries are made in firm’s books of account:

|  |  |
| --- | --- |
| 1. Payment of joint life premium ever year

  | Joint Life Policy A/c Dr. To Bank A/c(Being life Insurance premium paid on Joint Life Policy) |
| 1. Amount excess of surrender value written off to P & L A/c
 | Profit and Loss A/c Dr. To Joint Life Policy A/c(Being the amount in excess of surrender value written off to Profit and Loss A/c)  |
| 1. Amount of Join Life Policy being received
 | Bank A/c Dr. To Life Insurance Policy A/c (Being the amount of Joint Life Policy due)  |
| 1. Amount of Joint Life Policy received
 | Bank A/c Dr.  To Life Insurance Policy A/c (Being amount of Joint Life Policy received) |
| 1. Balance of Joint Life Policy A/c transferred to partner’s capital A/cs
 | Joint Life Policy A/c Dr.  To All Partners’ Capital A/cs(Being the balance of Joint Life Policy A/c transferred to all partners capital account in their profit sharing ratio) |

Presentation in Balance Sheet: Joint Life Policy Account is shown in assets side of Balance Sheet at its balance (surrender value of current year).

 At the death of partner joint life policy account is opened and profit is determined and this profit in distributed among all partners in their profit and loss ratio.

**(C) When Life Insurance Premium is treated as an Asset and Joint Life Policy Reserve Account is maintained.**

 This is modified form of the second method. Following journal entries are made in this regard:

|  |  |
| --- | --- |
| 1. On Payment of annual life insurance premium

  | Joint Life Policy A/c Dr. To Bank A/c(Being life Insurance premium paid on Joint Life Policy) |
| 1. Premium of Joint Life Policy transferred to P & L A/c
 | Profit and Loss Appropriation A/c Dr. To Joint Life Policy Reserve A/c(Being premium of Joint Life Policy transferred to Profit & Appropriation A/c)  |
| 1. Transferring balance of Joint Life Policy A/c to Joint Life Policy Reserve A/c at the end of the year
 | Joint Life Policy Reserve A/c Dr.  To Joint Life Policy A/c (Being the transfer of balance on excess of surrender value)  |
| 1. Sum insured on Joint Life Policy being due
 | Life Insurance Corporation A/c Dr.  To Joint Life Policy A/c (Being the amount of Joint Life Policy due) |
| 1. Receipt of sum insured on Joint life Policy from L.I.C.
 | Bank A/c Dr. To Life Insurance Corporation A/c (Being amount of Joint Life Policy received) |
| 1. Transfer of Joint Policy reserve account to joint life policy account
 | Joint Life Policy Reserve A/c Dr. To Joint Life Policy A/c (Being balance of Joint Life Policy Reserve A/c transferred to Joint Life Policy A/c  |
| 1. On distributing credit balance of Joint Life Policy account among all partners in their profit and loss ratio.
 | Joint Life Policy A/c Dr. To All Partners’ Capital A/cs(Being profit on Joint Life Policy transferred to all partners’ capital accounts in their profit sharing ratio) |

 Presentation in Balance Sheet: Joint Life Policy Account and Joint Life Policy Reserve

Account is opened every year. Balance of joint life policy account is shown in assets side of sheet.

Balance of these two accounts is always same.

 In case of death of a partner, balance of joint life policy reserve accounts is transferred to joint

life policy account. Then amount received from L.I.C. is written in credit side of joint life policy.

Now profit (balancing figure) of the account is transferred to all partners’ capital accounts in their

profit and loss sharing ratio.

**DISSOLUTION OF PARTNERSHIP FIRM WITH INSOLVENCY**

**Dissolution of firm –** The dissolution of partnership between all the partners of a firm is calledthe dissolution of the firm. In the case of dissolution of a firm, the business of the firms is closed down and its affairs are wound up. The assets are realized and the liabilities are paid off.

**Model of dissolution of firm –**

1. **Dissolution without the intervention of the court**
	1. Dissolution by agreement
	2. Compulsory dissolution
	3. Dissolution on the happening of certain contingencies.
	4. Dissolution by notice
2. **Dissolution by the court**
	* 1. Insanity
		2. Permanent incapacity
		3. Misconduct
		4. Breach of agreement
		5. Transfer of interest
		6. Loss in business
		7. Just and equitable

**Steps in the dissolution process –**

|  |  |
| --- | --- |
| Step 1 | Prepare a balance sheet of the firm as on the date of the dissolution of the firm. |
| Step 2 | Realize the non-cash assets which are not acceptable for distribution in their present form, |
|  | pay the debts of the firm to third parties. Realization account is prepared to calculate the |
|  | loss or profit on realization of assets and settlement of liabilities. Loss or profit on |
|  | realization of assets and settlement of liabilities is transferred to partners’ capital accounts. |
| Step 3 | Pay the amount due to each partner ratably for advances (or Loan) |
| Step 4 | Pay the available cash to the partners. |

**Accounting treatment on dissolution of firm –**

In case of dissolution of firm the following accounts are prepared to close the books of the firm –

* 1. Realisation Account
	2. Partners’ loan account
	3. Parnters’ capital account
	4. Cash or bank account

**1. Realization account –** This is a special type of account. It is a nominal account. The purposeof preparing this account is to find out the result of realization of assets and discharge of liabilities. The following steps involved in preparing this account.

**Step 1. For Transfer of all accounts given in the balance sheet**

1. **For transfer of assets –** All the assets except cash in hand, cash at bank, debitbalance of current accounts of partners and fictitious assets are transferred to debit of this account at book values as under –

Realisation A/c Dr.

To Various assets (individually)

(For transfer of various assets to realization a/c)

**For transfer of outside liabilities –** All the external liabilities including partnersloan are transferred to the credit of realization account at book value as under –

|  |  |
| --- | --- |
| Various Liabilities A/c | Dr. |
| To Realisation A/c |  |

(For transfer of various liabilities to realisation a/c)–

Note: Liabilities have got credit balance, so debiting to close them.

**a. For sale of assets**

 Cash / Bank A/c Dr.

 To Realisation A/c

 **b.** (For assets realised in cash)

 Partner's Capital A/c Dr.

 To Relisation A/c

**Step 3. Entry** (For assets taken over by a partner)

 a. For cash payment

 Realisation A/c Dr.

 To Cash / Bank A/c

(For payment of dissolution expenses)

b. For payment made by a partner

Realisation A/c Dr.

To Partner's Capital A/c

**Note :** (For dissolution expenses paid by a partner)

If any partner is to bear all expenses of realisation, no journal entry is required in the books of the firm but in this case if the partner is paid the realisation expenses, the following entry will be made:

Partner's Capital A/c Dr.

To Cash / Bank A/c

**Step 4. Entry** (For dissolution expenses paid on behalf of a partner.)

a. For cash payment

 Realisation A/c Dr.

 To Cash / Bank A/c Dr.

(For payment to outside liabilities)

b. For liabilities taken over by a partner

 Realisation A/c Dr.

To Partner's Capital A/c

 (For liabilities taken over by a partner)

**Step 5.**

a. In case of profit

 Realisation A/c Dr.

 To Partners' Capital A/c

(For profit on realisation transferred to partner's capital a/cs in their profit sharing ratio)

b. In case of loss

 Partners' capital A/cs Dr.

To Realisation A/c

 (For loss on realisation transferred to partners' capital a/cs in their profit sharing ratio)

**Note :**

(1) Intangible assets such as goodwill, patents, copyrights, prepaid expense are normally value less in case of dissolution. So if a question is silent it should be presumed that nothing could be realised

from such assets.

(2) If question is silent about the realisation of tangible assets it is presumed that their book values have been realised.

1. **Partner’s loan Account –** This are transferred to the credit side of realization account andthe payments there of are shown on debit side of realization account. Alternatively the payment can be credited directly to cash account.
2. **Partner’s capital accounts –** All the reserved and undivided profit or loss, realization profitor loss, balance of current accounts. Now the difference is adjusted in cash if there is credit balance it is surplus to be withdrawn by the concerned partner from their personal resources.

Entry for surplus withdrawn or deficiency brought in by the concerned partner from their personal resources. Entry for surplus withdrawn or deficiency brought in are as under –

a. Cash/Bank A/c Dr. To Partner’s capital A/c

(For deficit amount of capital brought in cash)

b. Partner’s Capital A/c To cash/Bank A/c

(For final payment made to a partners)

1. **Cash account –** At first opening balance is written. Then cash at bank is also transferred to this account. Amount realized from assets and deficiency brought in by partners is debited to this account and payment of liabilities, realization expenses and surplus withdrawn by partners are credited. Now both side of cash account will be equal. The agreement of both the sides of cash account is the cross checks of accounting and arithmetical accuracy.

**Formate of Accounts**

**Realisation A/c**

|  |  |  |  |
| --- | --- | --- | --- |
| **Particulars** | **Amount** | **Particulars** | **Amount** |
| To land and Building A/cTo Plant Machinery A/cTo furniture A/cTo investment A/cTo stock A/cTo Debtors a/cTo B/R A/cTo cash A/c (Payment of Liabilities)To Capital A/c (Liab. Taken by Partners)To Cash A/c (Realization Exps.)To Capital A/cs (Profit): |  | By Creditors a/cBy B/P A/cBy Bad Debts Reserve A/cBy Bank Loan A/cBy Bank Overdraft A/cBy Loan A/cBy Cash A/c (Assets Realised)By Capital A/c (Assets taken)By Capital A/cs (Loss): |  |
|  |  |
|  |  |

**Partner’s Capital A/cs**

|  |  |  |  |
| --- | --- | --- | --- |
| **Particulars** |  | **Particulars** |  |
| To Balance b/dTo Current A/cTo P & L A/c (Loss)To Realisation A/c (Assets taken)To Realisation A/c (Loss)To cash A/c (Surplus) (Bal. fig) |  | By Balance b/dBy current A/cBy P & L A/c (Profit)By General Reserve A/cBy Realisation (Liab. Taken)By Realisation A/c (Profit) |  |
|  |  |
|  |  |

**Insolvency of Partners**

At the time of dissolution of a partnership firm, the capital account of a partner may show a debit balance after his share of realisation loss or profit and accumulated profits or losses etc. have been transferred to his capital account. In such a case, the partner is a debtor of the firm to the extent of debit balance in his capital account and he has to bring in the necessary cash to make up the deficiency in his capital account. If the partner is unable to bring in the necessary cash, e.g. when he cannot pay in full the amount of debit balance in the capital account, he is said to be insolvent. The solvent partners have to bear the capital deficiency of the insolvent partner. There is no provision in the Indian Partnership Act., 1932 regarding this matter. Therefore, if there is a provision regarding this matter in the partnership deed it would be decisive. The partners may provide in partnership deed that loss due to insolvency of a partner will be shared by the solvent partners in their profit sharing ratio or any other ratio. But the problem arises when there is no provision in the partnership deed regarding this matter.

**Decision in Garner V/s Murray**

In this case Garner, Murray and Wilkins were equal partners in England. Their capitals were unequal. The Balance Sheet of the firm after satisfying all the liabilities were as follows:

**Balance Sheet**

|  |  |  |  |
| --- | --- | --- | --- |
| **Liabilities** | **£** | **Asset** | **£** |
| Capital Accounts:GarnerMurray | 2,500314 | CashWilkins— OverdrawnDeficiency (Realisation loss) | 1,916263635 |
| 2,814 | 2,814 |
|  |  |

Wilkins was insolvent and unable to pay anything. Thus the assets of the firm were not sufficient to repay the capitals in full. There was a dispute between the solvent partners regarding the method of sharing of loss due to insolvency of Wilkings. Justice Joyce held in 1904 as follows:

"The solvent partners are only liable to make good their share of the deficiency, and that the remaining assets should be divided among them in proportion to their capitals,"

In other words, the learned judge held as follows:

1. The solvent partners should bring in cash their share of the realisation loss.
2. The loss due to insolvency of a partner should be borne by the solvent partners in proportion to their last agreed capitals.

It should noted that a partner having a debit balance or nil balance, will not have to bear the loss due to insolvency of a partner.

The decision in the above case has taken into consideration only the book capital of the partners. It ignores the private estate of the solvent partners.

**Meaning of last agreed capitals**

In case of fixed capital method, the expression, "Last Agreed Capitals" means the fixed capital.

In case of fluctuating capital method, it means the capitals after malting adjustment for accumulated profits and losses, drawings, interest on capital, salary to a partner etc. to the date of dissolution but before transferring realisation loss or profit.

**Applicability of Garner V/s Murray to India**

It is reasonable to assume that Garner v. Murray case will also apply to India as S. 48 of the Indian Partnership Act., 1932 is almost identical with S.44 of the English Partnership Act and there has been no case law which has examined the question of sharing of loss due to the insolvency of a partner. However, some Accountants contend that the above decision is not inconformity with S.48

(a) of the Indian Partnership Act., 1932. The students, in an examination problem, should indicate whether or not the ruling in Garner v. Murray has been applied.

**Piecemeal distribution of cash**

It has been presumed so far that all the assets are realised on the date of dissolution and all the liabilities are also simultaneously discharged on the same day itself. But usually this is not true in practice. In actual practice, assets are realised gradually and liabilities are paid gradually depending upon the amount realised from the sale of assets. Therefore, the realsiation loss or profit can be ascertained only after the realisation of all assets and payment of all liabilities.

Available cash is used in the following order:

1. Payment of realisation expenses or a provision is made for realisation expenses.
2. Payment of outside liabilities i.e., bank loan, sundry creditors, bills payable, outstanding expenses etc. It must be noted here that a secured creditor has priority whenever an asset provided by way of security to the concerned creditor is realised. After satisfying the claim of the secured creditor the surplus, if any, is paid to unsecured creditors. Amount realised from an asset which is not charged or mortgaged is used to pay all the creditors, whether secured or unsecured in the ratio of their claims.
3. Payment of partners' loan in the ratio of their respective loans.
4. Payment of partners capitals.

If there is any contingent liability an account of bills discounted, a provision should be made in the beginning for the same and when provision is no longer required, the amount should be distributed.

**Basis of distribution of cash among partners**

The following are the two basis of distribution of cash among partners:

1. Proportionate or surplus capital method
2. Maximum loss method

**Proportionate or surplus capital method**

Under this method, the partners who have contributed more capital than his proportionate share are paid off first. In other words, the partners who have surplus capital are given the payment first. The following procedure should be adopted for calculation of surplus:

**Step 1** Calculate adjusted capitals of all the partner after making adjustment for accumulated profits and losses and transfer of balances of current accounts etc.

**Step 2** Divide the adjusted capitals of all partners by their respective profit sharing ratio and treat the smallest quotient as base capital.

**Step 3** Calculate proportionate capitals by multiplying base capital and profit shaft ratio.

**Step 4** Calculate surplus capitals by subtracting proportionate capital (step 3)from adjusted capital (Step 1)

**Step 5** If there is only one partner having surplus capital make payment to that partner first to the extent of surplus capital. If there are two or more partner having surplus capitals and surplus capitals are in profit sharing ratio, distribute cash among such partners to the extent of surplus capitals in the profit sharing ratio. If there are two or more partners having surplus capitals and the surplus capitals are not in profit sharing ratio, go to the next step.

**Step 6** Divide surplus capital of the concerned partners (Step 4) by their profit sharing ratio andtreat the smallest quotient as revised base capital.

**Step 7** Calculate the proportionate surplus by multiplying the revised base capital (Step 6).

**Step 8** Calculate the excess surplus capital by subtracting revised proportionate surplus (Step 7) from surplus capital (Step 4)

**Step 9** See step 5 and repeat the process until there is only one partner having excess surplus.

The partner or partners having excess surplus are paid off first to the extent of excess surplus and after that payment is made to the partners having surplus capitals to the extent of surplus capitals and lastly payment is made to all the partners in the profit sharing ratio.

**Maximum Loss Method**

Under this method, it is assumed that every installment realised is a final realisation, i.e., the remaining assets will realise nothing. The following procedure is adopted for distribution of cash among the partners after the payment has been made for outside liabilities and partners’ loan :

**Step 1.** Calculate the adjusted capitals of the partners after making adjustments for accumulatedprofits and losses, transfer of balance of current accounts etc.

**Step 2.** Calculate the maximum possible loss assuming that the remaining assets are worthless.Maximum possible loss is calculated by subtracting cash available from the total of the balances of adjusted capital accounts.

**Step 3.** Distribute the maximum possible loss among the partners in their profit sharing ratio.

**Step 4.** Calculate the balances of capital accounts of partners after distribution of maximum possible loss.

**Step 5.** If the balances of capital accounts of all the partners (Step 4) show positive balances, distribute the available cash among the partners equal to their respective balances of capital accounts (Step 4). On the other hand, if balance of capital account of any partner (Step 4) shows a negative balance, transfer the negative balance of that partner to the capital accounts of other partners having positive balances in the ratio of capitals just before dissolution assuming the partner having negative balance as insolvent. If the capitals are fixed the negative balance should be transferred in the fixed capital ratio and in case of fluctuating capitals after adjusting for accumulated profits and losses. This process is repeated till the negative balance is completely transferred. Distribute the available cash to the partners whose capital balances after transfer of negative balance, show positive balances and the amount paid will be equal to their respective balances of capital accounts.

**Step 6.** Calculate the balances due after subtracting the amount paid (Step 5) from the adjustedcapitals (Step 2)

**Step 7.** Calculate the maximum possible loss at the time of next realisation. Maximum possible loss at this stage will be calculated by subtracting the available cash at this stage from the balances due (Step 6)

**Step 8.** Go to Step 5.

**Step 9.** Calculate the balance due at this stage after subtracting the amount paid (Step 8) from the balances due (Step 6) and repeat the process till the final realisation.

This method is suitable when a partner is inslvent or is likely to be insolvent.